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OF DONAHUE AND FIDUCIARY DUTY: MUCH ADO ABOUT . . . ?

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INTRODUCTION

In the landmark decision of *Donahue v. Rodd Electrottype Co.*, the Supreme Judicial Court of Massachusetts discussed the dangers faced by minority shareholders in closely held corporations, as well as the obstacles that such shareholders encounter in challenging oppressive conduct under traditional corporate law¹:

Although the corporate form provides . . . advantages for the stockholders (limited liability, perpetuity, and so forth), it also supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders. The minority is vulnerable to a variety of oppressive devices, termed “freeze-outs,” which the majority may employ. An authoritative study of such “freeze-outs” enumerates some of the possibilities: “The squeezers (those who employ the freeze-out techniques) may refuse to declare dividends; they may drain off the corporation’s earnings in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders . . . ; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders” In particular, the power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders.

The minority can, of course, initiate suit against the majority and their directors. Self-serving conduct by directors is proscribed by the director’s fiduciary obligation to the corporation. However, in practice, the plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors [G]enerally,

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1. See *Donahue v. Rodd Electrottype Co.*, 328 N.E.2d 505 (Mass. 1975).

plaintiffs who seek judicial assistance against corporate dividend or employment policies do not prevail.

Thus, when these types of “freeze-outs” are attempted by the majority stockholders, the minority stockholders, cut off from all corporation-related revenues, must either suffer their losses or seek a buyer for their shares [They] must liquidate [their] investment in the close corporation in order to reinvest the funds in income-producing enterprises.

At this point, the true plight of the minority stockholder in a close corporation becomes manifest. He cannot easily reclaim his capital. In a large public corporation, the oppressed or dissident minority stockholder 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. Majority “freeze-out” schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. When the minority stockholder agrees to sell out at less than fair value, the majority has won.²

To protect against this potential for abuse, the *Donahue* court concluded that shareholders in closely held corporations owed a fiduciary duty of “utmost good faith and loyalty”³ to each other:

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. In our previous decisions, we have defined the standard of duty owed by partners to one another as the “utmost good faith and loyalty.” Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict

2. *Id.* at 513-15 (alterations in original) (footnotes omitted) (quoting F.H. O’NEAL & J. DERWIN, *EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: “SQUEEZE OUTS”* 42 (1961)).

3. *Id.* at 515 (quoting *Cardullo v. Landau*, 105 N.E.2d 843, 845 (Mass. 1952)) (internal quotation marks omitted).

good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.⁴

Donahue played a significant role in spawning a new era of judicial activity⁵ that focused on providing protection to minority shareholders in closely held corporations from abusive majority conduct. *Donahue*'s influence in this "movement" has been far-reaching, as a number of courts outside of Massachusetts have also imposed a fiduciary duty between shareholders in closely held corporations.⁶ Indeed, due in no small part to decisions like *Donahue*, most jurisdictions have gradually come to recognize that closely held corporations and their publicly held counterparts, as well as the expectations of the shareholders in those ventures, are sufficiently distinct to warrant a different legal treatment.⁷

Unquestionably, *Donahue*'s legacy stems primarily from its recognition of the dangers faced by minority shareholders in closely held corporations. But did *Donahue* do more than simply call attention to the plight of the minority shareholder—did *Donahue* change the law? And if so, how? After *Donahue*, in other words,

4. *Id.* (footnote omitted) (citations omitted) (quoting *Cardullo*, 105 N.E.2d at 845).

5. That judicial activity was often aided by statute. As one authority observes, "Thirty-nine states have statutes providing for dissolution or other relief on the grounds of 'oppressive actions' (or similar term) by 'directors or those in control.'" DOUGLAS K. MOLL & ROBERT A. RAGAZZO, *THE LAW OF CLOSELY HELD CORPORATIONS* § 7.01[D][1][b], at 7-70 n.192 (2009) (citations omitted); *see also id.* at 7-163 to 7-181, fig. 7.1 (providing a fifty state chart on oppression statutes and their operative language).

6. *See, e.g.*, *Georgeson v. DuPage Surgical Consultants, Ltd.*, No. 05 CV 1653, 2007 WL 914219, at *6 (N.D. Ill. Mar. 22, 2007); *Guy v. Duff & Phelps, Inc.*, 672 F. Supp. 1086, 1090 (N.D. Ill. 1987); *Orchard v. Covelli*, 590 F. Supp. 1548, 1556-59 (W.D. Pa. 1984); *Melrose v. Capitol City Motor Lodge, Inc.*, 705 N.E.2d 985, 991 (Ind. 1998); *Evans v. Blesi*, 345 N.W.2d 775, 779 (Minn. Ct. App. 1984); *Fought v. Morris*, 543 So. 2d 167, 170-71 (Miss. 1989); *Whitehorn v. Whitehorn Farms, Inc.*, 195 P.3d 836, 843 (Mont. 2008); *I.P. Homeowners, Inc. v. Radtke*, 558 N.W.2d 582, 589 (Neb. Ct. App. 1997); *Walta v. Gallegos Law Firm, P.C.*, 40 P.3d 449, 456-57 (N.M. Ct. App. 2001); *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989); *A. Teixeira & Co. v. Teixeira*, 699 A.2d 1383, 1386-88 (R.I. 1997); *McLaughlin v. Schenck*, 220 P.3d 146, 150, 156 (Utah 2009); *Jorgensen v. Water Works, Inc.*, 582 N.W.2d 98, 104-06 (Wis. Ct. App. 1998); *see also Hollis v. Hill*, 232 F.3d 460, 468 (5th Cir. 2000) (noting that "[*Donahue*'s] recognition of special rules of fiduciary duty applicable to close corporations has gained widespread acceptance"); *Hoggett v. Brown*, 971 S.W.2d 472, 488 n.13 (Tex. App. 1997) (noting that "a majority shareholder's fiduciary duty ordinarily runs to the corporation," but stating that "in certain limited circumstances, a majority shareholder who dominates control over the business may owe such a duty to the minority shareholder" (citations omitted)).

7. *See supra* notes 5-6 and accompanying text.

was the law of fiduciary duty in closely held corporations different from what it was before under traditional corporate law?

The *Donahue* opinion itself suggests that it is changing the traditional law of fiduciary duty, as it contrasts the “strict good faith standard” that it announced with “the somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere in the discharge of their corporate responsibilities.”⁸ Unfortunately, other than generally emphasizing that the *Donahue* duty is “strict,” “more rigorous,” and “more exacting” than fiduciary duty under traditional corporate law,⁹ the *Donahue* opinion gives very little guidance on precisely what is different about the duty it articulates. Similarly, it is not clear how those differences should affect a judicial inquiry beyond the vague notion that the analysis should be more rigorous. Although the later *Wilkes v. Springside Nursing Home, Inc.* decision refined the *Donahue* framework by introducing a legitimate business purpose inquiry, the *Wilkes* court largely reaffirmed the core fiduciary duty holding of *Donahue* without further elaborating on the differences between the *Donahue* duty and fiduciary duty generally.¹⁰

This Article seeks to articulate precisely how *Donahue* and its progeny changed the law of fiduciary duty in closely held corporations. Surprisingly, some of the changes that *Donahue* is credited with may not be changes in corporate law at all, while other changes suggested by *Donahue* (and acted on by later cases) deserve more attention.

Part I argues that certain changes in the law that *Donahue* is credited with are not really changes at all. Traditional corporate law, in other words, already provides a shareholder-to-shareholder fiduciary duty, imposes that duty on the minority in certain circumstances, and regulates the disproportionate award of de facto dividends. Moreover, *Donahue*'s partnership analogy does not effectuate a change in the law, as neither *Donahue* nor traditional corporate law would allow partnership principles to apply in toto to closely held corporation disputes.

Part II asserts that the real changes in the law brought about by *Donahue* are the protections provided to employment and management rights even in the absence of de facto dividends, and the dilu-

8. *Donahue*, 328 N.E.2d at 515-16 (footnote omitted).

