Close Corporations-Rights and Duties of Shareholders-Fiduciary Relationship Among Shareholders-Shareholders’ Right of Equal Opportunity to Participate in Corporate Purchase of Its Own Stock for Corporate Treasury

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RECENT DEVELOPMENTS

Close Corporations—Rights and Duties of Shareholders—Fiduciary Relationship Among Shareholders—Shareholders' Right of Equal Opportunity To Participate in Corporate Purchase of Its Own Stock for Corporate Treasury


The term "close corporation" generally connotes a business association in the corporate form, with a small number of shareholders who actively participate in the management of the business, and whose shares are not publicly traded. Close corporations usually attempt to attain certain corporate advantages, such as limited liability and perpetual existence, while preserving the internal attributes of an individual proprietorship or partnership. The shareholders typically double as officers and directors, equating ownership with management and control. Procedural formalities in the operation of the business are usually held to a minimum, and transactions are often completed without rigid compliance with applicable corporate statutes. Although a large percentage of American business enter-

1 H. Henn, Handbook of the Law of Corporations § 257 (2d ed. 1970) [hereinafter cited as Henn]. The exigencies of a business organization with this type of dual identity have caused statutory and judicial recognition of the distinctive nature of close corporations. See note 6 and accompanying text infra.

2 Corporate shareholders do not ordinarily manage the business affairs of the corporation they own. The close corporation concept, however, reflects a desire to own and control a business, and to the extent that shareholders also function as directors or officers, there is a coincidence of ownership and management control. "[I]n close corporations, management and ownership are substantially identical, while in public issue corporations the contrary is true." Fleming, Desirability of Enacting Separate Statutes for Closely Held and Public Issue Corporations, 1957 N.Y. Leg. Doc. No. 17, at 115 (1957). See also Helms v. Duckworth, 249 F.2d 482, 484-85 (D.C. Cir. 1957) (equating of ownership and control as a distinctive close corporation characteristic); Kruger v. Gerth, 16 N.Y.2d 802, 263 N.Y.S.2d 1 (1965).

3 Henn § 273.


Close corporations are often given special treatment in dissolution proceedings. See notes 40 & 93 and accompanying text infra.

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prises are closely held,\(^5\) statutory recognition of their separate legal status is far from commensurate with their numerical importance.\(^6\)

In recent years, however, there has been a marked trend toward awarding distinct legal status to close corporations.\(^7\) Reform in this area has nevertheless been slow. Development of close corporation law has often resulted from distinction, exception carving, and doctrinal innovation by the courts. The Supreme Judicial Court of Massachusetts recently utilized the last approach in *Donahue v. Rodd Electrotype Co. of New England, Inc.*\(^8\) Lacking comprehensive statutory

\(^5\) Henn § 257. Professor Henn bases this conclusion on data relating to the size of American businesses as determined by their assets, number of employees, and tax status as small business corporations, as indicative of "closeness." See also Bureau of Census, Statistical Abstract of the United States 490-91 (1975); F. O'Neal, Close Corporations § 1.02 (1971).

\(^6\) Close corporations are usually forced to comply with their state's general corporate statutes. See W. Cary, Cases and Materials on Corporations 15 (4th ed. 1969). This requirement can obviously lead to harsh results, and has induced judicial tolerance of slight deviations from corporate norms in the close corporation context. For examples of such tolerance, see cases cited in note 4 supra.

Although the essence of a close corporation venture is often an attempt to tailor the corporate form to the particular needs of a small business, it has been pointed out that state corporation laws... are designed primarily for an enterprise characterized by a separation of ownership and management, a large number of shareholders, and free transferability of shares... Thus, the owners of a close corporation will often be unable to arrange corporate affairs in the manner they consider most satisfactory.


New York has certain provisions in its corporate statute not textually addressed to close corporations, but which are utilized primarily by close corporations, and perhaps drafted with reference to them. See, e.g., N.Y. Bus. Corp. Law § 616 (McKinney 1963 & Supp. 1975) (allowing certificate of incorporation to provide for greater than normal quorum requirements); id. § 702 (allowing corporations with less than three shareholders to have less than the statutory number of directors).

For a discussion of the definitional criteria used in these statutes for classifying a corporation as a close corporation, see notes 56-62 and accompanying text infra.

\(^7\) "There has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as sui generis." Galler v. Galler, 32 Ill. 2d 16, 28, 203 N.E.2d 577, 584 (1965). See also Kruger v. Gerth, 16 N.Y.2d 802, 806, 263 N.Y.S.2d 1, 4 (1965) (Fuld, J., dissenting). See generally Note, supra note 6.

\(^8\) Mass. --, 328 N.E.2d 505 (1975).
treatment of the close corporation, the court faced a ripe and inviting opportunity for innovation and change.

I

**Factual Setting of Donahue**

*Donahue* involved a purchase by Rodd Electrotype Co. of New England, Inc., ("Rodd Electrotype") of its own shares from Harry Rodd, a former director, officer, and controlling shareholder of the corporation. Wishing to retire from the business due to age, Rodd suggested a repurchase agreement to his son, who was president and general manager of the corporation. A subsequent resolution of the board of directors authorized Rodd Electrotype to purchase forty-five shares from Rodd. The agreed price was $800 per share; the corporation was to hold the stock as treasury stock.

Approximately one year after the negotiation of the repurchase agreement, a special shareholders' meeting was held at which the transaction was officially disclosed. Mrs. Donahue, a minority shareholder, voted against a resolution ultimately adopted by the other shareholders ratifying the stock repurchase from Rodd. In protest, Mrs. Donahue offered her shares for sale to the corporation on the

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9 At the time of this transaction it was well-settled in Massachusetts that a corporation could purchase its own stock unless forbidden by statute, and such agreements were enforceable subject to the limitation that the purchase be in good faith and without prejudice to creditors and shareholders. See *Winchell v. Plywood Corp.*, 324 Mass. 171, 85 N.E.2d 454 (1949); *Scriggins v. Thomas Dalby Co.*, 290 Mass. 414, 195 N.E. 749 (1935); *Dupee v. Boston Water Power Co.*, 114 Mass. 37 (1873); accord, *In re Estate of Brown*, 130 Ill. App. 2d 514, 264 N.E.2d 287 (1970). See generally *Note, Stock Repurchase Abuses and the No Prejudice Rule*, 59 *Yale L.J.* 1177 (1950). The *Donahue* court, however, employed a new test, different from and stricter than the "good faith and fairness to shareholders and creditors" standard, to evaluate the transaction involved. See notes 63-95 and accompanying text *infra*.


10 The term "repurchase" is used to refer to a purchase by a corporation of its own shares from its shareholders.

11 This quantity represented slightly more than one-half of Rodd's interest in Rodd Electrotype at the time. During the following year, Rodd distributed his remaining shares to his children, two of whom were directors of Rodd Electrotype, in a series of gift transactions. At the time of the repurchase agreement in question, Rodd was not technically a majority shareholder, but the court treated him as a member of a controlling group of shareholders for the purpose of its decision. See text accompanying note 117 *infra*.

same terms as those given to Rodd, but the corporation refused to consummate a deal, and the suit in the principal case ensued.

The plaintiff, Mrs. Donahue, alleged that the stock repurchase by Rodd Electrotype was a violation of fiduciary duties owed to her by the defendants in their respective capacities as controlling shareholders, officers, and directors.\(^{13}\) She thus sought to have the purchase rescinded on the basis of its infringement on her personal rights as a minority shareholder.\(^{14}\) More specifically, she urged that the controlling shareholders had a duty to cause the corporation to offer her, as a minority shareholder, an equal opportunity to sell her shares to the corporation. The Rodd family, as defendants, denied that a right to equal opportunity existed in corporate stock purchases for the corporate treasury. The trial court agreed with the Rodds and found that the transaction had been carried out in good faith and with inherent fairness.\(^{15}\) The plaintiff's suit was dismissed,

\(^{13}\) The named defendants were Harry Rodd, the three directors of Rodd Electrotype (two of Harry Rodd's children and a third party), and Rodd Electrotype. Although the plaintiff claimed to be representing the other Rodd Electrotype shareholders with the corporation as a nominal defendant, the court did not treat the suit as a derivative action, but rather as a direct vindication of personal rights. \(-\text{Mass. at-}, 328\text{ N.E.2d at 508 n.4}\): \text{See note 14 infra.}\n
\(^{14}\) Mrs. Donahue had originally alleged other breaches of fiduciary duties by the controlling shareholders and directors, including misappropriation of corporate funds for the benefit of the Rodd family. She requested injunctive relief and restitution of misappropriated funds in her complaint. At trial, however, her counsel stipulated that the only transaction challenged was Rodd Electrotype's purchase of Harry Rodd's stock. \(-\text{Mass. at-}, 328\text{ N.E.2d at 508 n.2.}\) Preferring substance over form, the court reasoned that a proper suit had been brought to vindicate a personal right of the plaintiff, based on the alleged breaches of fiduciary duties owed to her, a minority stockholder, by the controlling stockholders. \text{Id.}\n
A shareholder has the right to seek redress from another shareholder to vindicate a personal, as distinguished from a corporate, right. Mairs v. Madden, 307 Mass. 378, 30 N.E.2d 242 (1940). Usually, corporate rights can be enforced by shareholders only through a derivative action, whereas personal rights of the stockholders may be enforced by a direct personal action. Courts will look to the allegations of a complaint to determine whether a suit is direct or derivative in nature, but if the allegations are merely a subterfuge to disguise corporate harm as shareholder injury, a direct action will not be allowed. \text{See Reifsnyder v. Pittsburgh Outdoor Advertising Co., 406 Pa. 142, 173 A.2d 319 (1961).}\) In Rose v. Schantz, 56 Wis. 2d 222, 201 N.W.2d 593 (1972), the court employed a primary-injury test, and noted that although any injury to a corporation may incidentally harm the shareholder by depressing the value of his shares, such injury is not sufficient to maintain a personal suit by the shareholder. "Where the injury to the corporation is the primary injury, and any injury to stockholders secondary, it is the derivative action alone that can be brought and maintained." \text{Id. at 229, 201 N.W.2d at 598.}\) Where some individual right of a stockholder is being impaired by the improper acts of a director, however, the stockholder may bring a direct suit on his own behalf because it is his individual right that is being violated. \text{Id. at 228-29, 201 N.W.2d at 597.}\) Breach of a fiduciary duty imposed on a director or shareholder vis-à-vis another shareholder would be a personal wrong sufficient to maintain a direct action against the wrongdoer. \text{See Pepper v. Litton, 308 U.S. 295, 307 n.15 (1939); Cole Real Estate Corp. v. Peoples Bank & Trust Co., \text{-Ind.-, 310 N.E.2d 275, 278-79 (1974); Gieselman v. Stegeman, 443 S.W.2d 127, 131 (Mo. 1969); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 196, 123 N.E. 148, 152 (1919).}\n
\(^{15}\) \text{-Mass. at-}, 328 N.E.2d at 508.
and the appeals court of Massachusetts for Middlesex County affirmed.16