9. *Id.*

10. See *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 661-63 (Mass. 1976); see also *infra* notes 11, 71 (discussing *Wilkes*).

tion of business judgment rule deference in the closely held setting. Traditional corporate law does not consider employment and management interests to be part of one's rights as a shareholder. Further, the business judgment rule ordinarily makes it especially difficult to challenge majority conduct that is harmful to those interests. By providing protection to employment and management rights and significant scrutiny of majority decisions that affect those rights, *Donahue* and its progeny did change the law in ways that benefit minority investors in closely held corporations.¹¹

I. DONAHUE'S CHANGES: MUCH ADO ABOUT . . . NOTHING

A. *The Shareholder-to-Shareholder Fiduciary Duty*

To whom are fiduciary duties owed? Under traditional corporate law, fiduciary duties are conventionally viewed as running to

11. In applying the fiduciary duty of utmost good faith and loyalty, the *Donahue* court also announced an accompanying "equal opportunity" rule:

[I]f 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. Purchase by the corporation confers substantial benefits on the members of the controlling group whose shares were purchased. These benefits are not available to the minority stockholders if the corporation does not also offer them an opportunity to sell their shares. The controlling group may not, consistent with its strict duty to the minority, utilize its control of the corporation to obtain special advantages and disproportionate benefit from its share ownership.

Donahue, 328 N.E.2d at 518 (footnote omitted). This Article does not consider the equal opportunity rule to be a change in the law because, soon after the *Donahue* opinion was rendered, Massachusetts effectively abandoned the rule. In *Wilkes*, the Massachusetts Supreme Judicial Court reaffirmed the *Donahue* fiduciary duty, but scaled back the accompanying equal opportunity standard. *See Wilkes*, 353 N.E.2d at 663. In its place, the court articulated an oppression framework that effectively permits unequal treatment between controlling and minority shareholders so long as: (1) a legitimate business purpose exists for such unequal treatment; and (2) there is no alternative course of action less harmful to the minority's interest. *See id.*; *see also* Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 296 (1986) ("The court in *Wilkes* inquired into the business purpose of the conduct at issue Thus the court effectively repudiated the equal opportunity rule of *Donahue*."). Moreover, a number of courts outside of Massachusetts have rejected the equal opportunity aspect of *Donahue*. *See, e.g.*, *Toner v. Baltimore Envelope Co.*, 498 A.2d 642, 647-54 (Md. 1985); *Delahoussaye v. Newhard*, 785 S.W.2d 609, 611-12 (Mo. Ct. App. 1990); *see also Nixon v. Blackwell*, 626 A.2d 1366, 1376 (Del. 1993) ("It is well established in our jurisprudence that stockholders need not always be treated equally for all purposes."). The language of some opinions, however, still seems to embrace the equal opportunity rule. *See, e.g.*, *Crosby*, 548 N.E.2d at 221 ("Majority or controlling shareholders breach such fiduciary duty to minority shareholders when control of the close corporation is utilized to prevent the minority from having an equal opportunity in the corporation." (citations omitted)).

the corporation (or to the shareholders collectively), but not to an individual shareholder.¹² As a consequence, a minority shareholder can have difficulty challenging, for example, a termination of employment or a removal from management on traditional fiduciary duty grounds, as a court usually requires that harm to the corporation be shown, rather than harm merely to the minority shareholder.¹³ By holding that shareholders in a closely held corporation “owe one another” a fiduciary duty, however, courts such as *Donahue* change the principal focus of a fiduciary duty analysis to an individual shareholder.¹⁴ A plaintiff shareholder can emphasize the harm that he (rather than the corporation) has suffered, and the

12. See, e.g., *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (observing that “directors’ duties of loyalty and care run to the corporation, not to individual shareholders or even to a majority of the shareholders”); *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App. 1997) (“A director’s fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.”); *id.* at 488 n.13 (“We note that a majority shareholder’s fiduciary duty ordinarily runs to the corporation.”); *Faour v. Faour*, 789 S.W.2d 620, 621-22 (Tex. App. 1990) (“A corporate officer owes a fiduciary duty to the shareholders collectively, i.e. the corporation, but he does not occupy a fiduciary relationship with an *individual* shareholder, unless some contract or special relationship exists between them in addition to the corporate relationship.”); *McLaughlin v. Schenck*, 220 P.3d 146, 153 (Utah 2009) (“Under the revised business code, directors and officers are required to carry out their corporate duties in good faith, with prudent care, and in the best interest of the corporation. These corporate duties have been interpreted to coincide with the common law understanding that officers and directors owe these duties to the corporation and shareholders collectively, not individually.” (citation omitted)); *Lynch v. Patterson*, 701 P.2d 1126, 1136 (Wyo. 1985) (“The duty of the directors . . . is a duty to the corporation and not a duty to the stockholder instituting the action.”); J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 12 & n.30 (1977) (mentioning the traditional view that duties run “solely between the majority and the corporation,” and observing that “[t]he notion that the fiduciary obligations of management run only to the corporation provides the minority in close corporations virtually no protection against oppression and exploitation by the control group”).

13. See Hetherington & Dooley, *supra* note 12, at 12 (“[C]ourts undoubtedly . . . have been influenced by traditional common law attitudes emphasizing . . . proof of harm to the corporation, as distinguished from the interests of individual shareholders.”); *cf. Donahue*, 328 N.E.2d at 513 & n.14 (noting, while discussing traditional fiduciary duty principles, that “in practice, the plaintiff will find difficulty in challenging dividend or employment policies,” and observing that “[i]t would be difficult for the plaintiff in the instant case to establish breach of a fiduciary duty owed to the corporation, as indicated by the finding of the trial judge” (emphasis added)).

14. See *Donahue*, 328 N.E.2d at 515. Indeed, the court found that the shareholder-to-shareholder fiduciary duty was breached, even though the court did not disagree with the trial court’s finding that the stock repurchase was fair to the corporation. See *id.* at 519 (“Although the purchase price for the controlling stockholder’s shares may seem fair to the corporation and other stockholders . . . the controlling stockholder whose stock has been purchased has still received a relative advantage over his fellow stockholders, inconsistent with his strict fiduciary duty.” (citation omitted)).

action can be brought directly without having to comply with derivative lawsuit requirements.¹⁵

While *Donahue* has been credited with contributing to this legal development, the notion of a shareholder-to-shareholder fiduciary duty is not unique to *Donahue* and its progeny. Under traditional corporate law, a number of judicial decisions speak of a duty owed by the majority to the minority in the controlling shareholder context.¹⁶ Even Delaware—a jurisdiction that has explicitly rejected special common law rules for minority shareholders in closely held corporations¹⁷—has judicial decisions indicating that controlling shareholders owe fiduciary duties directly to individual

15. See, e.g., *Joseph v. Koshy*, No. 01-98-01432-CV, 2000 WL 124685, at *4 (Tex. App. Feb. 3, 2000) (stating that plaintiff minority shareholders' allegations of oppression and breach of fiduciary duty "were individual [actions] and did not belong to the corporation," and concluding, as a result, that compliance with derivative lawsuit requirements was unnecessary); *id.* (noting that plaintiff minority shareholders alleged "breach of a fiduciary duty owed to them," and stating that "[c]ourts have recognized minority shareholders' individual causes of action for oppressive conduct and breach of fiduciary duty" (emphasis added)).

16. See, e.g., *S. Pac. Co. v. Bogert*, 250 U.S. 483, 487-88 (1919) (noting that "[t]he majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority . . ."); *In re Reading Co.*, 711 F.2d 509, 512-13, 520 (3d Cir. 1983) (concluding, in a lawsuit by a minority shareholder (Reading Company) for breach of fiduciary duty, that "neither the directors nor the majority shareholders of [the corporation] have breached their fiduciary duty to Reading"); *Riblet Prods. Corp. v. Nagy*, 683 A.2d 37, 40 (Del. 1996) ("To be sure, the Majority Stockholders may well owe fiduciary duties to Nagy [a single shareholder] as a minority stockholder."); *Yiannatsis v. Stephanis*, 653 A.2d 275, 279 & n.3, 280 (Del. 1995) (noting that Demos and Stella were controlling shareholders of the corporation and that John was a minority shareholder, and stating that "Demos and Stella had a fiduciary duty to [John] as an individual as well as their fiduciary duty to the corporation"); see also *Byelick v. Vivadelli*, 79 F. Supp. 2d 610, 623-25 (E.D. Va. 1999) (noting that the rule that a director's fiduciary duty runs to the shareholders as a class rather than to an individual shareholder is appropriate for the publicly held corporation, but acknowledging that "closely-held corporations raise a different set of concerns [:] . . . it is reasonable to conclude that, if faced with the question whether a minority shareholder of a closely held corporation has a cognizable claim against an inside director for breach of fiduciary duty in respect of a corporate transaction which benefits the inside director, the Supreme Court of Virginia would hold in the affirmative, particularly where, as here, there is only one minority shareholder").