The Supreme Judicial Court of Massachusetts reversed the lower courts, formulated a new definition of close corporations, and determined that Rodd Electrotype met the criteria.17 By drawing analogies to partnerships and other business enterprises, the court emphasized the need for trust and loyalty in a close corporation, and expanded the fiduciary duties applicable to close corporation shareholders.18 Noting that shareholders in close corporations face a restricted market for their holdings19 and that the remedy of voluntary dissolution was available primarily to majority interests,20 the court held that the dissident minority shareholder was entitled to protection. A strict standard of “utmost good faith and loyalty”21 was imposed by the court on all close corporation shareholders, applicable to all actions affecting the “rights and investments of other stockholders.”22 Applying this new standard of fiduciary duty to close corporation stock repurchases, the court held that:

To meet this test, if the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer to each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price.23

The court determined that the Rodd family had a sufficient community of interest to make them a controlling group of shareholders,24 and since an equal opportunity to sell had not been offered to the plaintiff, the court granted relief.25

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17 See notes 46-55 and accompanying text infra.
18 See notes 63-91 and accompanying text infra.
19 See notes 86-90 and accompanying text infra.
20 See notes 92-94 and accompanying text infra.
21 —Mass. at —, 328 N.E.2d at 515.
22 Id. at —, 328 N.E.2d at 515 n.18.
23 Id. at —, 328 N.E.2d at 518.
24 Id. at —, 328 N.E.2d at 519.
25 The case was remanded with directions to enter either of two alternative judgments: (1) requiring Rodd to tender the purchase price back to the corporation in return for his shares, or (2) requiring Rodd Electrotype to purchase all of Mrs. Donahue's stock at $800 per share, plus interest from the date of the original transaction. Id. at 521. The court's computation of the pro rata amount to be purchased from Mrs. Donahue under the second alternative judgment is slightly confusing. Although Rodd sold only half of his shares to the corporation, then later gave away the remaining shares to his children, Chief Justice Tauro both ignored the time sequence and, in effect, pierced the corporate veil, and reasoned that by virtue of the repurchase agreement, the corporation "acquired one hundred per cent of that portion of his holdings (forty five shares) which he did not intend his children to own. [Therefore],
This Note will discuss the impact of requiring equal opportunity for all shareholders in close corporation stock repurchases by analyzing the following four areas: (1) the Supreme Judicial Court’s definition of close corporations; (2) the new standard of fiduciary duty imposed on close corporation shareholders; (3) the equal-opportunity doctrine derived from that duty; and (4) the implications of Donahue with respect to other corporate enterprises and transactions.

II

DEFINING THE CLOSE CORPORATION

A. Origin of the Enterprise

Courts and commentators have employed a variety of terms to refer to what Chief Justice Tauro called "the close corporation" in Donahue: "closed corporation," "closely held corporation," "one-man corporation," "family corporation," "incorporated partnership," and "chartered partnership." These expressions have all been used to describe the same type of organization—a business corporation owned by a small number of people unwilling to trade their shares freely with the public, and wishing to carefully control the business they own.

A close corporation usually originates as a small business that recognizes the risks inherent in a partnership or a sole proprietorship—the personal liability of the owner. By incorporating, the owners of such a business can utilize the advantages of the corporate form such as limited liability and perpetual existence.

[The plaintiff is entitled to have one hundred per cent of her forty five shares similarly purchased.] Id.

26 Id. at —, 328 N.E.2d at ’511.
27 F. O’Neal, supra note 5, § 1.04.
28 Id. O’Neal draws a distinction between the close corporation and the closely-held corporation. “Close” implies shareholder intent or agreement to keep outsiders from acquiring any interest in the corporation, while “closely-held” implies a small number of shareholders.
29 Henn § 258.
30 Id.
31 Id.
32 Id. The chartered partnership was at one time a statutorily distinct entity. See Ripin v. United States Woven Label Co., 205 N.Y. 442, 447, 98 N.E. 855, 856 (1912). In Hill v. Bellevue Gardens, Inc., 190 F. Supp. 760 (D.D.C. 1960), aff’d, 297 F.2d 185 (D.C. Cir. 1961), the court pierced the corporate veil because of oppression and bad faith on the part of majority shareholders, and referred to the “pierced” corporation as a “chartered partnership.” 190 F. Supp. at 769.
33 W. Cary, supra note 6, at 20.
34 As soon as states began to allow incorporation for any lawful business purpose, many
The formalities of corporate organization and management, however, are often ill-suited to the needs of businesses that originated with a limited scope of ownership and control. Though adopting the corporate form, most close corporations desire to preserve the internal structure of a sole proprietorship or partnership. The American legal system is aware of this desire, and has often taken steps to facilitate it. To preserve the principle of delectus personae, reasonable restraints imposed on the transfer of shares in close corporations are usually upheld. Close corporation shareholder agreements allocating management functions traditionally vested in the board of directors are granted both statutory and judicial tolerance. Even the extreme remedy of dissolution is more readily applied to a close corporation than to a public-issue corporation, if circumstances such as deadlock or oppression exist.

35 "In America today there is developing some recognition that a closely held concern may in fact function upon an entirely different basis than a public corporation. Its success may depend upon the cooperative efforts and mutual confidence of its shareholder owners." W. Cary, supra note 6, at 362-63.

36 See also Henn § 257.


38 Henn § 281. A restriction agreement in the by-laws or among shareholders usually takes the form of an option, giving the corporation or certain shareholders a first right of refusal on any shares offered for sale. The option to buy can often be drafted to vest on the death or other incapacitation of a shareholder. —Mass. at —, 328 N.E.2d at 512 n.13. In Massachusetts, such restrictions are valid and binding on the corporation and its shareholders. Samia v. Central Oil Co., 339 Mass. 101, 158 N.E.2d 469 (1959); Albert E. Touchet, Inc. v. Touchet, 264 Mass. 499, 163 N.E. 184 (1928). These restrictions are important in keeping a close corporation "close," and in addition may also be crucial in maintaining SEC exemptions and Subchapter S status. See notes 42, 50 and accompanying text infra.

39 See Hornstein, Shareholder Agreements in the Closely Held Corporation, 59 Yale L.J. 1040 (1950); note 6 and accompanying text supra.

For a well-reasoned point of view on shareholder agreements in close corporations, see Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965), where the court said:

Several shareholder-director agreements that have technically "violated" the letter of the Business Corporation Act have nevertheless been upheld in the light of the existing circumstances.

... Where... no injury to a minority interest appears, no fraud or apparent injury to the public or creditors is present, and no clearly prohibitory statutory language is violated, we can see no valid reason for precluding the parties from reaching any arrangements concerning the management of the corporation which are agreeable to all.

Id. at 28, 30, 203 N.E.2d at 585.

40 See generally Note, Dissolution of The Close Corporation, 41 St. John's L. Rev. 239 (1966). In In re Pivot Punch & Die Corp., 15 Misc. 2d 713, 182 N.Y.S.2d 459 (Sup. Ct. 1959), the court treated the close corporation as a partnership clothed with benefits peculiar to a corporation,
By employing a combination of these devices, a close corporation can achieve informality of organization and operation, flexibility of financing and distribution of profits, participation by shareholders in management, and ease of dissolution. Prohibitive taxation can also be avoided by the close corporation in certain instances. However, close corporations have an inherent tax disadvantage and decided that when the requisite trust, loyalty, and confidence of this quasi-partnership ceased to exist, the corporation was no longer beneficial to its deadlocked shareholders and would be dissolved. Id. at 716, 182 N.Y.S.2d at 463. This case has been praised as standing for the proposition that a lack of faith and trust, which produces a deadlocked close corporation, may be the basis for finding that dissolution is beneficial to the shareholders of even a profitable corporation. In re Surchin, 55 Misc. 2d 888, 286 N.Y.S.2d 580 (1967). A public-issue corporation, on the other hand, would have to comply strictly with the applicable corporate statutes to obtain dissolution. See also notes 93-94 and accompanying text infra.

A close corporation will not always, however, provide the desired protection of the business enterprise. Just as some courts overlook minor deviations from corporate norms in the close corporation context, other courts go more readily to the heart of the enterprise and treat the shareholders as partners, especially where outsiders are involved. "[G]rounds for disregarding corporateness or regarding the corporation as an instrumentality of the shareholders, thereby subjecting the shareholders to personal liability, arise more frequently in close corporations than in others." HENN § 261. See In re Ostwald's Estate, 20 Misc. 2d 1001, 1006, 189 N.Y.S.2d 472, 479 (1959), holding:

Since the question is not between the corporation and an outsider, this Court in an application of its equitable jurisdiction disregards the corporate form, deals with the relationship as one not wholly impersonal and treats the parties as co-partners. See also Hill v. Bellevue Gardens, Inc. 190 F. Supp. 760 (D.D.C. 1960), where the court stated that it would pierce the corporate veil and regard close corporations as associations of persons to the extent necessary to grant appropriate relief following a wrongful use of the corporate form.