17. See, e.g., *Nixon v. Blackwell*, 626 A.2d 1366, 1379-81 (Del. 1993); see also *Clemmer v. Cullinane*, 815 N.E.2d 651, 652 (Mass. App. Ct. 2004) ("That [*Nixon*] decision—in 'very forceful dicta'—declined to adopt the heightened fiduciary duty of 'utmost good faith and loyalty' our courts have found applicable to close corporations. Rather, the court declared that no 'special judicially-created rules' would be recognized to protect minority shareholders in closely held corporations." (footnotes omitted) (quoting *Nixon*, 626 A.2d at 1380-81)). See generally MOLL & RAGAZZO, *supra* note 5, § 7.01[D][2], at 7-108 to 7-119 (discussing *Nixon*).

minority shareholders.¹⁸ At least with respect to minority shareholders challenging the actions of a controlling shareholder or controlling group, therefore, decisions like *Donahue* seem unnecessary to establish a direct, shareholder-centered cause of action.

B. *A Duty for Everyone, Including the Minority*

Perhaps the change in the law brought about by *Donahue* and similar cases is the fact that minority shareholders may also owe a fiduciary duty. Traditional corporate law accepts that controlling shareholders owe fiduciary duties, but whether minority shareholders owe similar duties is less clear. In *Donahue*, however, the court explicitly stated that “[w]e do not limit our holding to majority stockholders,” and it noted that, “[i]n the close corporation, the minority may do equal damage through unscrupulous and improper ‘sharp dealings’ with an unsuspecting majority.”¹⁹

While the notion that *Donahue* changed the law by imposing a fiduciary duty on minority shareholders is promising, there are two complications. First, presumably a minority shareholder would not be subject to a fiduciary duty analysis unless the minority possessed the power to cause harm to the corporation or the other shareholders. The possession of such power, however, would likely cause a court to characterize the minority as a de facto controlling shareholder—at least with respect to the activities that the minority does have the power to control.²⁰ Even without the *Donahue* holding, in other words, traditional corporate law might be sufficiently pliable to allow a court to impose a fiduciary duty on a minority share-

18. See *supra* note 16.

19. *Donahue*, 328 N.E.2d at 515 n.17; see, e.g., *A.W. Chesterton Co. v. Chesterton*, 128 F.3d 1, 3, 6 (1st Cir. 1997) (concluding that a minority shareholder breached his fiduciary duty by threatening to transfer his shares in a manner that would have destroyed the S-corporation status of the company); see also *Zimmerman v. Bogoff*, 524 N.E.2d 849, 853 (Mass. 1988) (noting that “[t]he protections of *Donahue* are not limited to those with less than 50% share ownership,” and stating that “fiduciary obligations may arise regardless of percentage of share ownership”); *Whitehorn v. Whitehorn Farms, Inc.*, 195 P.3d 836, 843 (Mont. 2008) (noting that “fiduciary duties run between all shareholders, not just from majority shareholders to minority shareholders”).

20. See, e.g., *Smith v. Atl. Props.*, 422 N.E.2d 798, 799, 802 (Mass. App. Ct. 1981) (involving a 25% minority shareholder who possessed a veto power pursuant to an 80% supermajority provision: “The 80% provision may have substantially the effect of reversing the usual roles of the majority and the minority shareholders. The minority, under that provision, becomes an ad hoc controlling interest”).

holder under the “controlling” shareholder precedents. The matter, however, is not free from doubt.²¹

Second, it is not clear that other jurisdictions have followed this part of the *Donahue* holding.²² Many of the non-Massachusetts courts imposing a fiduciary duty between shareholders in closely held corporations speak of a duty owed by the majority or controlling shareholder to the minority shareholders.²³ While such state-

21. *See, e.g.*, *Merner v. Merner*, 129 Fed. App'x 342, 342-44 (9th Cir. 2005) (allowing a minority shareholder in a closely held corporation to transfer shares in a manner that destroyed the S-corporation status of the company, and concluding that a minority shareholder in a closely held corporation owes no special fiduciary duties); *cf. Hunt v. Data Mgmt. Res., Inc.*, 985 P.2d 730, 732-33 (Kan. Ct. App. 1999) (allowing a minority shareholder in a closely held corporation to transfer shares in a manner that destroyed the S-corporation status of the company, and noting that “[t]he law does not impose a strict fiduciary duty on a shareholder to act in the best interests of the corporation; a shareholder is free to act in his or her own self-interest”).

22. It is not clear, in other words, that the law, at least outside of Massachusetts, has changed on this point.

23. *See, e.g.*, *Guy v. Duff & Phelps, Inc.*, 672 F. Supp. 1086, 1090 (N.D. Ill. 1987) (stating that “the majority shareholder of a closely-held corporation clearly has a fiduciary responsibility to the other shareholders” (citation omitted)); *Orchard v. Covelli*, 590 F. Supp. 1548, 1556 (W.D. Pa. 1984) (discussing “the majority’s fulfillment of its fiduciary duty to the other shareholders”); *Fought v. Morris*, 543 So. 2d 167, 171 (Miss. 1989) (concluding that “in a close corporation where a majority stockholder stands to benefit as a controlling stockholder, the majority’s action must be ‘intrinsically fair’ to the minority interest”); *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989) (“Generally, majority shareholders have a fiduciary duty to minority shareholders.”); *Hoggett v. Brown*, 971 S.W.2d 472, 488 n.13 (Tex. App. 1997) (noting that “a majority shareholder’s fiduciary duty ordinarily runs to the corporation,” but stating that “in certain limited circumstances, a majority shareholder who dominates control over the business may owe such a duty to the minority shareholder”); *Jorgensen v. Water Works, Inc.*, 582 N.W.2d 98, 105 (Wis. Ct. App. 1998) (“Courts in other jurisdictions that, like Wisconsin, recognize a claim for breach of fiduciary duty by directors and majority shareholders to minority shareholders have permitted such claims in circumstances factually similar to those alleged here.”).

Like *Donahue*, other cases speak of a fiduciary duty owed between shareholders in closely held corporations. Unlike *Donahue*, however, these cases do not include language explicitly imposing this duty upon minority shareholders. Moreover, the fact patterns do not involve minority shareholder defendants. *See, e.g.*, *Georgeson v. DuPage Surgical Consultants, Ltd.*, No. 05 CV 1653, 2007 WL 914219, at *6 (N.D. Ill. Mar. 22, 2007) (stating that “[s]hareholders in a close corporation owe a fiduciary duty to deal fairly, honestly, and openly with each other,” but involving alleged misconduct by the controlling shareholders); *Melrose v. Capitol City Motor Lodge, Inc.*, 705 N.E.2d 985, 987 & n.3, 991 (Ind. 1998) (stating that “we have held that ‘shareholders in a close corporation stand in a fiduciary relationship to each other, and as such, must deal fairly, honestly, and openly with the corporation and with their fellow shareholders,’” but involving alleged misconduct by a 50% shareholder (quoting *Barth v. Barth*, 659 N.E.2d 559, 561 (Ind. 1995))); *Evans v. Blesi*, 345 N.W.2d 775, 777-80 (Minn. Ct. App. 1984) (stating that “Blesi and Evans were partners in a closely held corporation,” that “the relationship between them was fiduciary,” and that “[t]he law imposes on each the highest standard of integrity in their dealings with each other,” but involving alleged mis-

ments do not preclude a finding that a minority shareholder also owes a fiduciary duty, the explicitness of the proposition in *Donahue* is not usually present in these other opinions.²⁴

C. *The Policing of De Facto Dividends*

It could be argued that *Donahue* changed the law by signaling a willingness to provide greater judicial assistance to shareholders challenging dividend or employment policies. After mentioning that “[s]uch policies are considered to be within the judgment of the directors,” and after observing that, “generally, plaintiffs who seek judicial assistance against corporate dividend or employment policies do not prevail,” the court then imposed its duty of utmost good faith and loyalty.²⁵ The juxtaposition of problem and apparent solution suggests that the court meant for the *Donahue* duty to provide greater judicial scrutiny of majority dividend and employment decisions than traditional corporate law would provide.

While there is something to the notion that *Donahue* altered the traditional business judgment rule discretion afforded to man-

conduct by a 50% shareholder who later became a controlling shareholder); *McLaughlin v. Schenck*, 220 P.3d 146, 151, 156, 158 (Utah 2009) (concluding that “shareholders in closely held corporations owe their coshareholders fiduciary obligations,” but involving alleged misconduct by a controlling shareholder).