The New York courts have also developed a line of cases that limit the dual-identity recognition for joint ventures under the corporate form. In Weisman v. Awnair Corp. 3 N.Y.2d 444, 165 N.Y.S.2d 745 (1957), the court said:

"T"he rule is well settled that a joint venture may not be carried on by individuals through the corporate form . . . . The two forms of business are mutually exclusive, each governed by a separate body of law. When parties "adopt the corporate form, with the corporate shield extended over them to protect them against personal liability, they cease to be partners and have only the rights, duties, and obligations of shareholders. They cannot be partners inter sese and a corporation as to the rest of the world". Id. at 449, 165 N.Y.S.2d at 749-50, quoting Jackson v. Hooper, 76 N.J. Eq. 592, 598-99, 75 A. 558, 571 (1910). The court refused to extend fiduciary relationships between the co-owners of this incorporated joint venture:

[When individuals do determine to conduct business through a corporation, as is here alleged, they are not at one and the same time joint venturers and stockholders, fiduciaries and non-fiduciaries, personally liable and not personally liable. Id. at 449, 165 N.Y.S.2d at 749-50. Macklem v. Marine Park Homes, Inc., 17 Misc.2d 439, 191 N.Y.S.2d 374 (1955), aff'd mem., 8 A.D.2d 824, 191 N.Y.S.2d 545 (2d Dep't 1959), aff'd without opinion, 8 N.Y.2d 1076, 207 N.Y.S.2d 451, 170 N.E.2d 455 (1960) appears to retreat from this strict non-recognition of the dual nature of incorporated joint ventures. For a critical discussion of the New York case law on joint ventures under the corporate form, see Conway, New York Fiduciary Concept in Incorporated Partnerships and Joint Ventures, 30 FORDHAM L. REV. 297 (1961).
vantage because they may face more frequent application of the accumulated earnings tax than their publicly-owned counterparts. The end result of these features is a corporation recognized by courts and statutes as exemplifying corporate externalities while utilizing noncorporate internalities. It has been recommended that close corporation statutory reform reflect this recognition.

B. The Donahue Definition

Because Massachusetts had no corporate statutes specifically directed at close corporations, any judge-made law regulating close corporations required a definitional starting point to determine threshold coverage of an equal-opportunity holding and to place a limitation on its applicability. The court in Donahue deemed a close corporation to be typified by: (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority stockholder participation in the management, direction and operations of the corporation. These three criteria are used with varying degrees of emphasis in other definitions of close corporations.

Although a close corporation is usually a small business, size
corporation, and again as income to shareholders in the form of dividend distributions. Int. Rev. Code of 1954, § 61(a). Subchapter S of the Internal Revenue Code of 1954 allows qualifying small business corporations to elect to have their earnings taxed as personal income to the shareholders, and not at the corporate level, thus avoiding double taxation of corporate profits. A small business corporation as defined by Int. Rev. Code of 1954 § 1371(a), can make the election referred to if the corporation has a single class of shares that are held by not more than ten shareholders, and meets certain other requirements, including unanimous shareholder election of Subchapter S. Int. Rev. Code of 1954 §§ 1371-72 (1975). The court in Donahue suggested that Subchapter S is a recognition by the federal government that close corporations are merely incorporated partnerships, and will be taxed accordingly. Mass., 328 N.E.2d 512 n.12.

44 See Golconda Mining Corp. v. Commissioner, 507 F.2d 594 (9th Cir. 1974), where the court noted that although §§ 531-37 do not distinguish between publicly and closely held corporations,

Congress did not intend to change the longstanding practice and application of the tax to closely held corporations and these corporations alone. [Golconda is] a widely held, publicly owned corporation whose stock is similarly and actively traded. It is, therefore, not subject to the accumulated earnings tax provisions.

Id. at 597. The Internal Revenue Service has stated that it will not follow Golconda and that it recognizes no impediment to the imposition of the accumulated earnings tax on publicly held corporations. Rev. Rul. 75-305, 1975 Int. Rev. Bull. No. 30, at 12. For an extended discussion of the taxation aspects of close corporations, see T. Ness & E. Vogel, Taxation of the Closely Held Corporation (1967).

45 "[I]t is believed that participants in a close corporation desire to and do act as partners, insofar as possible, and it is in this area that their needs must be accommodated in the statutes.

See notes 96-134 and accompanying text infra.

47 —Mass. at—, 328 N.E.2d at 511.
alone is not a determinative factor. But because of the peculiar characteristics of close corporations that arise from the coincidence of ownership and management, a close corporation is usually defined as a corporation with relatively few shareholders. The limited number of shareholders is directly related to the infrequent trading of close corporation shares.

A close corporation differs from other corporations because there is usually no public issue or public trading of its voting shares, due to a desire to preserve the identity of ownership and control. This is accomplished by restricting share ownership to a certain group or family. A lack of free share trading, however, results in a limited market for the close corporation's stock. "Since shares in a close corporation are rarely traded, much less listed on a security exchange, their value is usually difficult to determine, and there is, as a practical matter, very little market for such shares." Lack of a ready market for shares outside the corporation is a problem for

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48 It has been noted that "[t]he amount of a corporation's assets, the scope of its operations, the number of persons it employs, or the volume of its sales does not determine whether [a corporation] is 'close.'" F. O'Neal, supra note 5, § 1.03. In fact, the Ford Motor Company was a close corporation until it publicly offered its stock in 1955. Id.

49 "In other words, a 'close corporation' means, in the vernacular a corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling." Brooks v. Willcuts, 78 F.2d 270, 273 (8th Cir. 1935); accord, Galler v. Galler, 32 Ill. App. 2d 16, 21, 203 N.E.2d 577, 583 (1965).

See notes 57-61 and accompanying text infra for numerical limitations placed on the number of shareholders by statutory definitions of close corporations. See quotation from Brooks v. Willcuts, 78 F.2d 270 (8th Cir. 1935), in note 49 supra.

50 A lack of free share trading, however, results in a limited market for the close corporation's stock. "Since shares in a close corporation are rarely traded, much less listed on a security exchange, their value is usually difficult to determine, and there is, as a practical matter, very little market for such shares." Lack of a ready market for shares outside the corporation is a problem for

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51 This limitation is usually embodied in shareholder-imposed restrictions found in the by-laws or other shareholder agreements. See note 38 and accompanying text supra.

52 HENN § 281.
dissident close corporation shareholders, and much of Donahue turns on this restricted ability to trade.\textsuperscript{53}

The close corporation is also often characterized by an integration of ownership and management.\textsuperscript{54} This characteristic reflects the quasi-partnership features of the close corporation. Some statutory provisions expressly allow close corporation shareholders to exercise management rights.\textsuperscript{55} The court in Donahue refers to majority shareholder participation in management, as opposed to total shareholder participation, probably recognizing that even in close corporations there may be nominal or dormant shareholders.

C. Statutory Comparison

Those corporate statutes that provide special subchapters applicable to close corporations\textsuperscript{56} use essentially the same threshold tests to define close corporations as the Donahue court employed. Delaware and Pennsylvania, for example, require close corporations to file a certificate of incorporation, in accordance with their corporate statute. These statutes provide that all classes of stock be held of record by not more than thirty people, that they be subject to one or more permissible restrictions on transfer, and that the shares not be publicly offered within the meaning of the Securities Act of 1933.\textsuperscript{57} Texas has essentially the same requirements, but limits the number of permissible shareholders to fifteen.\textsuperscript{58} Florida once defined a close corporation simply as a corporation for profit whose shares are not generally traded in organized securities markets, but this separate treatment has been abandoned.\textsuperscript{59} Other states have enacted certain statutory provisions applicable to corporations whose shares are not traded on any organized securities exchange,\textsuperscript{60} without expressly

\textsuperscript{53} See text accompanying notes 86-87 infra.
\textsuperscript{54} See note 2 and accompanying text supra. See generally Note, supra note 6.
\textsuperscript{56} See note 6 supra.
\textsuperscript{59} See Fla. Stat. Ann. § 608.70(2) (Supp. 1975), repealed by Fla. Stat. Ann. §§ 607.001-.411 (Supp. 1975) (Special Pamphlet). A qualified corporation could elect to bring itself within the provision of the close corporation subchapter; otherwise its provisions were permissive, not mandatory. Id. § 608.70(1) (Supp. 1975). Florida's General Corporation Act has been amended, and since January 1, 1976, there has been no statutory distinction between close corporations and general corporations. See id. §§ 607.001-.411 (Supp. 1975) (Special Pamphlet).
\textsuperscript{60} See note 6 supra.
differentiating between close and public-issue corporations. In statutory definitions the emphasis seems to be on the lack of free or organized trading of shares. This reflects a recognition that the most distinctive feature of close corporations, and the feature that merits special statutory treatment, is their closely-held aspect; i.e., in order to provide identity of ownership and management and close personal working relationships, the share ownership in close corporations must be restricted to a limited group of individuals.

Justice Stewart once declined to define obscenity, stating only that he knew it when he saw it. Perhaps the *Donahue* court has done the same. *Donahue* provides a framework for analyzing corporate practices to determine whether a corporation is close, but later cases will demonstrate whether the Massachusetts courts will merely "know one when they see one." The strictness of definitional criteria for close corporations is primarily a function of the degree of sophistication of the corporate statutes in a jurisdiction. Obviously, special statutory close corporation provisions need a screening threshold definition to determine scope of coverage. Since Massachusetts has no developed statutory scheme for close corporations, the court's definition in *Donahue* has merit. It combines the features traditionally associated with close corporations in a manner that has enough flexibility to allow for intercorporate differences and judicial interpretation before binding a corporation to close corporation case law.

III

Shareholders' Fiduciary Duties In Close Corporations

The court in *Donahue* imposed a new standard of fiduciary duty on close corporation stockholders:

Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another. . . . [W]e have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty" . . . . Stockholders in close corporations must dis-

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61 Jacobellis v. Ohio, 378 U.S. 184, 197 (1963) (concurring opinion, Stewart, J.)
62 The trend toward statutory definition and differentiation for close corporations seems to be increasing. See generally Note, *supra* note 6. But note also Florida's reversion to general coverage for close corporations. See note 59 *supra.*
charge their management and stockholder responsibilities in con-
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This standard is imposed on all shareholders in close corporations, without regard to status as a majority or minority shareholder, and without regard to official capacity as an officer or director. A signif-

icant departure from traditional notions of corporate fiduciary
duties has therefore been adopted in Massachusetts.