Other cases indicate that a fiduciary duty is imposed upon minority shareholders by (1) explicit language saying as much and/or (2) fact patterns involving minority shareholder defendants. *See, e.g., Whitehorn*, 195 P.3d at 843 (noting that “fiduciary duties run between all shareholders, not just from majority shareholders to minority shareholders,” but involving a claim against majority shareholders); *I.P. Homeowners, Inc. v. Radtke*, 558 N.W.2d 582, 589, 591-92 (Neb. Ct. App. 1997) (stating that “[s]hareholders in a close corporation owe one another the same fiduciary duty as that owed by one partner to another in a partnership,” and imposing a fiduciary duty on a minority shareholder who usurped a corporate opportunity); *A. Teixeira & Co. v. Teixeira*, 699 A.2d 1383, 1386-87 (R.I. 1997) (stating that “[t]oday we conclude on the basis of the small number of shareholders in plaintiff corporation, the active participation by these shareholders in management decisions, and their close and intimate working relations, that the shareholders of plaintiff corporation, by acting as if they were partners, thus assumed a fiduciary duty toward one another and their corporation,” and imposing that duty on two minority shareholders who allegedly usurped a corporate opportunity); *cf. Walta v. Gallegos Law Firm, P.C.*, 40 P.3d 449, 456, 458 (N.M. Ct. App. 2001) (noting that “some courts have explicitly recognized that the [fiduciary] duty extends to minority shareholders in close corporations,” but stating that “[i]n adopting the Massachusetts approach, we are clearly aligning ourselves with the line of cases which impose a high duty of candor and good faith when majority shareholders are dealing with minority shareholders”).

24. *See supra* note 23 and accompanying text.

25. *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 513-15 (Mass. 1975) (footnote omitted).

agers over internal business matters,²⁶ the claim should not be overstated. Dividend and employment policies are frequently used to deny a minority investor his proportionate share of the distributed profits of the company. When used in this manner, however, traditional corporate law is available to remedy the misconduct.

For example, it is common for a closely held corporation to distribute its earnings to shareholders in the form of employment-related compensation rather than in the form of dividends.²⁷ Many closely held corporations, in other words, distribute profit to shareholders not as “true” dividends but as “de facto” dividends—i.e., dividends disguised, for tax purposes, as employment-related compensation.²⁸ So long as all of the stockholders are receiving their proportionate share of any de facto dividends, the presence of such dividends is largely unobjectionable.²⁹ When a controlling share-

26. See *infra* Part II.B.

27. When calculating its taxable income, a closely held corporation can deduct reasonable salaries paid to its employees to decrease the amount of income tax that the company pays. See 26 U.S.C. § 162(a)(1) (2006) (stating that “a reasonable allowance for salaries or other compensation for personal services actually rendered” is deductible). A closely held corporation cannot, however, deduct any dividends paid to its shareholders. Robert B. Thompson, *Corporate Dissolution and Shareholders’ Reasonable Expectations*, 66 WASH. U. L. Q. 193, 197 n.12 (1988). As a consequence, corporate income paid as dividends is subject to double taxation—once as business income at the corporate level, and once as personal income at the shareholder level. *Id.* As a result of the tax-disadvantaged nature of dividends, many closely held corporations forego “true” dividends and instead provide a return to shareholders via salary and other employment-related benefits. See, e.g., *Landorf v. Glottstein*, 500 N.Y.S.2d 494, 499 (Sup. Ct. 1986) (stating that, in a closely held corporation, “dividends are often provided by means of salaries to shareholders”); *Hirschhorn v. Severson*, 319 N.W.2d 475, 477 (N.D. 1982) (“[T]he corporation paid no dividends Rather, the corporate directors distributed the profits via salary increases, bonuses, and benefits.”). It should be noted that the impact of the double tax is ameliorated by the fact that qualifying dividends (as well as long-term capital gains) are presently taxed at a 15% rate, which is lower than the highest rates applicable to salary and other forms of ordinary income. See IRS.GOV, <http://www.irs.gov/publications/p17/ch08.html> (last visited Mar. 31, 2011). Unless extended, the current 15% rate is set to expire at the end of 2010. *Tax Cuts Set to Expire at the End of 2010: What This May Mean for Investors* (Sept. 28, 2010), available at <https://admin.emeraldconnect.com/files/44735/Janney%20Tax%20Sunsetting.pdf>.

28. See *supra* note 27.

29. While perhaps unobjectionable to the shareholders, such de facto dividends are objectionable to the Internal Revenue Service (IRS). The IRS often sues to disallow the deduction of “unreasonable” amounts of compensation. When the IRS is successful, the amount of compensation that exceeds a “reasonable” amount is treated as a dividend and is not deductible from the corporation’s income. See, e.g., *Eberl’s Claim Serv., Inc. v. Comm’r of Internal Revenue*, 249 F.3d 994, 996, 1004 (10th Cir. 2001) (affirming a determination that a portion of a taxpayer’s salary constituted “disguised dividend payments that should have been subject to taxation”); *Rapco, Inc. v. Comm’r of Internal Revenue*, 85 F.3d 950, 955-56 (2d Cir. 1996) (upholding a determination that an officer’s salary was excessive).

holder terminates the minority's employment in a corporation where profits are distributed solely via salary, however, the termination often results in the controlling shareholder continuing to receive de facto dividends while the minority is denied his proportionate share.³⁰ This is problematic, as a de facto dividend is still a dividend and, like all dividends, it must ordinarily be paid on an equivalent, per-share basis.³¹ Such a non-uniform declaration of dividends is impermissible and even traditional corporate law—with its business judgment rule deference—would not protect it.³²

30. See, e.g., *Landorf*, 500 N.Y.S.2d at 499 (“In a close corporation, since dividends are often provided by means of salaries to shareholders, loss of salary may be the functional equivalent of the denial of participation in dividends.”); see also *Nagy v. Riblet Prods. Corp.*, 79 F.3d 572, 577 (7th Cir. 1996) (“Many closely held firms endeavor to show no profits (to minimize their taxes) and to distribute the real economic returns of the business to the investors as salary. When firms are organized in this way, firing an employee is little different from canceling his shares.” (emphasis added)).

31. See, e.g., *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270, 277 (Alaska 1980) (“Courts have not allowed the form of the transaction to prevent tax liability when the transaction is in substance a distribution of dividends. We think a similar analysis should apply to payments which exclude some shareholders in a closely held corporation. Such transactions should be examined to determine whether they are in fact a distribution of dividends, and if so the excluded shareholder must participate equally in the payments received by other shareholders.” (footnote omitted) (citation omitted)); *Leslie v. Boston Software Collaborative, Inc.*, No. 010268BLS, 2002 WL 532605, at *9 (Mass. Super. Ct. Feb. 12, 2002) (“What must not be done is to make payments only to the majority shareholders, payments having different names or styles but being in reality dividends.”).

32. See, e.g., *Cratty v. Peoria Law Library Ass'n*, 76 N.E. 707, 708 (Ill. 1906) (“Dividends among stockholders of the same class must always be equal and without discrimination”); *Toner v. Baltimore Envelope Co.*, 498 A.2d 642, 645 (Md. 1985) (“We have said that a corporation in making a dividend . . . has no power to discriminate between its stockholders [of the same class].” (alteration in original) (citation omitted) (internal quotation marks omitted)); see also *In re Reading Co.*, 711 F.2d 509, 519 (3d Cir. 1983) (noting that “ordinarily . . . dividends must be apportioned among the shareholders pro rata to their several holdings”); *In re Sealand Corp. S'holders Litig.*, 642 A.2d 792, 799 (Del. Ch. 1993) (noting the “uncontroversial proposition” that “all shares of the same type, series, or class are, by definition, equal”). As the *Sealand* court observed:

It has long been acknowledged that absent an express agreement or statute to the contrary, all shares of stock are equal. Flowing from that premise is the rule that all shares of the same class or series are equally entitled to share in the profits of the corporation and in the distribution of its assets on liquidation.

Id. at 799 n.10 (citations omitted).