As a vehicle for protection of shareholder interests, imposing
fiduciary duties between individuals in various corporate capacities is
not a novel idea. Corporate law abounds with well-settled fiduciary
relationships, often differing only in the verbal formulations of
tests and standards. For example, directors of a corporation stand in
a fiduciary relationship with the corporation, requiring the directors
to exercise their powers with due care, best judgment, and utmost
}

Based on these duties, challenged transactions between
directors and their corporation are closely scrutinized with the burden
on the director to show the good faith and inherent fairness of
} Directors also owe a fiduciary duty to the share-
Appeals in *Kavanaugh v. Kavanaugh Knitting Co.* held that directors of a corporation stand in a fiduciary relationship to the shareholders.

The directors are bound by all those rules of conscientious fairness, morality and honesty in purpose, which the law imposes as the guides for those who are under the fiduciary obligations and responsibilities. They are held, in official action, to the extreme measure of candor, unselfishness and good faith. Those principles are rigid, essential and salutary.

The *Donahue* standard, however, applies to all close corporation shareholders, not only to those who are also directors, and must therefore be compared with prevailing views on shareholder fiduciary duties.

Majority shareholders owe a fiduciary duty to minority shareholders. If the majority shareholder is not a director or an officer, the imposition of a fiduciary obligation is often conditioned on the exercise of sufficient control in the management of the corporation. In close corporations, however, there is an assumption that


At one time officers and directors were considered fiduciaries toward the corporation only, but the concept of fiduciary duty was later expanded to the shareholders. See *Weatherby v. Weatherby Lumber Co.*, 94 Idaho 504, 492 P.2d 43 (1967). See also notes 88-90 and accompanying text infra. Since shareholders are the personification of a corporation, an entity that is otherwise intangible, it follows that if directors owe a fiduciary duty to the corporation they must also owe a fiduciary duty to the shareholders.

68 Id. at 193, 124 N.E. at 151. The fiduciary obligation of directors to shareholders bars them from using the stock-issue device to change voting control patterns (see Condec Corp. v. Lunkenheimer Co., 43 Del. Ch. 353, 230 A.2d 769 (1967)), from selling stock to other directors to place corporate control within a certain group (see Gieselmann v. Stegeman, 443 S.W.2d 127 (Mo. 1969)) or from otherwise discriminating against a shareholder or group of shareholders in corporate transactions. The fiduciary standard employed by the *Donahue* court—utmost good faith and loyalty—has been used by other courts to bind directors in their official action. See *Pepper v. Litton*, 308 U.S. 295 (1939); Nordin v. Kaldenbaugh, 7 Ariz. App. 9, 435 P.2d 740 (1968); *Johnson v. Central Standard Life Ins. Co.*, 102 Ill. App. 2d 15, 243 N.E.2d 376 (1968).
69 Bayliss v. Rood, 424 F.2d 142 (4th Cir. 1970); United States v. Gates, 376 F.2d 65 (10th Cir. 1967). As with a director’s fiduciary duty to the corporation, the cases supporting the proposition that majority shareholders owe fiduciary duties to minority shareholders are voluminous. Even under Zambian law this duty is recognized. *Kohn v. American Metal Climax, Inc.*, 322 F. Supp. 1331 (E.D.P.A. 1971). *But see* Jacobs v. Regas, 75 Ill. App. 2d 283, 221 N.E.2d 140 (1966), rev’d, 37 Ill. 2d 578, 229 N.E.2d 487 (1967); Mairs v. Madden, 307 Mass. 378, 30 N.E.2d 242 (1940) (shareholders not fiduciaries by virtue of majority interest per se). The *Donahue* court stated that *Mairs* will no longer be followed in this respect. —Mass. at—, 328 N.E.2d at 517.
70 See *South Pacific Co. v. Bogert*, 250 U.S. 483 (1919), where the court explained that
shareholders exercise management control by definition.\textsuperscript{71} Thus, there is even less need for correlating fiduciary duty with a shareholder's official status within the corporation. In \textit{Hartung v. Architects Hartung/Odle/Burke, Inc.},\textsuperscript{72} the Indiana Court of Appeals held that directors, officers, and shareholders of close corporations were fiduciaries, and that the same standard of fairness, honesty, and openness applied regardless of the capacity in which it arose.\textsuperscript{73} As with directors, several standards have been imposed by courts on shareholders in their dealings that affect other shareholders. At minimum, the equivalent of an arms-length bargain is required,\textsuperscript{74} and most courts require that elements of fairness, honesty, and openness be present in dealings among shareholders.\textsuperscript{75}

\textit{[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.}


\textit{[t]he New York courts have frequently held that a dominant or majority stockholder does not become a fiduciary for other stockholders merely by reason of his voting power. It is only when he steps out of his role as stockholder and begins to usurp the functions of director in the management of corporate affairs that such a duty is imposed.}


\textsuperscript{71} See text accompanying notes 54-55 supra.

\textsuperscript{72} —Ind.—, 301 N.E.2d 240 (1973).

\textsuperscript{73} In view of the informal way in which the affairs of most close corporations are conducted, there is usually no necessity for distinguishing between the fiduciary duties of the controlling participants in their various capacities as shareholders, directors, and officers. . . . [W]henever a number of stockholders "constitute themselves or are by the law constituted, the managers of corporate affairs or interests, they stand in much the same attitude towards the other or minority stockholders that the directors sustain generally toward all the stockholders, and the law requires of them the utmost good faith" and a court of equity "will protect a minority stockholder against the acts or threatened acts of the board of directors or of the managing stockholders of the corporation, which violate the fiduciary relation and are directly injurious to the stockholders."


\textsuperscript{74} See, e.g., \textit{In re Brunner Air Compressor Corp.}, 287 F. Supp. 256 (N.D.N.Y. 1968).

Shareholders also have rights derived from the fiduciary duties owed to them by other shareholders, even as to transactions in which they are not directly involved. Minority shareholders often object to the results of a sale by a majority shareholder of his controlling interest. If the transaction represents a breach of fiduciary duty owed to other shareholders, the sellers will be held liable to them. In *Perlman v. Feldmann*, for example, the Second Circuit held that a seller of a controlling interest in a corporation could be liable to the other shareholders, based on either a director’s or a controlling shareholder’s fiduciary duty for that part of the sale price that unfairly reflected a premium for control.

[A] duty of the finest loyalty [is required]. Many forms of conduct permissible in a workaday world for those acting at arm’s length, are forbidden by those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

When a court cites Judge Cardozo in *Meinhard*, or Justice Douglas in *Pepper v. Litton*, it often spells doom for the challenged transaction. See also *Helms v. Duckworth*, 249 F.2d 482 (D.C. Cir. 1957), where the court held:

In an intimate business venture such as this, stockholders of a close corporation occupy a position similar to that of joint adventurers and partners. While courts have sometimes declared that stockholders “do not bear toward each other that same relation of trust and confidence which prevails in partnerships,” this view ignores the practical realities of . . . a small business enterprise in which the stockholders, directors, and managers are the same persons.

*Id.* at 486 (citations omitted). These standards, however, mean little when standing alone; their force is better understood by examining the result dictated by fiduciary duty requirements in a given situation. For example, shareholder fiduciary duty bars the majority from excluding the minority from fair participation in the fruits of a sale of corporate property made through exercise of majority control. *South Pacific Co. v. Bogert*, 250 U.S. 483 (1919). When shareholders induce other shareholders to sell their shares in the corporation, fiduciary duties require full and honest disclosure by the buying shareholders concerning all matters relating to the enterprise. *Mendelsohn v. Leather Mfg. Corp.*, 326 Mass. 226, 93 N.E.2d 537 (1950). See also *Shermer v. Baker*, 2 Wash. App. 845, 472 P.2d 589 (1970), where the court required full disclosure of all material and relevant inside information that the selling shareholders were unable to obtain. Similar disclosure would be required by directors when inducing shareholders to sell their interest in the corporation. Each of these cases is merely an application of fiduciary duty standards to a given fact situation, but the result is that certain practices become mandatory in similar transactions.


*7* *Perlman* stands for the proposition that a majority shareholder may usually dispose of his shares to outsiders without having to account to the corporation for profit, but under circumstances amounting to a breach of fiduciary duty, the minority shareholders may have a cause of action against the seller for the premium he received to the extent that it represents a corporate asset. For an extensive discussion of this case, see Hill, *Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957). In *Donahue*, the price at which Rodd sold his shares was less than either book value or liquidating value per share, so accountability for a premium was not an issue. —Mass. at—, 328 N.E.2d at 509-11, 521.

Liability to minority shareholders may also be imposed when the sale results in looting or fraud perpetrated on the corporation by the purchaser of the controlling interest. *Insur-
Donahue was similar to the sale-of-control cases in that it involved a shareholder objecting to a transaction in which she was not directly involved. Mrs. Donahue had a more immediate interest, however, since the corporation itself was a party to the transaction. She asserted that the purchase of Rodd’s shares by the corporation was a breach of the fiduciary duty owed to her by the participants in the transactions. To grant relief, the court had several alternatives. First, because Rodd and his sons were directors, the court could have looked at the directors’ fiduciary obligations. Second, although Rodd was not a majority shareholder, he was a member of the controlling group of shareholders. The court could have aggregated these controlling shareholders and assessed their fiduciary duties. Instead, the court chose a broader approach: Donahue imposed a requirement of utmost good faith and loyalty on all close corporation shareholders, whether they were merely shareholders, majority shareholders, directors, or officers. All transactions affecting the rights and investments of other shareholders must meet this test. The extension of fiduciary duties by Donahue to all close shareholders of a controlling interest in a corporation were under a duty to the corporation to refrain from selling their control to outsiders when a reasonable person would anticipate damage to the corporation at the hands of the outsiders. This recovery would run in favor of the corporation. In McDaniel v. Painter, 418 F.2d 545 (10th Cir. 1969), the court admitted that even a majority shareholder is generally free to dispose of his shares at any time and for any price to which he may agree. Nonetheless, the court pointed out that a majority shareholder exercising control, and hence a fiduciary, would be liable to the other shareholders for disposing of his shares when the surrounding circumstances were such that the seller should have known that his purchaser was unscrupulous; accord, Swinney v. Keebler Co., 480 F.2d 573 (4th Cir. 1973). It is not necessary to show that the seller had actual knowledge that the buyer would defraud the corporation in order to grant relief. It is sufficient that a reasonably prudent man would have been put on guard by the surrounding circumstances. Harman v. Willbern, 374 F. Supp. 1149 (D. Kan. 1974). Both Swinney and McDaniel, however, involved cases where the facts did not justify a finding of negligence in the sale of control, and recovery was denied. The ability of the remaining shareholders to recover personally, as opposed to a recovery for the corporation, is therefore not established clearly. See note 14 supra.

78 See id. and text accompanying note 117 infra.

79 See notes 69-70 and accompanying text supra.

80 The court suggested that the phrase “transactions affecting the rights and investments of other stockholders” limited the holding, and that the duties imposed by Donahue did not necessarily apply where the corporation was not a party to the transaction. —Mass. at—, 328 N.E.2d at 515 n.18. As Justice Wilkens pointed out in his concurrence, however, the implications seem broader than the court indicates. Id. at—, 328 N.E.2d at 521. It is hard to imagine a corporate or shareholder transaction that will not eventually affect the rights and investments of other nonparticipating shareholders, especially in a close corporation. The cases involving a sale of control to outsiders seem to apply the same fiduciary duties to the selling shareholders as in transactions directly involving the corporation. See, e.g., text accompanying notes 76-77, 88-90. Thus, Donahue’s standard of fiduciary duty will probably have a broader application than the court was willing to admit. At a minimum, however, the Donahue court has preserved enough latitude to re-examine other corporate and shareholder transactions in light of this new standard, and the strictness of the standard “utmost good faith and loyalty” seems to
corporation shareholders, regardless of their capacity, thus takes
cognizance of the fact that these capacities do merge in a close
corporation. To obtain the coincidence of ownership and control
that is sought in close corporations, the shareholders, officers, and
directors are very often the same persons. Therefore, it seems only
logical that fiduciary duties in close corporations should cut across
the full gamut of corporate activity and apply with equal force to all
of the individual participants. 81

The stringency of the standard imposed by the court in Donahue
is also significant. Admittedly, a standard such as utmost good faith
and loyalty is hollow and impotent when standing by itself, and its
ture import will depend on judicial application in various fact situa-
tions. But the Donahue court did imply that an extremely high
measure of duty is required of close corporation shareholders. This
standard of behavior for close corporation shareholders was man-
dated, in the court's opinion, by several peculiarities and dilemmas
facing minority shareholders in close corporations. 82

The Donahue court justified the imposition of a strict fiduciary
duty on several grounds. The similarity of close corporations to
partnerships and sole proprietorships has already been discussed, 83
and the extent to which the court accommodated reality by basing its
rationale on this similarity was therefore not surprising. 84 The court
was also concerned with the plight of a dissident close corporation
minority shareholder, who faced no ready market for his shares and
was unable to obtain dissolution, and thus was readily susceptible to
oppression and freeze-out techniques exercised by the majority. 85

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81 It seems unlikely that nominal shareholders will be unduly hampered by this test, since
by definition they will lack the leverage needed to become intimately involved in corporate
transactions. Any shareholder in a close corporation with more than a nominal interest,
however, should be subject to this standard since he will invariably be an active participant in
corporate affairs.

82 The standard of utmost good faith and loyalty applies equally to all close corporation
shareholders, including the minority. The court's main concern, however, was for the plight
of the minority. See notes 85-94 and accompanying text infra.

83 See text accompanying notes 1-5, 26-47 supra.

84 In Cain v. Cain, --App. Dec.--, 334 N.E.2d 650 (Mass. App. 1975), the court supported
Donahue's recognition of the similarity of close corporation shareholders' fiduciary
duties to partners' fiduciary duties, and applied partnership law to assess the shareholders' duties to the close corporation.

85 The danger of oppression of a minority shareholder was recognized as early as the
turn of the century. See Ripin v. United States Woven Label Co., 205 N.Y. 442, 98 N.E. 855
However, the facts surrounding the stock repurchase in *Donahue* do not reveal an attempted freeze-out. The only direct effect on the plaintiff was a restriction on the available market for her shares, with no apparent conscious effort to force her out of the enterprise. The court, therefore, seemed to be more concerned with the lack of judicial and extra-judicial remedies facing a dissident minority shareholder.

This lack of adequate minority shareholder remedies was appropriately illustrated by the court's statement that the minority stockholder in a close corporation cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority shareholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation. . . . Thus, in a close corporation, the minority stockholders may be trapped in a disadvantageous situation. No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties. To cut losses, the minority stockholder may be compelled to deal with the majority. This is the capstone of the majority plan.86

Because of the lack of a ready market for close corporation shares, artificially created markets, especially those concocted by individuals in a position of control, were viewed by the *Donahue* court with great suspicion.87

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86—Mass. at→, 328 N.E.2d at 514-15. See also Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1965), where the court said:

While the shareholder of a public-issue corporation may readily sell his shares on the open market should management fail to use, in his opinion, sound business judgment, his counterpart of the close corporation often has a large total of his entire capital invested in the business and has no ready market for his shares should he desire to sell.

87—Mass. at→, 328 N.E.2d at 518-19.

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(1912), where the court said:

There was danger, however, in the very plenitude of the power granted to such corporations, as has been shown by the litigations in the courts on claims of oppressive or dishonest action of the majority towards the minority. Indeed, abuse of power by a majority in many of these private corporations had become a scandal.

*Id.* at 447, 98 N.E. at 856.

The potential opportunities for the majority to oppress or freeze out a minority shareholder are numerous and no one would quarrel with provision of a remedy for an oppressed minority shareholder. The definitive work on freeze-outs is F. O'Neal, "Squeeze Outs" of Minority Shareholders—Expulsion or Oppression of Business Associates (1975). O'Neal discusses several oppressive techniques frequently employed by majority shareholders in close corporations: withholding dividends, appropriation of business opportunity, mergers and consolidations, issuance of new shares, and other techniques designed to force shareholders to leave the enterprise.

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In *Jones v. H.F. Ahmanson & Co.*, majority shareholders created a market for their shares outside the corporation by forming a holding company and exchanging their shares for shares of that holding company. No similar opportunity was given to the minority. The majority shareholders then made a public offering of the holding company stock, creating a public market for their shares, and making stock in the original company unmarketable except to the holding company. The California Supreme Court held that using majority control to obtain a market for shares not available to all shareholders violated the fiduciary duties owed to minority shareholders by directors, officers, and controlling shareholders. The court further held that when no market existed for shares, such as in a close corporation, controlling shareholders could not use their power to promote a marketing scheme benefitting themselves at the expense of the minority.

If fiduciary duties are owed to minority shareholders by the sellers of controlling shares when the sale is to outsiders, as in *Perlman*, or to another enterprise controlled by the controlling shareholders, as in *Jones*, the *Donahue* court has pursued the logical extension of the *Jones* holding. As in *Jones*, the *Donahue* case concerned an artificially created market for close corporation shares. In *Donahue*, however, the corporation was the purchaser. In *Jones*, fiduciary duties were imposed on majority shareholders based on the assumption that the minority, lacking power to act, needs protection against overreaching by the majority. Inside the corporation, where the majority’s control is essentially unbounded, this assumption is even more likely to be true. By imposing fiduciary duties on

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88 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).
89 Id. at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604. At the time of *Jones*, the so-called majority rule was that majority shareholders had a perfect right to dispose of their stock without regard to the wishes of the minority, because a director’s or controlling shareholder’s trust relationship did not extend to individual shareholders in the sale and purchase of stock. The “special facts” rule developed as an exception to the majority rule, and put the directors and controlling shareholders in a limited fiduciary relationship with other stockholders in transactions involving their stock, whenever these individuals possessed “special information” regarding the value of corporate shares not available to the minority. The court in *Jones* proposed to follow what was then called the minority rule, and held that transactions involving transfers of stock among shareholders in the corporation were subject to the comprehensive rule of good faith and inherent fairness to the minority where control of the corporation was a material factor in the transaction.
90 1 Cal. 3d at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604. The court added: Although a controlling shareholder who sells or exchanges his shares is not under an obligation to obtain for the minority the consideration that he receives in all cases, when he does sell or exchange his shares the transaction is subject to close scrutiny.
91 Id. at 111-12, 460 P.2d at 473-74, 81 Cal. Rptr. at 601-02.
all close corporation shareholders (not only the majority shareholders), the Donahue court offers even more protection against the discriminatory creation of markets. Any shareholder or group of shareholders able to manipulate corporate policy and negotiate a stock repurchase is now bound under Donahue by the standard of utmost good faith and loyalty.

The court in Donahue was also concerned with the inability of a minority shareholder to obtain dissolution.\textsuperscript{92} If this remedy was readily available to dissident shareholders fearing either a freeze-out or a freeze-in, it would have been an alternative to seeking redress for breach of fiduciary duty, albeit somewhat more drastic. It would, however, allow the complaining shareholder to remove his assets from the enterprise. But as the court noted, dissolution was not readily available to the likely victims of these marketing schemes:

\begin{quote}
[T]he stockholder in the close corporation or “incorporated partnership” may achieve dissolution and recovery of his share of the enterprise assets only by compliance with the rigorous terms of the applicable chapter of the General Laws. . . . To secure dissolution of the ordinary close corporation . . . the stockholder, in the absence of corporate deadlock, must own at least fifty percent of the shares . . . or have the advantage of a favorable provision in the articles of organization . . . . The minority stockholder, by definition lacking fifty percent of the corporate shares, can never “authorize” the corporation to file a petition for dissolution . . . by his own vote. He will seldom have at his disposal the requisite favorable provision in the articles of organization.\textsuperscript{93}
\end{quote}

By recognizing the difficulty of obtaining dissolution, and granting other relief and protection rather than liberalizing the availability of dissolution to dissident close corporation shareholders, the Donahue court preserved the concept that an operative corporation should not be dissolved if otherwise avoidable.\textsuperscript{94}

\textsuperscript{92} See note 93 and accompanying text infra.

\textsuperscript{93} —Mass. at—, 328 N.E.2d at 514-15. As noted by Donahue, a petition for dissolution could be filed in Massachusetts when authorized by a majority of the voting stock, or by 40% or more of the voting stock, if the directors and the shareholders were deadlocked in their voting power. Mass. Ann. Laws, ch. 156, § 99 (1970). Voluntary dissolution could be effected only by a vote of two-thirds of the voting shares, unless otherwise provided by the articles of incorporation or the by-laws. Id. § 100.