As the above citations suggest, the business judgment rule would not prevent a court from granting relief if only certain shareholders received dividends. Such conduct would likely be viewed as fraud, bad faith, or irrational conduct—all of which would preclude application of the rule. See, e.g., Ralph A. Peebles, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 NOTRE DAME L. REV. 456, 471 & n.18 (1985) (“If only certain shareholders received dividends, the business judgment

Simply put, disputes involving de facto dividends are relatively easy to resolve. After all, these disputes typically involve a controlling shareholder who takes a disproportionate amount of the company's profit. Such conduct is clearly unlawful, and it can be characterized as unlawful in a number of different ways—e.g., fraud on the minority investors, bad faith to the minority investors, an illegal dividend to the majority, or plain and simple theft by the majority.³³ Thus, the existence of a *Donahue* duty is not needed to trigger liability in de facto dividend disputes, even when those disputes involve employment issues. If dividends are distributed in a disproportionate manner through employment, related-party contracts, or any other manner, such conduct is antithetical to the pro rata nature of a dividend and is illegal under traditional corporate law principles.³⁴

To be clear, one can credit *Donahue* with recognizing that employment in a closely held corporation is often a vehicle for distributing de facto dividends.³⁵ This recognition is an important contribution. My point is simply that traditional corporate law already prohibits disproportionate dividends, and the de facto nature of the dividends should make no difference. Thus, while *Donahue*'s recognition of the employment-as-disguised-dividends problem is important, the *Donahue* duty is not needed to regulate the problem.

D. *The Application of Partnership Principles*

As part of its rationale for imposing a shareholder-to-shareholder fiduciary duty, the *Donahue* court discussed the similarities between the closely held corporation and the partnership.³⁶ According to the court, “[m]any close corporations are ‘really partner-

rule would not bar a court from granting relief to the excluded shareholders. . . . Such conduct would presumably lack the ‘rational basis’ required for the invocation of the business judgment rule. It would also strongly indicate [a] lack of good faith.”); *see also infra* note 68 and accompanying text. As mentioned, because employment is often the vehicle for distributing profits in a closely held corporation, the termination of a minority shareholder's employment can be a mechanism for the majority to appropriate a disproportionate share of the company's income stream to itself. In such circumstances, the termination would likely be viewed as tainted by a conflict of interest, which would also preclude the application of the business judgment rule. *See infra* note 68 and accompanying text.

33. *See supra* note 32 and accompanying text.

34. *See supra* notes 31-32 and accompanying text.

35. *See Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 513-14 (Mass. 1975).

36. *See id.* at 512-15.

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ships, between two or three people who contribute their capital, skills, experience and labor.’”³⁷ Similarly, the court observed that “[c]ommentators and courts have noted that the close corporation is often little more than an ‘incorporated’ or ‘chartered’ partnership.”³⁸ Perhaps the legal change effectuated by *Donahue*, therefore, is that it provides doctrinal authority for courts to incorporate partnership principles into closely held corporation disputes.³⁹

Such an interpretation of *Donahue*, however, is erroneous. The *Donahue* court was not arguing for the wholesale application of partnership principles to the closely held corporation. The court analogized to partnerships simply to impose a partnership-like owner-to-owner fiduciary duty.⁴⁰ Other aspects of partnership law that might have been helpful to the plaintiff—e.g., the more liberal dissolution rules, or the granting of a right to participate in the management of the business⁴¹—were not imported. This strongly suggests that the *Donahue* court did not intend to hold that partnership law applies in toto to closely held corporation disputes. As further evidence, in the later decision of *Wilkes v. Springside Nursing Home, Inc.*, the Massachusetts Supreme Judicial Court confronted the issue of whether a minority shareholder could be removed from the management of a closely held corporation.⁴² The court granted relief to the plaintiff minority without even referencing a partner’s right to participate in the management of the business.⁴³ Finally, in the recent decision of *Brodie v. Jordan*, the Supreme Judicial Court addressed the propriety of a buyout award in a closely held corporation dispute.⁴⁴ The court’s analysis does not even mention the right under partnership law to a buyout or dissolution upon the dissociation of a partner from the business.⁴⁵

37. *Id.* at 512 (quoting *Kruger v. Gerth*, 210 N.E.2d 355, 356 (N.Y. 1965) (Desmond, C.J., dissenting)).

38. *Id.*

39. I have had several conversations with practicing attorneys who read *Donahue* and similar precedents as authority for precisely this point.

40. See REVISED UNIF. P’SHP ACT § 404 (1997) (imposing fiduciary duties on a partner that he owes to the partnership “and the other partners”). As discussed, it is not clear that an analogy to partnership law was necessary to impose this duty. Under traditional corporate law, a number of judicial decisions speak of a duty owed by the majority to the minority in the controlling shareholder context. See *supra* Part I.A.

41. See REVISED UNIF. P’SHP ACT §§ 401(f), 801.

42. *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

43. *Id.* at 661-65.

44. *Brodie v. Jordan*, 857 N.E.2d 1076 (Mass. 2006).

45. *Id.* at 1080-82.

Thus, it is simply inaccurate to read *Donahue* for the proposition that partnership law applies in its entirety to closely held corporation disputes.⁴⁶

Importing the entirety of partnership law into the closely held corporation setting is unwise from a policy standpoint as well. While courts such as *Donahue* suggest that shareholders form a corporation for its limited liability protection but otherwise wish to be treated as partners, that suggestion is questionable. Perhaps the shareholders chose a corporation to avoid the default agency provisions of the partnership structure.⁴⁷ Perhaps they chose a corporation to eliminate the ability of one owner to veto extraordinary business decisions.⁴⁸ Simply put, shareholders in closely held corporations may have chosen a corporation for various reasons; as a result, a wholesale application of partnership law may be just as likely to defeat their expectations as it is to meet them.⁴⁹

46. In the previous three sections, the focus of my argument is that *Donahue* did not change the law because the same result would be reached under traditional corporate law principles. See *supra* Part I.A-C. In this section, the focus of my argument is different—*Donahue* did not change the law because the purported change is premised on an erroneous interpretation of the decision.

47. See REVISED UNIF. P'SHIP ACT § 301 (1997).

48. See *id.* § 401(j).

49. As Professors Easterbrook and Fischel have observed:

The participants incorporated for a reason. Perhaps the reason was only limited liability or favorable tax treatment, and in all other respects they wanted to be treated like partners. But this is not the only possibility. Corporate law is different from partnership law in many ways, and the venturers may desire to preserve these differences. Partners, for example, are entitled to share equally in the profits and management of the partnership, are mutual agents for each other, have the right to veto any decisions made by the majority on matters outside the ordinary course of business, and have the right to dissolve the partnership at any time if they are willing to bear the consequences. Corporate law treats each of these differently. Proponents of the partnership analogy assume that participants in closely held corporations are knowledgeable enough to incorporate to obtain the benefits of favorable tax treatment or limited liability but ignorant of all other differences between corporate and partnership law. There is no support for this assumption once you realize that people have to jump through a lot of formal hoops (assisted by counsel) to incorporate but could become partners by accident.

Easterbrook & Fischel, *supra* note 11, at 298 (footnotes omitted); cf. Bagdon v. Bridgestone/Firestone, Inc., 916 F.2d 379, 384 (7th Cir. 1990) (“Corporations are *not* partnerships. Whether to incorporate entails a choice of many formalities. Commercial rules should be predictable; this objective is best served by treating corporations as what they are, allowing the investors and other participants to vary the rules by contract if they think deviations are warranted.”).

II. DONAHUE’S CHANGES: MUCH ADO ABOUT . . . SOMETHING (AND IMPORTANT SOMETHING(S) AT THAT)

A. The Protection of Employment and Management Rights

Even if a fiduciary duty analysis under traditional corporate law focuses on an individual shareholder,⁵⁰ that analysis is implicated only when majority conduct affects shareholder rights.⁵¹ Employment and management positions with a corporation, however, are not traditionally viewed as part of one’s rights as a shareholder. In fact, stock ownership and employment/management benefits are largely viewed as unrelated in the publicly held setting.⁵² This helps to explain why terminations of employment and removals from management positions—two primary components of a classic freeze-out—rarely invoke corporate law scrutiny in publicly held corporations. Such actions are not viewed as affecting shareholder rights.⁵³

In a closely held corporation, however, most terminations of employment and removals from management positions do affect shareholder rights, as employment and management benefits are typically a substantial part of a shareholder’s return on investment.

50. See supra Part I.A.

51. See, e.g., Riblet Prods. Corp. v. Nagy, 683 A.2d 37, 40 (Del. 1996) (“This is not a case of breach of fiduciary duty to Nagy [a minority shareholder] qua stockholder Nagy does not allege that his termination amounted to a wrongful freeze out of his stock interest in [the corporation], nor does he contend that he was harmed as a stockholder by being terminated.”).