\textsuperscript{94} Close corporation dissolution is a more readily available remedy for a dissident shareholder in other jurisdictions. See generally Note, supra note 40. The notion that corporations bear a strong resemblance to partnerships is an important factor in the more liberal views. See In re Gordon & Weiss, 32 App. Div. 2d 279, 301 N.Y.S.2d 839 (1st Dep't 1969), where the court stated:

It is being increasingly realized that the relationship between the stockholders in close corporations vis-à-vis each other in practice closely approximates the relationship between partners. . . . As a consequence, when a point is reached where the
It seems, therefore, that the Donahue court was justified in raising the standard of fiduciary duty for close corporation shareholders. To protect those who have placed their trust, confidence, and financial assets in the hands of close business associates, a strict test of utmost good faith and loyalty is required. The test only has meaning when applied to a set of facts, and this gives the court flexibility to deal with a variety of situations and to determine when and if a breach of this standard of duty has occurred. If predictability suffers, it suffers at the expense of equity. More importantly, by employing what is essentially a bifurcated decision process, the Donahue court has preserved wide latitude for the equal-opportunity shareholders who are actively conducting the business of the corporation cannot agree, it becomes in the best interests of those shareholders to order a dissolution. Id. at 281, 301 N.Y.S2d at 842. See also Kruger v. Gerth, 16 N.Y.2d 802, 210 N.E.2d 355, 263 N.Y.S.2d 1 (1965), where Chief Judge Desmond, dissenting, said:

The modern and just rule . . . is that a court of equity should wind up the affairs even of a solvent going corporation when gross mismanagement or fraudulent or inequitable conduct causes real danger of imminent loss to stockholders which danger cannot be prevented except by liquidation, and where the circumstances have created a real exigency and liquidation will serve a beneficial purpose to all stockholders. Id. at 805, 210 N.E.2d at 356, 263 N.Y.S.2d at 3.

Other New York cases agree that the lack of faith and trust that produces deadlock may be the basis for a finding that dissolution is beneficial to the shareholders, even for a profitable corporation. In the case of deadlock among shareholders and directors, dissolution should not be denied merely because the corporation has been, or could be, carried on at a profit, but in the absence of deadlock, dissolution would seem to be a last-resort remedy. See N.Y. Bus. Corp. Law § 1111(b)(3) (McKinney 1963); see Surchin v. Approved Business Mach. Co., 55 Misc. 2d 888, 286 N.Y.S.2d 580 (Sup. Ct. 1967); In re Pivot Punch & Die Corp., 15 Misc. 2d 713, 182 N.Y.S.2d 459 (Sup. Ct. 1959).

Notwithstanding the broad New York view, courts are still hesitant to decree the winding up of a going corporation. In the absence of statutes, equity courts refuse to wind up a solvent corporation or appoint a receiver for the liquidation of its affairs unless there is sufficient fraud, oppression, or deadlock so as to render the corporation inoperative. See Johnston v. Livingston Nursing Home, Inc., 282 Ala. 309, 211 So. 2d 151 (1968); Baker v. Commercial Body Builders, Inc., 264 Ore. 614, 507 P.2d 387 (1973). But see Gidwitz v. Lanzit Corrugated Box Co., 20 Ill. 2d 208, 170 N.E.2d 131 (1960), where the court said:

It is not necessary that fraud, illegality or even loss be shown to exhibit oppression of plaintiffs and their interest in the corporation. Corporate dissolution is a drastic remedy that must not be lightly invoked. . . . Nevertheless, when oppression is positively shown, the oppressed are entitled to the protection of the law. Id. at 220-21, 170 N.E.2d at 138.

Today, courts are reluctant to interfere with the internal workings of a corporation due to entrenchment of the business-judgment rule and principles of majority rule. This also reduces the frequency of dissolution decrees issued at the request of dissident shareholders. By granting relief to the minority shareholders in Donahue on grounds broader than mere oppression, the court created an alternative remedy to dissolution not often found in other jurisdictions. Whether a court with jurisdiction to enter a dissolution decree would do so, in a case similar to Donahue, with added oppressive actions by controlling shareholders, is not clear. The Donahue court's concern with the inability of minority shareholders to obtain dissolution in Massachusetts does, however, seem to imply that dissolution is not to be liberalized where other equitable relief is available.
requirement. The court first defined the standard of fiduciary duty applicable to close corporation shareholders. It then determined that, based on this duty, equal opportunity was required under certain circumstances as a component of that duty. Since the shareholders were not offered an equal opportunity to sell, the court held that the duty was breached, and awarded relief. The next section of this Note will attempt to demonstrate that this two-step analysis will prevent the spread of the equal-opportunity requirement to inappropriate fact situations.

IV

THE EQUAL-OPPORTUNITY DOCTRINE

After defining the standard of fiduciary duty applicable to close corporation shareholders, the Donahue court applied the standard to close corporation stock repurchases:

When the corporation reacquiring its own stock is a close corporation, the purchase is subject to the additional requirement . . . that the stockholders, who, as directors or controlling stockholders, caused the corporation to enter into the stock purchase agreement, must have acted with the utmost good faith and loyalty to the other stockholders.

. . . To meet this test, if the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price.96

The court in Donahue believed that equal opportunity was necessary to make the same benefits available to both the minority and the majority: the ability to artificially create a market for shares and to reach liquid corporate assets for personal use.97 To the extent that close corporations were characterized by the court as lacking a ready market,98 the holding, as limited to close corporations, furthers valid policy goals—limited marketability of shares accompanied by an inability to obtain dissolution provides ample opportunities for locking minority shareholders into the corporation if the majority is allowed to create markets and siphon off corporate assets in payment for their shares to the exclusion of other shareholders.

The notion that all shareholders have an equal (proportionate)
right to corporate assets in the absence of stated preferences underlies the requirement imposed by many cases that a reduction of stated capital must operate pro rata on all shareholders. In Donahue, however, the purchased shares were held in the corporate treasury and not retired; thus the cases concerning the reduction of stated capital would at first seem inapplicable. Indeed, in Massachusetts, as elsewhere, the mere purchase of stock by a corporation does not necessarily result in a reduction of stated capital. Therefore, prior to Donahue, a Massachusetts corporation was not required to buy stock to be held and not retired in a ratable manner from the shareholders. By referring to a preferential distribution of assets as a rationale for the equal opportunity holding, the Donahue court implied that the mere repurchase-reduction of stated capital distinction may only be superficially valid. In both ordinary repurchases and reductions of stated capital, assets flow immediately to the selling shareholders, and if one shareholder or group of shareholders is excluded from participating, the distribution would seem to be inequitably preferential. In a reduction of stated capital, there is, in effect, an overall contraction of assets, so it seems logical that all shareholders should participate. Similarly, in a repurchase of stock for the corporate treasury, the treasury shares acquired are not regarded as an asset of the corporation and thus there is also a contraction of assets. Although the excluded shareholders theoretically retain an increased proportionate interest in corporate assets after the repurchase, the corporation's liquid assets are decreased. The Donahue court, by extending equal opportunity to treasury share repurchases, may be implying that stability of

99 In General Investment Co. v. American Hide and Leather Co., 98 N.J. Eq. 326, 129 A. 244 (Ct. Err. & App. 1925), the court held that a corporation purchasing stock for retirement in a plan for the reduction of stated capital must buy ratably from each shareholder who wishes to sell. Id. at 351, 129 A. at 246; accord, Iback v. Elevator Supplies Co., 118 N.J. Eq. 90, 177 A. 458 (Chancery 1935). See also Herwitz, Stock Redemptions and the Accumulated Earnings Tax, 74 Harv. L. Rev. 866 (1961), where the author notes that "[i]t seems doubtful as a matter of corporate law today that the majority shareholders could compel a corporation to redeem their own shares, to the exclusion of the minority shareholders, unless the latter were willing." Id. at 910.


101 Id. at 431, 8 N.E.2d at 914.

102 See D. Herwitz, Business Planning 459 (1966):

[A]s a general proposition the fact that stock is being repurchased from some stockholders does not entitle other stockholders to demand pro rata treatment. . . . Some early . . . cases which intimated the existence of such a requirement . . . may be explained by the fact that they involved repurchase of stock as a method of reducing capital, as authorized by some corporate statutes, and of course a requirement for pro rata distribution in connection with a reduction of capital stands on a very different footing and establishes no precedent for an ordinary repurchase transaction.

103 See id. at 422-26.
the excluded shareholder's proportionate interest in the corporate assets after a share repurchase is illusory if the majority is able to manipulate policy affecting the status or ultimate disposition of the repurchased treasury shares or the course of future corporate share transactions.

Although other courts have also suggested the equal-opportunity concept as a remedy for breach of fiduciary duties involved in the sale of shares, one obvious problem with requiring an equal opportunity to sell is that if the other shareholders want to

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104 In Massachusetts, stockholders do not have preemptive rights to acquire stock of the corporation unless such rights are provided by the articles of incorporation or the by-laws. See notes 131-34 and accompanying text infra.

105 Unless an equal opportunity is given to all stockholders, the purchase of shares from a member of the controlling group operates as a preferential distribution of assets. In exchange for his shares, he receives a percentage of the contributed capital and accumulated profits of the enterprise. The funds he so receives are available for his personal use. The other stockholders benefit from no such access to corporate property and cannot withdraw their shares of the corporate profits and capital in this manner unless the controlling group acquiesces.

—Mass. at —, 328 N.E.2d at 518-19 (emphasis in original).

106 See Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) where the court noted:

Had defendants afforded the minority an opportunity to exchange their stock on the same basis or offered to purchase them at a price arrived at by independent appraisal, their burden of establishing good faith and inherent fairness would have been much less.

Id. at 114, 460 P.2d at 476, 81 Cal. Rptr. at 604. The court reasoned that the dissenting shareholders in Jones should have been given the same opportunity to tender their shares and obtain the same consideration as given the majority in their marketing scheme.

The California courts have also suggested the equal-opportunity doctrine as a remedy in sale-of-control cases involving a disproportionate price reflecting a premium for control. In Brown v. Halbert, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969), majority shareholders accepted an outside offer for the purchase of their shares and excluded the minority from participation in the sale. The court found a breach of fiduciary duty and held:

The rule we have adopted here simply is that the duty of the majority stockholder-director, when contemplating the sale of the majority stock at a price not available to other stockholders and which sale may prejudice the minority stockholders, is to act affirmatively and openly with full disclosure so that every opportunity is given to obtain substantially the same advantages that such fiduciary secured and for the full protection of the minority. This duty was violated here.