52. As one commentator observed:

From the standpoint of an employee in a publicly held corporation . . . the economic interest in stock ownership and the economic interest in employment are largely separate. As a stockholder, the employee’s interest is the same as all other stockholders. The employee-stockholder seeks an expected return on his investment that adequately compensates for the risk of investing in the enterprise. . . .

Such an employee’s interest in his job, by contrast, is some function of the personal satisfaction that the job brings and the level of monetary compensation and other benefits that the job provides. If the employee is satisfied with his job, but comes to believe that the stock in his employer is a bad investment, the employee can simply sell the stock. If the employee desires to change jobs or is fired, but continues to believe that the stock is a good investment, the employee may continue to hold stock in his former employer. The act of changing jobs does nothing to alter the risk-return calculation that makes the stock in the employer either a good or a bad investment.

Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L. Q. 1099, 1107-08 (1999).

53. Cf. *id.* at 1108 (“Because these employee and stockholder interests are largely separate in a publicly held corporation, it is entirely proper that the general corporate rule provides the employee-stockholder with no special protection against discharge.”).

As mentioned, many closely held corporations distribute much, if not all, of their earnings as salaries and other employment compensation.⁵⁴ Consequently, one needs to maintain a job to receive a financial return on investment. If this were the only purpose of employment and management positions in a closely held corporation, the *Donahue* duty would not be needed, as traditional corporate law can police de facto dividend abuses. In other words, if terminations of employment and removals from management positions have the effect of excluding a minority investor from his share of the company's distributed earnings, those actions would be illegal under traditional corporate law principles.⁵⁵

Employment and management positions in a closely held corporation, however, are important even in the absence of de facto dividends. Many closely held corporations are small start-up businesses that face a high risk of failure.⁵⁶ Because of the uncertainty surrounding whether the business will have any earnings at all, let alone earnings growth or consistency,⁵⁷ the shareholder's initial decision to invest is often based primarily on the definitive benefits of employment and related management positions, rather than on the speculative possibilities of earnings growth. Indeed, a job and a management position in a closely held corporation is often associated with a higher salary,⁵⁸ a significant participatory role in the

54. See *supra* Part I.C.

55. See *supra* Part I.C.

56. See MICHAEL E. GERBER, *THE E-MYTH REVISITED: WHY MOST SMALL BUSINESSES DON'T WORK AND WHAT TO DO ABOUT IT 2* (HarperCollins eds., 1995). As Gerber observes:

Businesses start and fail in the United States at an increasingly staggering rate. Every year, over a million people in this country start a business of some sort. Statistics tell us that by the end of the first year at least 40 percent of them will be out of business. Within five years, more than 80 percent of them . . . will have failed [M]ore than 80 percent of the small businesses that survive the first five years fail in the second five.

Id.; see also Ragazzo, *supra* note 52, at 1109 (“Small businesses are exceedingly risky enterprises with high failure rates.”). R

57. Cf. GERBER, *supra* note 56, at 2 (noting that “hundreds of thousands of people every year . . . pour their energy and capital—and life—into starting a small business and fail,” and stating that “many others . . . struggle along for years simply trying to survive”). R

58. This assertion, of course, assumes a comparison between similar jobs in businesses at similar stages of development. See, e.g., SHANNON P. PRATT ET AL., *VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES* 121 (3d ed. 1996) (“It is not uncommon to find an owner/manager of a successful closely held company earning a greater amount in annual compensation than the amount an equivalent nonowner employee would earn as compensation.”); see also *Bonavita v. Corbo*, 692 A.2d 119, 124 (N.J. Super. Ct. Ch. Div. 1996) (“[W]hile there is no claim

company's activities,⁵⁹ and intangible benefits stemming from working for oneself.⁶⁰ These financial and other benefits of employment and management positions in a closely held corporation help to offset the high risk of failure associated with investing in a small business. Without these benefits, an investment in a closely held corporation often makes little economic sense:

that the [closely held corporation] salaries are excessive, neither was there a showing that if the 'inside' employment were terminated those family members could earn as much elsewhere."); *Nelson v. Martin*, 958 S.W.2d 643, 644 (Tenn. 1997) (noting that the annual compensation of a shareholder-employee of a commercial printing business "was in excess of \$250,000").

59. This participatory role provides the shareholder with both the prestige of a senior management position and the opportunity to monitor his investment:

[I]nvestors are also motivated to commit capital to a close corporation because of their desire for management participation as a director or officer of the company. Aside from the prestige and other intangibles associated with holding a director or officer position, a management role also presents an opportunity to effectively monitor the shareholder's investment.

Within a close corporation, such a monitoring ability is vitally important. After all, close corporation shareholders often invest a substantial portion of their life savings in the company and, as a consequence, they need some way of protecting their investment. Unfortunately, a mere shareholder has no say in routine corporate decisionmaking. Moreover, although shareholders have the statutory right to inspect a company's books and records with a proper purpose, that right is easily hindered by a majority shareholder intent on obstructing such an inspection. As a consequence, mere shareholders often lack both a voice in the company's decisionmaking process as well as access to information about the company's affairs. Because management has the ability to make corporate decisions and has access to corporate information, however, a management role provides a direct opportunity for a shareholder to effectively participate in and monitor the company's activities. Ideally, such an opportunity allows the shareholder to try and steer the business away from investment-threatening decisions.

Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1015-16 (2001) (footnotes omitted); see also 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL AND THOMPSON'S OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS § 3:6, at 3-45 (2d ed. 2004) ("[L]osing the prestige of a directorship may be of considerable consequence to the shareholder."); *id.* § 3:7, at 3-57 (referring to the "prestige, privileges, and patronage that come from controlling a corporation and occupying its principal offices").

60. See, e.g., *Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311, 1319 (N.Y. 1989) (Hancock, J., dissenting) (noting "the challenge, the independence, the prestige, the feeling of achievement, and the other intangible benefits of being part of the management of a successfully run small company"); see also Steven C. Bahls, *Resolving Shareholder Dissension: Selection of the Appropriate Equitable Remedy*, 15 J. CORP. L. 285, 290-91 (1990) (noting that ownership in a closely held corporation includes "the social status and challenge of operating one's own company and the satisfaction of providing employment to one's children"); *id.* at 319 n.212 (mentioning the "loss of satisfaction and other qualitative perks associated with operating a business").

In a closely held corporation, a shareholder-employee has interests in his job and stock that are often economically intertwined. Holding stock in a closely held corporation, viewed purely as an investment decision, seems almost irrational from an economic perspective. Small businesses are exceedingly risky enterprises with high failure rates. To compensate fairly for this level of risk, the expected return would also have to be disproportionately large. Moreover, many investors in small businesses invest a significant portion of their life savings in the business. This practice defeats their ability to diversify their investment portfolios and exposes them to company- and industry-specific risk. As a result, investors in closely held corporations would seem well advised to trust their capital to diversified mutual funds rather than a small corporation.

If investors in closely held corporations are economically rational, it can only be because such investments have compensating benefits not available to investors in publicly held corporations. In many cases, a shareholder in a closely held corporation expects to receive such compensating benefits through employment. The shareholder may invest for the purpose of having a job that produces higher compensation than could be garnered through employment by third parties. Even if the employee-shareholder's compensation is no higher than his next best alternative, an investment in a closely held corporation may still be justified because the ability to keep his job may be more stable and certain. Additionally, the employee may simply derive satisfaction from working in a business that he himself takes a substantial part in managing. . . .

Thus, a shareholder in a closely held corporation often has a significant investment interest in his job. He often invests for the purpose of having a job, and the salary and other benefits he receives are conceived to be part of the return on his investment After discharge, the minority is relegated to the corporation's expected returns to justify the risk of its investment capital. As discussed above, these returns are unlikely to be satisfactory on their own.⁶¹

In the closely held setting, therefore, majority conduct that negatively affects a shareholder's employment or management position will often impact the shareholder's expected return. As a result, the conduct can usually be viewed as harming the shareholder's rights, and a fiduciary duty analysis should be in-

61. Ragazzo, *supra* note 52, at 1109-11.

voked.⁶² By citing terminations of employment and removals from management as examples of freeze-out conduct, and by suggesting that the shareholder-centered fiduciary duty was meant to protect against such conduct,⁶³ the *Donahue* court demonstrated that it appreciated these points. More importantly, courts following a *Donahue*-like approach have found breaches of fiduciary duty when the controlling group unjustifiably terminates the employment of a mi-

62. Majority conduct that negatively affects a shareholder's employment or management position will not always impact the shareholder's expected return and, correspondingly, should not always be viewed as harming the shareholder's rights. The shareholder must establish that all of the investors mutually understood that employment and/or management was a benefit granted to shareholders in the company. In the absence of such a showing, the employment/management position should be viewed as unconnected to the shareholder's expected return and outside the scope of the shareholder's protected rights. As a result, a fiduciary duty analysis should not be triggered:

A *Donahue*-like fiduciary duty protects shareholders and shareholder rights. When asserting that a *Donahue*-like fiduciary duty has been breached, therefore, the plaintiff minority has the burden of proving that his shareholder rights have been harmed. When that harm is to a right or benefit that is traditionally afforded to shareholders—e.g., the right to vote . . . —that burden is easily met. So long as the plaintiff has the status of a shareholder, he is entitled to all of the status-based benefits that shareholders receive. The controlling shareholder cannot interfere with those benefits without harming the plaintiff as a shareholder and, correspondingly, implicating the duty.

When the minority asserts that he has been deprived of employment or some other non-traditional shareholder benefit, however, his burden of proving that his shareholder rights have been harmed is satisfied only by showing that, in the corporation at issue, the benefit was part of his rights *as a shareholder*. In other words, the minority must demonstrate a connection between his shareholder status and the asserted benefit (an employment position, a management position, or any other non-traditional shareholder benefit) by establishing that the shareholders mutually understood that the status and the benefit went hand-in-hand in the company. Stated yet another way, a *Donahue*-like fiduciary duty protects non-traditional shareholder benefits only when the minority can establish that, in his company, the benefit was reasonably understood by the participants to be an entitlement that a shareholder received as a result of becoming a shareholder in the venture. By showing that the participants viewed the benefit as a component of a shareholder's return on investment, the minority demonstrates that the benefit was part of his rights *as a shareholder* in the particular corporation at issue. When the majority interferes with that benefit, therefore, the fiduciary duty provides protection.

MOLL & RAGAZZO, *supra* note 5, § 7.01[D][1][a][iii], at 7-59 to 7-61 (footnotes omitted); *see id.* § 7.01[D][1][a][iii], at 7-63 (“Because the plaintiff was unable to establish a connection between his shareholder status and his employment in the corporation, he was unable to show that his termination harmed him as a shareholder. As a result, his firing did not breach a fiduciary duty.”); *see also id.* § 7.01[D][1][b][ii][A] (discussing the same issue in “reasonable expectations” terms).

63. *See Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 513, 515 (Mass. 1975).

nority shareholder and removes him from the board of directors—even when de facto dividends are apparently not at issue.⁶⁴

It is important to underscore that acknowledging that employment and management positions are often part of a shareholder's rights in a closely held corporation,⁶⁵ and recognizing that judicial action is needed to protect those rights even when de facto dividends are not involved, enacted a meaningful change in the law. As mentioned, under traditional corporate law principles, employment and management positions are not ordinarily viewed as part of one's rights as a shareholder; thus, terminations of employment and removals from management do not generally invoke a fiduciary duty analysis.⁶⁶ The Supreme Court of Utah recently made similar observations:

In *Riblet Products Corp. v. Nagy* [683 A.2d 37 (Del. 1996)] . . . the Delaware Supreme Court noted that Delaware had not adopted Massachusetts' approach to fiduciary duties, but instead imposed identical duties on shareholders of closely held corporations and public corporations. Additionally, the Delaware Supreme Court distinguished between the plaintiff's rights as a stockholder and his contractual rights as an employee. While the court noted [that] the *Riblet* plaintiff had not alleged that his termination amounted to a wrongful freeze-out of his stock interest, in subsequent cases where the plaintiff has made such allegations, other courts following Delaware's approach have determined that any injury caused by a termination decision would only be an injury to an individual's employment interests and not to his interests as a stockholder. At least one court has described this approach as being more predictable because it treats all corporations the same way. The Delaware approach thus stands in sharp contrast to the fiduciary duty standard followed by the majority of states.⁶⁷

64. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 663-64 (Mass. 1976) (no evidence that employment or management position was used as a vehicle for distributing company profits); *Balvik v. Sylvester*, 411 N.W.2d 383, 384-85, 387-88 (N.D. 1987) (same).

65. To repeat, while employment and management positions are *often* part of a shareholder's rights in a closely held corporation, they should not *always* be viewed in this manner. See *supra* note 62.

66. See *supra* notes 52-53 and accompanying text.

67. *McLaughlin v. Schenck*, 220 P.3d 146, 154-55 (Utah 2009) (citations omitted); see also *Berman v. Physical Med. Assocs.*, 225 F.3d 429, 433 (4th Cir. 2000) (stating that "any injury caused by the termination decision itself would be an injury to his interests as an employee, not as a stockholder").

Thus, when *Donahue* and similar cases protect employment and management interests as part of one's rights as a shareholder, the protection goes above and beyond what traditional corporate law would provide. In this respect, the *Donahue* doctrine does result in a significant change in the law.

B. *The Dilution of Business Judgment Rule Deference*

In conjunction with its efforts to protect employment and management rights in the closely held corporation, *Donahue* and its progeny also changed the law by limiting the impact of the business judgment rule. Articulations of the business judgment rule vary, but the rule generally operates to shield a manager from liability so long as the manager's decision was made "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."⁶⁸ Under the rule, courts review the substantive business decisions of those in control with considerable deference and with a correspondingly minimal amount of scrutiny.⁶⁹ Because of this deference, it is usually difficult to challenge internal matters—such as employment, management, or dividend decisions—in disputes involving business organizations.

The *Donahue* doctrine, however, significantly curtails the effects of the business judgment rule. By specifically noting that employment, management, dividend, and other internal decisions can

68. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *see also Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) ("The business judgment rule has been well formulated by . . . other cases. Thus, directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available." (citation omitted)); *Fields v. Sax*, 462 N.E.2d 983, 986 (Ill. App. Ct. 1984) ("A corporate director will not be held liable for honest errors or mistakes of judgment as long as the decision does not involve fraud, illegality or conflict of interest."); *id.* at 989 ("Absent evidence of bad faith, fraud, illegality, or gross overreaching, courts are not at liberty to interfere with the exercise of business judgment by corporate directors."); *Ironite Prods. Co. v. Samuels*, 985 S.W.2d 858, 862 (Mo. Ct. App. 1998) ("We will not interfere with the decisions of the Board of Directors absent fraud, illegal conduct, or an irrational business judgment."). *See generally* MOLL & RAGAZZO, *supra* note 5, § 6.02[C][1], at 6-30 to 6-43 (discussing the business judgment rule).

69. *See, e.g.,* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 93 (1991) ("Statements of the [business judgment] rule vary; its terms are far less important than the fact that there is a specially deferential approach."); *see also Wilkes*, 353 N.E.2d at 662 ("[C]ourts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors or employees, which essentially involve management decisions subject to the principle of majority control.").

be part of a majority-directed freeze-out, and by explicitly mentioning the business judgment rule as a traditional impediment to challenging such decisions,⁷⁰ the *Donahue* court strongly suggested that its shareholder-to-shareholder fiduciary duty framework was meant to curb (if not displace) the traditional deference of the business judgment rule. In fact, in the subsequent decision of *Wilkes v. Springside Nursing Home, Inc.*, the business judgment rule did not prevent the Massachusetts Supreme Judicial Court from finding a breach of the *Donahue* fiduciary duty when a minority shareholder was unjustifiably terminated from employment and removed from the board of directors in a closely held corporation that did not pay dividends.⁷¹

70. See *Donahue v. Rodd Electrotyping Co.*, 328 N.E.2d 505, 513-14 (Mass. 1975).

71. *Wilkes*, 353 N.E.2d at 663-64. In *Wilkes*, the court acknowledged majority prerogatives and altered the *Donahue* framework as a result:

[W]e are concerned that untempered application of the strict good faith standard enunciated in *Donahue* to cases such as the one before us will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned. The majority, concededly, have certain rights to what has been termed “selfish ownership” in the corporation which should be balanced against the concept of their fiduciary obligation to the minority.

Therefore, when minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority, we must carefully analyze the action taken by the controlling stockholders in the individual case. It must be asked whether the controlling group can demonstrate a legitimate business purpose for its action. In asking this question, we acknowledge the fact that the controlling group in a close corporation must have some room to maneuver in establishing the business policy of the corporation. It must have a large measure of discretion, for example, in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees.

When an asserted business purpose for their action is advanced by the majority, however, we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest. If called on to settle a dispute, our courts must weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative.