Id. at 272, 76 Cal. Rptr. at 793-94.

See also Hill, supra note 77, where the author points out that generally a seller may accept a premium for a sale of controlling shares to reflect the value of control. Sometimes, however, the seller will be held accountable to the minority for this profit, and therefore it looks better if the seller can persuade the buyer to make the same offer to all shareholders. No control premium is then reflected, and there is no disadvantage to the minority. Id. at 991.

Some authors have also suggested that one of a minority shareholder's numerous rights is to have an equal opportunity with all other shareholders to participate ratably in any sale of shares pursuant to a favorable offer for the purchase of controlling shares in the corporation. See Hill, supra note 77, and Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505 (1965). The Andrews theory is concerned primarily with the right of equal opportunity as a remedy for sales of control reflecting a premium. Other authors have translated this right into a duty placed on the controlling shareholders to secure
participate, the original deal cannot be completed unless the buyer increases his investment or the seller either sells fewer shares or accepts a smaller consideration. Neither party may desire such a result. Of course, the problem is greater when the buyer is an outsider, for where the corporation is the purchaser, the controlling shareholders bound by the equal-opportunity doctrine theoretically may exercise their control to cause the corporation to commit more of its assets to the transaction.

Other advantages and disadvantages of the equal-opportunity doctrine surface by comparison with other techniques available for awarding relief for an unfair stock repurchase. Equal opportunity is preferable to allowing dissenting shareholders to tender their shares

the equal opportunity for the minority. See generally Israels, Corporate Purchase of Its Own Shares—Are There New Overtones?, 50 CORNELL L.Q. 620 (1965); Jennings, Trading in Corporate Control, 44 CALIF. L. REV. I (1956); Leech, Transactions in Corporate Control, 104 U. PA. L. REV. 725 (1956). The court in Donahue has taken this approach with respect to intracorporate share purchases by the corporation as indicated by its language requiring the controlling shareholders to "cause the corporation to offer" to the other shareholders an equal opportunity to sell.

—Mass. at —, 328 N.E.2d at 518.

Andrews, supra, suggests that equal opportunity would not be required when there is no established market for a corporation's stock, since equal opportunity would require "all stock sales to be consummated pursuant to purchase offers communicated to all stockholders." Id. at 548. The effect would be to require shareholders to maintain an orderly market for their corporation's stock, and to prohibit transactions outside of that market. Andrews believes that the benefits of equal opportunity do not justify this result unless the shares sold carry enough control to have a significant effect on the sale price. In that case equal opportunity would be required. On the other hand, the lack of a ready market was precisely the reason that the court in Donahue required equal opportunity, and it seems that Andrews's objections to the doctrine would have less validity when the corporation was the purchaser rather than an outsider.

Note, however, that the ability to commit more funds to the transaction may be hampered by the requirement that there be legally available funds. See generally, Annot., 61 A.L.R. 3d 1049 (1975). Such action would present a problem in those jurisdictions that allow stock repurchases only out of earned surplus (see note 9 supra), since this requirement places a finite limit on the amount of corporate assets available for such a transaction.

Prior to Donahue, a solvent Massachusetts corporation could purchase its own shares in good faith if there was no prejudice to creditors or stockholders. See Scriggins v. Thomas Dalby Co., 290 Mass. 414, 195 N.E. 749 (1935). Donahue sets out the required protection for shareholders, but perhaps more protection for creditors should be promulgated to accompany Donahue. A stock repurchase followed by fully exercised equal-opportunity rights in accordance with Donahue could conveniently deplete the assets available for creditors and thereby prejudice them. Presumably the Scriggins test would cover such a scenario, but a more objective standard to determine legally available funds for stock repurchases, such as surplus or earned surplus, would provide more predictability. Without such a standard, a creditor prejudiced by a corporate stock repurchase has a more difficult case to make out, although cases such as Pepper v. Litton, (308 U.S. 295 (1939) (directors owe fiduciary duty to entire corporate community of interest, including creditors)) provide some assistance. See generally Annot., 47 A.L.R.2d 758 (1956). Note again, the inherent tension between legally available funds and the ability of a given transaction to pass muster under the equal opportunity doctrine when a sufficient number of shareholders wish to exercise their rights under Donahue.
and receive fair value, since complex valuation problems are thereby avoided. In addition, under the equal-opportunity doctrine the other shareholders receive the benefit of the original repurchase price which is a potential consideration for shareholders negotiating a corporate repurchase. Requiring an equal-opportunity offering in close corporation stock repurchases also eliminates the difficult burden of proof problems facing minority shareholders seeking to establish a breach of fiduciary duty, and prevents disputes over what constitutes a proper sale price for the stock. A problem would exist, however, if equal opportunity were carried to its extreme: posit a situation where a controlling shareholder negotiates the purchase by the corporation of all of his shares. An equal-opportunity offering to all other shareholders could lead to a de facto dissolution upon full acceptance by all shareholders. It has been suggested, however, that this possibility is all the more reason for not allowing the majority to liquidate its holdings by using corporate assets, and depleting an already limited market for close corporation shares, unless all shareholders are thereby given the same right, and consent to the sale. It seems unlikely that this scenario would occur and result in the corporation owning all of its shares. A controlling shareholder or group of shareholders facing

109 This device, often referred to as a shareholder's appraisal right, is often employed to provide protection for minority shareholders oppressed in the contexts of mergers, consolidations, and other extraordinary corporate matters. See Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 116-17, 460 P.2d 464, 477, 81 Cal. Rptr. 592, 605 (1969).

110 Since close corporation shares are rarely traded, and are not listed on organized exchanges, their value at any given time is difficult to determine. This is especially troublesome for estate and gift tax matters. On close corporation valuation generally, see F. BeBarr & D. Harnack, Valuation of Close Corporation Business (1972).


112 The possibility of proportionate distributions following a pro rata share repurchase highlights the tax disadvantages inherent in the equal-opportunity doctrine, which may impede its effectiveness as a remedy for minority shareholders. A redemption of stock will be taxed as a dividend to the shareholder unless it qualifies for sale or exchange treatment because it is not essentially equivalent to a dividend, substantially alters his proportionate interest, or completely terminates his interest. Int. Rev. Code of 1954, §§ 302(a)-(b), (d), 301(a), (c), 316. (Section 317 defines a redemption to include a purchase by a corporation of its shares to be held as treasury stock.) The biggest potential tax problem with the equal-opportunity doctrine as set forth in Donahue is that if all shareholders fully exercise their equal-opportunity rights pursuant to a less than complete redemption of a controlling shareholder's stock, the distribution by the corporation will by definition be proportional to all shareholders, and thus taxable to them as dividends. See Treas. Reg. § 1.302-2(b). This tax cost could deter shareholders from accepting the equal-opportunity offering when made to them by the corporation, and could also develop into a strong-arm bargaining weapon for majority and minority shareholders. See also Overman, Section 303 Stock Redemptions By Closely Held Corporations, 50 Notre Dame Law. 218 (1974).

this dilemma would probably be unable to dispose of all of their shares to the corporation in this manner if all the remaining shareholders had the intention of exercising their equal-opportunity rights, since the corporation would then be the unwitting owner of all of its own shares. In this situation, dissolution is the more likely result. If all shareholders wish to sell their holdings, there is no reason to continue the enterprise.

Given the advantages and disadvantages inherent in the equal-opportunity doctrine, was its application justified on the facts of *Donahue*? It is not entirely clear what motivated the plaintiff's discontent and compelled her to attempt to sell her shares. The court seemed more concerned with the potential for abuse, rather than the existence of actual oppression, and the holding was at least partially motivated by a desire to protect other shareholders in future cases. The only requirement that must be met to invoke equal opportunity is that controlling shareholders cause the corporation to purchase stock from a member of the controlling group. The court found that the Rodd family constituted a controlling group because they were a "close-knit [family] . . . with [a] strong community of interest." The stock repurchase from Rodd was therefore a breach of the newly defined fiduciary duty owed to the plaintiff, because Rodd was a member of the controlling group, and no equal opportunity to sell was offered to the other shareholders. An alternative approach would have been to find a breach of fiduciary duty in a more general sense, based on the facts of *Donahue*, and require equal opportunity as a remedy for this particular case. The court instead defined a close corporation shareholder's fiduciary duty to include the duty of offering equal opportunity, and then found a breach in the failure to so offer. As the court indicated, this means that in future cases one of the essential elements of a close corporation stock repurchase from controlling shareholders is an offering of an equal opportunity to sell to the other shareholders. Nothing less will satisfy the fiduciary duty standard. This broader technique of judicial legislation now applicable to all similar

114 The lower court indicated that operating losses began to occur in the years immediately following the purchase of Rodd's shares, but it is not certain that this was the plaintiff's primary reason for objecting to the share repurchase. *See Donahue v. Rodd Electrotype Co.,* App. Dec.—, 307 N.E.2d 8 (Mass. App. 1975).

115 The court was also concerned that full control of the corporation was being manipulated and solidified in Rodd's sons. *Mass. at—, 328 N.E.2d at 520 n.28.

116 *Id.* at —, 328 N.E.2d at 518.

117 *Id.* at —, 328 N.E.2d at 519.

118 *Id.* at —, 328 N.E.2d at 518.
fact patterns has the advantage of predictability, but if the holding is not sufficiently limited by either its terms or its implications, unwarranted extensions of the equal-opportunity doctrine may unduly hamper other corporate transactions.

The court qualified the equal-opportunity requirement by subjecting it to waiver by consent of all shareholders, either in the corporate by-laws, the articles of incorporation, or in an appropriate shareholder agreement. Whether this escape route will allow regular avoidance of equal opportunity is unclear, but those shareholders most susceptible to oppression by a close corporation stock repurchase are also those most likely to give uninformed advance consent. It seems, however, that valid corporate transactions will be able to use one or more of these qualifications to avoid rescission by failure to comply with Donahue. The decision in Donahue also limited the equal-opportunity requirement to close corporations as defined in the opinion. This limitation will effectively prevent the spread of the equal-opportunity doctrine to larger public-issue corporations for several reasons. The Donahue court framed its holding in terms of a requirement that directors or controlling shareholders, who cause the corporation to enter into stock repurchase agreements, act with utmost good faith and loyalty toward other shareholders. To meet this standard of duty, these individuals must cause the corporation to give other shareholders an equal opportunity to sell a ratable number of shares. In most public-issue corporations, the controlling shareholders will infrequently cause the corporation to purchase shares, because this is a management function traditionally

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119 Id. at —, 328 N.E.2d at 518 n.24. See Kessler, Share Repurchases Under Modern Corporation Laws, 28 FORDHAM L. REV. 637 (1959-60), where the requirement of equal opportunity in share repurchases is urged as a general proposition. Exempted from this requirement, according to the author, are justifiable transactions such as buy-sell agreements on the death or retirement of one of the shareholders, or other such arrangements designed to keep the corporation “close.” Presumably such arrangements could comply with Donahue if all shareholders consent in advance, or ratify subsequent to the transaction. As illustrated by Donahue, however, without such consent, an allegedly bona fide repurchase is subject to rescission at the behest of other shareholders. Therefore, planning for compliance with Donahue is now of paramount importance.

120 Note the bargaining leverage that Donahue gives by implication to minority shareholders. Perhaps the only answer to the obvious implications for the indirect minority veto power over repurchase transactions is that the minority shareholders are also subject to the test of utmost good faith and loyalty in their dealings with the majority.

121 —Mass. at —, 328 N.E.2d at 511. See notes 46-55 and accompanying text supra.

122 The Donahue court expressly left open the question of the applicability of its holding to other than close corporations. —Mass. at —, 328 N.E.2d at 511.

123 Id. at —, 328 N.E.2d at 518.
vested in the board of directors.\textsuperscript{124} If the directors happen to be controlling shareholders, the second half of the \textit{Donahue} test provides a means of avoiding the equal-opportunity requirement—shareholders in public-issue corporations are not held to as high a standard of fiduciary duty as shareholders in close corporations.\textsuperscript{125} Note that the equal-opportunity doctrine was derived from, and is a function of, fiduciary-duty standards. It is clear that the \textit{Donahue} court believed that equal opportunity was required on the facts, after completion of its two-step decisional methodology.\textsuperscript{126} Moreover, the advantage of the methodology employed by the court is that it is flexible, and it is feasible to find on other facts that equal opportunity is not required to meet the fiduciary-duty standards applicable to public-issue corporation, however that standard is verbalized. Finally, the holding requiring equal opportunity is limited to purchases from, and action by, members of the controlling group of stockholders, defined with reference to a community of interest. A community of interest was easy for the court to identify in \textit{Donahue}, since most of the defendants were members of the same family. As a corporation increases both in size and extent of public ownership, the danger of oppressive action by this type of a controlling group decreases.\textsuperscript{127}

In addition to the logic and verbalization of the \textit{Donahue} equal-opportunity holding, the fundamental rationale for the doctrine is another reason why the requirement will probably not spread to public-issue corporations. \textit{Donahue} revolves around the peculiarities of close corporations, the intimacy of the relationship between shareholders, the trust and confidence required for successful existence, and the legal problems facing shareholders outside the corporation. The standards of fiduciary duty are, and should be, different for the two types of corporations. The \textit{Donahue} court leaves open the question of the applicability of its holding to corporations other than close corporations,\textsuperscript{128} but the implication is that the differences

\textsuperscript{124} Close corporations are characterized by identity of ownership and management, whereas larger publicly-held corporations are not. See note 2 and accompanying text \textit{supra}.

\textsuperscript{125} See notes 69-70 and accompanying text \textit{supra}. The validity of this distinction as a basis for the court’s holding is debatable, but it does exist, and it allows a convenient method for judicial manipulation of the \textit{Donahue} doctrine. The court in \textit{Donahue} expressly contrasted the standards of fiduciary duties owed in publicly held and close corporations. —Mass. at —, 328 N.E.2d at 515-16.

\textsuperscript{126} See text accompanying note 95 \textit{supra}.

\textsuperscript{127} If a "controlling group" were to arise in a large public-issue corporation and institute oppressive action, traditional fiduciary-duty standards would afford relief. See notes 69-77 and accompanying text \textit{supra}.

\textsuperscript{128} —Mass. at—, 328 N.E.2d at 511.
between the two types of corporations will prevent the extension of the holding to public-issue corporations. Shareholders in public-issue corporations do not face as restricted a market as do shareholders in close corporations. Dissatisfied shareholders can readily liquidate their holdings in public markets, and although the price may not always be satisfactory, the market does exist. The administrative burden on a large public-issue corporation required to extend an offering to every shareholder whenever a stock repurchase is contemplated is a prohibitive factor, especially as the corporation’s financial structure increases in complexity. This practice could also have an undesirable effect on the securities market, where investors base their decisions on supply and demand price factors on listed exchanges. Finally, although a repurchase of shares by a public-issue corporation depletes liquid corporate assets in the same way as in a close corporation, there is not the corresponding decrease in an already limited market as in close corporations, since public-issue stockholders can still utilize outside markets. The key to preventing the spread of equal opportunity to public-issue corporations is the definitional control retained by the Donahue court, and the court has preserved enough flexibility to draw the line and require equal opportunity only for those close corporations that are indeed close and are hampered by a lack of marketability for their shares.

V
Other Implications

What are the ramifications of Donahue for other corporate transactions? Will the sale of shares by close corporations require equal opportunity, even in the absence of preemptive rights in the by-laws? The same logic would seem to apply: if buying from the majority oppresses the minority by contraction of the market, so does selling. By definition there is no market for the minority to buy shares in order to maintain proportionate control, and in Massachusetts stockholders do not have preemptive rights to acquire stock of the corporation unless provided by the articles of incorporation or the by-laws. Moreover, Donahue explicitly negated the suggestion that preemptive rights will be required where not provided by law. The court suggested instead that traditional

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129 To the extent that publicly-held corporations habitually make pro rata offers, the issue is somewhat academic. Cf. N.Y.S.E. Company Manual § A10.
130 See text accompanying note 46-55 supra.
132 —Mass. at—, 328 N.E.2d at 519 n.25.
fiduciary duties protect minority shareholders from dilution of control at the hands of the majority by self-serving stock issuances. Nevertheless, it is possible that the higher standard of fiduciary duty made applicable by Donahue to close corporations could be construed to require preemptive rights even where not mandated under traditional circumstances.

The real significance of Donahue lies in its support of the trend of recognizing the close corporation as a legal entity apart from public-issue corporations. By acknowledging the peculiarities and special characteristics inherent in close corporations, and providing relief for shareholders based on these distinctions, the court has helped to alleviate the identity crisis that plagues those close corporations forced to comply with a corporate law ill-suited to their internal operation. Furthermore, as courts become more willing to subject close corporation transactions to a higher degree of scrutiny and require a higher standard of fiduciary duty, shareholders will

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133 Id. at —, 328 N.E.2d at 519 n.25.

134 See Schwartz v. Marien, 37 N.Y.2d 487, 335 N.E.2d 334, 373 N.Y.S.2d 122 (1975), which affirmed a denial of plaintiff's motion for summary judgment in an action charging three directors of a corporation with a breach of fiduciary duty involving a sale of treasury stock. The plaintiff alleged that the directors violated their fiduciary duty by selling treasury shares to themselves and to two other corporate employees without offering her the opportunity to purchase a proportionate number of shares. Plaintiff tendered an offer to buy enough treasury shares from the corporation to maintain her proportionate control, but this offer was refused. The plaintiff alleged conspiracy and fraud on the part of the defendants to deprive her family of their proportionate holdings, and moved for summary judgment. In affirming a denial of this motion, the court noted that although shareholders in New York do not have preemptive rights to purchase treasury stock unless the articles of incorporation so provide, directors owe a "fiduciary responsibility . . . to treat all shareholders fairly and evenly." Id. at 491, 335 N.E.2d at 337, 373 N.Y.S.2d at 126. The court said that departure from a uniform treatment of stockholders (or, not offering an equal opportunity to buy) would be justified only by a bona fide business purpose, which the directors had the burden of proving. Id. at 492, 335 N.E.2d at 338, 373 N.Y.S.2d at 127. Even if such a bona fide purpose exists, the purpose must be such that it could not have been accomplished any other way than by a failure to make an equal-opportunity offering: [Plaintiff's recovery] would follow, . . . if it were found that the actions of the directors were not, in objective and accomplishment, in good faith furtherance of an independent, significant corporate purpose sufficient to override the obviously legitimate interest of plaintiff in retaining or regaining an equal 50% interest in the corporation and which purpose could not have been substantially accomplished by other means which would not have disturbed the equality of the two-family ownership.

Id. at 493, 335 N.E.2d at 338-39, 373 N.Y.S.2d at 128.

This case may imply that a strong showing of compliance with fiduciary duties is required before equal opportunity may be avoided in the sale of treasury stock, even in the absence of preemptive rights. See also Kessler, supra note 119, where Professor Kessler argues for equal opportunity in the resale of treasury shares. His reasons are similar to those advanced in the context of share repurchases: to protect shareholders from dissolution of the asset value of their shares. Kessler would make a "legitimate transaction" exception here for issuance of treasury shares pursuant to employee incentive plans.
receive more protection not only in stock repurchases, but also in other oppressive situations such as dividend withholdings, excessive salary payments, freeze-outs, and other breaches of fiduciary duty.

Conclusion

In *Donahue*, the Supreme Judicial Court of Massachusetts recognized by doctrinal innovation that close corporations have a distinct identity and distinct problems. By showing a willingness to accord close corporations the special treatment that they require, the court developed a standard of fiduciary duty for close corporation shareholders that will protect shareholders' rights in most situations. The court placed an added burden on close corporations by requiring equal opportunity to participate in close corporation stock repurchases, but it is a justifiable burden. By developing the equal-opportunity concept as an element of the fiduciary duty required in this particular context, the court preserved enough flexibility to prevent the unwarranted spread or misuse of the doctrine, and the strict standard of fiduciary duty will help alleviate other injustices perpetrated on close corporation shareholders by their compatriots.

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