Id. at 663 (citations omitted). Despite this acknowledgement of majority prerogatives, subjecting the majority’s conduct to a legitimate business purpose/less harmful alternative analysis indicates that the business judgment rule has largely been displaced, as the court is doing more than simply asking whether a decision by the controlling group can be attributed to a rational business purpose. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (observing that decisions are protected under the business judgment rule “if they can be attributed to any rational business purpose”). Indeed, the *Wilkes* framework requires proof of a legitimate business purpose for the majority’s conduct—not simply an attribution by the court. See, e.g., Stephen M. Bainbridge, *The*

Put differently, the *Donahue* court recognized, at least implicitly, that conflicts of interest—the presence of which bar application of the business judgment rule⁷²—can be more subtle in the closely held setting. As a result, the court understood that a broader view of such conflicts was needed. For example, whereas a majority-directed decision to withhold dividends may affect all shares in the same manner,⁷³ the decision in a closely held corporation may be motivated by an effort to coerce a minority shareholder to sell out to the majority at an unfairly low price.⁷⁴ In a publicly held corporation, the denial of dividends does not have a similar coercive effect, as a company's retention of profits simply boosts the market value of its shares—a value that an investor can capture at any time by selling into the market.⁷⁵ Actions that do not appear to provide disproportionate benefit to the controlling group in the publicly held setting, in other words, may very well be designed to impro-

Business Judgment Rule as Abstention Doctrine, 57 VAND. L. REV. 83, 100 (2004) (“[T]he reference to a rational business purpose requires only the possibility that the decision was actuated by a legitimate business reason, not that directors must prove the existence of such a reason.”). In addition, even with proof of a legitimate business purpose, the *Wilkes* analysis still finds liability if there are alternatives that are less harmful to the minority. Thus, the *Donahue/Wilkes* framework is quite different from a classic business judgment rule approach, as the framework calls for close scrutiny of the majority's decisions. See Terry A. O'Neill, *Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations*, 22 SETON HALL L. REV. 646, 692 (1992) (“The burden-shifting scheme devised in *Wilkes* effectively deprives majority shareholders of the protection of the business judgment rule by requiring close judicial scrutiny of the majority's action whenever the minority is harmed.”).

72. See *supra* note 68 and accompanying text.

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73. See Douglas K. Moll, *Shareholder Oppression & Dividend Policy in the Close Corporation*, 60 WASH. & LEE L. REV. 841, 858-59 & n.64 (2003) (discussing the dividend “irrelevance proposition” and noting that “[i]f a dividend of one dollar per share is paid, a . . . shareholder is enriched by one dollar per share,” while “[i]f that same amount is instead retained in the company, the company's value increases by one dollar per share and, correspondingly, the value of the . . . stock increases by one dollar per share”).

74. See, e.g., *Donahue*, 328 N.E.2d at 515 (“Majority ‘freeze-out’ schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices.”); see also *Little v. Waters*, Civ. A. No. 12155, 1992 WL 25758, at *8 (Del. Ch. Feb. 11, 1992) (describing the plaintiff's allegation “that the company was rich with cash and that the only reason that the company did not make dividends was to aid [the majority] to buy [the minority] out for less than fair value”); *Wilkes*, 353 N.E.2d at 664 (“[W]e may infer that a design to pressure *Wilkes* into selling his shares to the corporation at a price below their value well may have been at the heart of the majority's plan.”).

75. See *supra* note 73 and accompanying text.

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erly favor the controlling group in the closely held setting.⁷⁶ By suggesting that internal management decisions should be subject to real scrutiny, the *Donahue* court showed an appreciation of this point and signaled that traditional business judgment rule deference was less appropriate in the closely held setting.⁷⁷ In the years following *Donahue*, several courts have acknowledged even more explicitly that majority shareholder decisions in closely held corporations call for more judicial scrutiny than conventional business judgment rule deference.⁷⁸

76. *Cf.* *Georgeson v. DuPage Surgical Consultants, Ltd.*, No. 05 CV 1653, 2007 WL 914219, at *5-6 (N.D. Ill. Mar. 22, 2007) (rejecting the defendants' argument that, "as a matter of law, their conduct was not oppressive because it was protected by the business judgment rule" because "the presumption that normally shields defendants for their business decisions does not apply if the plaintiff presents evidence of fraud, bad faith, or self-dealing," and observing that the evidence, "if true, would establish that the defendants acted in their own self-interest when they refused to compensate [the minority shareholder] for his shares and denied him the other compensation to which he contends he is entitled").

77. *Donahue*, 328 N.E.2d at 512-16. In addition, because the managerial constraints provided by a market are absent in a closely held corporation, the judicial deference embodied in the business judgment rule makes even less sense:

Market restraints are most visible and workable in the case of publicly held corporations. If management is inefficient, indulges its own preferences, or otherwise acts contrary to shareholder interests, dissatisfied shareholders will sell their shares and move to more attractive investment opportunities. As more shareholders express their dissatisfaction by selling, the market price of the company's shares will decline to the point where existing management is exposed to the risk of being displaced through a corporate takeover. . . . The mere threat of displacement, whether or not realized, is a powerful incentive for managers of publicly held corporations to promote their shareholders' interests so as to keep the price of the company's shares as high and their own positions as secure as possible.

Hetherington & Dooley, *supra* note 12, at 39-40; *see, e.g.*, *Rosenfield v. Metals Selling Corp.*, 643 A.2d 1253, 1262 n.18 (Conn. 1994) ("The market for corporate control serves to constrain managers' conduct that does not maximize shareholder wealth. It therefore serves to align the interests of managers more closely with the interests of shareholders in publicly traded corporations. The market for corporate control does not affect, however, the incentives of managers of closely held corporations.").

78. *See, e.g.*, *Smith v. Atl. Props., Inc.*, 422 N.E.2d 798, 801, 804 (Mass. App. Ct. 1981) (stating, in a closely held corporation dispute, that "[t]he judgment . . . necessarily disregards the general judicial reluctance to interfere with a corporation's dividend policy ordinarily based upon the business judgment of its directors"); *Fox v. 7L Bar Ranch Co.*, 645 P.2d 929, 935 (Mont. 1982) ("When it is also considered that in close corporations dividend withholding may be used by controlling shareholders to force out minority shareholders, the traditional judicial restraint in interfering with corporate dividend policy cannot be justified." (internal quotation marks omitted)); *Grato v. Grato*, 639 A.2d 390, 396 (N.J. Super. Ct. App. Div. 1994) ("[J]udicial consideration of a claim of majority oppression or freeze-out in a closely held corporation is guided by considerations broader than those espoused in defendants' version of the 'business judgment rule.'"); *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554, 561 (N.J. Super. Ct. Law

CONCLUSION

Donahue had (and continues to have) a significant impact on the law of fiduciary duty in closely held corporations. Unquestionably, *Donahue*'s legacy stems primarily from its recognition of the peculiar vulnerability of minority shareholders in closely held corporations. This Article has argued, however, that *Donahue* did more than merely recognize a problem—*Donahue* changed the law, although the changes that it has been credited with are overstated in some respects and understated in others. While debate over the impact of *Donahue* will undoubtedly continue, it is beyond debate that *Donahue* helped to spark an evolution in the law of fiduciary duty in closely held corporations—an evolution that has improved the rights of minority shareholders in Massachusetts and beyond.

Div. 1979) (“[T]he statutory language embodies a legislative determination that freeze-out maneuvers in close corporations constitute an abuse of corporate power. Traditional principles of corporate law, such as the business judgment rule, have failed to curb this abuse. Consequently, actions of close corporations that conform with these principles cannot be immune from scrutiny.”); *see also* Easterbrook & Fischel, *supra* note 11, at 293 (“It makes sense, therefore, to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgment rule. The same approach could be used with salary, dividend, and employment decisions in closely held corporations where the risks of conflicts of interest are greater.”).

When courts suggest that a rejection of business judgment rule deference is warranted, they are presumably contemplating majority decisions that impact the rights of individual shareholders. For more general decisions, such as the choice of one business opportunity over another, courts should typically defer to the majority's prerogatives. *Cf.* James D. Cox, *Equal Treatment for Shareholders: An Essay*, 19 CARDOZO L. REV. 615, 631 (1997) (“Though great flexibility should be accorded managers on matters related to the conduct of the corporation's business, this is not necessarily the case regarding decisions that impact the relative rights of owners' interests in the firm. The former is more clearly the type of business activity which is best lodged with the firm's managers; the latter is not.” (footnote omitted)).

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