may be part of Massachusetts caselaw but cannot fairly be counted as a majority-rule principle. Thus, it is incorrect to equate any statute, or any interpretation of a statute, that adopts the doctrine of reasonable expectations with codifying the majority rule.

Many other arguments contradict equating a statutorily-based reasonable expectations doctrine with the majority rule. Minnesota, North Dakota, Oregon and Pennsylvania, which rely primarily or exclusively on their dissolution statutes to resolve shareholder complaints, have statutes that provide a definition of oppression, which, among other things, includes consideration of reasonable expectations.[297] Despite the explicit incorporation of reasonable expectations into the statute, and despite ruling solely or primarily under these statutes, even these states have not adopted all majority-rule principles. The clearest example is Minnesota, whose statute directs courts to:

> take into consideration the duty which all shareholders in a closely held corporation owe one another to act in an honest, fair, and reasonable manner in the operation of the corporation and the reasonable expectations of all shareholders as they exist at the inception and develop during the course of the shareholder's relationship with the corporation and with each other.[298]

Irrespective of this broad language, which seems to follow the spirit of *Rodd*, Minnesota courts are inconsistent about what majority-rule principles they see as mandated by the statute.[299] Similarly, Oregon does not interpret

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determining oppression but refusing to permit it to be the sole reason for finding dissolution). It is also interesting to note that the doctrine of reasonable expectations is a doctrine of implied contract, as opposed to a doctrine of heightened fiduciary duty. Moll, *supra* note 8, at 761 ("In the close corporation context, therefore, it is sensible to view the parallel development of the statutory cause of action and the enhanced fiduciary duty action as two sides of the same coin—*i.e.*, the shareholder's cause of action for oppression.").

[297]*See, e.g.*, MINN. STAT. ANN. § 302A.751 (West Supp. 1992); N.J. STAT. ANN. § 14A:12-7 (West Supp. 1992); N.D. CENT. CODE § 10-19.1-115 (1985); PA. STAT. ANN. tit. 15, § 1981 (West 1995).

[298]MINN. STAT. ANN. § 302A.751 (West Supp. 1992); *see also* N.D. CENT. CODE § 10-19.1-115 (1985) (stating a similar proposition requiring consideration of shareholder's reasonable expectations).

[299]*See* Advanced Communication Design v. Follet, 615 N.W.2d 285, 293-94 (Minn. 2000) (finding that the statute imposes fiduciary duties on minority shareholders only if they have management duties); Wessin v. Archives Corp., 592 N.W.2d 460 (Minn. 1999) (noting that corporations are not partnerships and refusing to find that the statute implies that partnership duties apply to close corporations). *Cf.* Powell v. MVW Holdings, Inc., 626 N.W.2d 451, 463-64 (Minn. Ct. App. 2001) (finding that the equal opportunity rule is generally available but holding it inapplicable where the doctrine is invoked by a majority shareholder).

the doctrine of reasonable expectations as requiring adoption of all majority-rule principles and instead interprets its statute as imposing fiduciary duties only on those in control.[300] Finally, the comment to the Pennsylvania statute is highly critical of courts who arrogate the legislative function; the comment notes that the statute has adopted reasonable expectations in its oppression statute "rather than forcing the courts to distort the general rules of corporate law in order to grant relief in closely held situations."[301] Thus, adoption of the doctrine of reasonable expectations cannot be deemed to be adoption of the majority rule.

Curiously, both Massachusetts and Delaware are two of only twelve states and the District of Columbia without oppression statutes.[302] Although one author has proffered that courts without an oppression-based statute are likely to adopt *Rodd*'s enhanced fiduciary duty,[303] in reality, Massachusetts is the *only one* of this group that lacks an oppression statute that has adopted the majority rule. Three states without oppression statutes have partially adopted the majority rule,[304] and one other state and the District of Columbia are in the "too close to call" column.[305] Five states without oppression statutes have embraced the minority rule.[306] Two remaining states without oppression statutes[307] have not considered the issues involved in the majority/minority-rule debate.

In sum, the support for the majority rule has been grossly exaggerated and the support for the minority rule has been highly understated. The reasons for this discrepancy are many, including utilizing

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[300]*See, e.g.*, Hayes v. Olmsted & Assocs., 21 P.3d 178, 181 (Or. 2001) (finding that a breach of fiduciary duty by those in control of the corporation generally constitutes oppression); Naito v. Naito, 35 P.3d 1068, 1079 n.26 (Or. Ct. App. 2001) (explaining that fiduciary duties apply to those who are in control of the corporation, regardless of whether the individual is a majority or minority shareholder); Locati v. Johnson, 980 P.2d 173, 176 (Or. Ct. App. 1999) (stating that fiduciary duties are owed only by an individual or a group that owns the majority of shares or otherwise controls the corporation).

[301]*See* PA. STAT. ANN. tit. 15, § 1767 (Am. Comm. Cmt. 1990).

[302]Only twelve states and the District of Columbia do not have statutes providing for dissolution based on oppression. *See supra* note 46 (listing the thirty-seven states with oppression statutes). States without oppression statutes are Alaska, California, Delaware, Florida, Indiana, Kansas, Kentucky, Louisiana, Massachusetts, Ohio, Oklahoma, Nevada, and the District of Columbia. *See* chart, app. A, *infra* notes 3, 11, 5, 31, 23, 15, 13, 40, 1, 30, 47, 34, & 45.

[303]*See* Moll, *supra* note 8, at 760.

[304]*See* cases cited in chart cols. 3-4, app. A (identifying specifically California, Indiana, and Ohio as the three states without an oppression statute that have partially accepted the majority rule).

[305]*See* cases cited in chart col. 8, app. A (identifying D.C. and Nevada as the states without an oppression statute that are too close to call regarding whether they have adopted either rule).

[306]*See* cases cited in chart cols. 5-6, app. A (identifying Delaware, Kansas, Louisiana, Florida, and Maine as states without an oppression statute that have adopted the minority rule).

[307]*See* cases cited in chart col. 11, app. A (identifying Kentucky and Oklahoma as states without an oppression statute that have yet to consider the majority/minority debate).

outdated cases, imprecise reading of cases, and relying on *dicta*. A major cause of the discrepancy, however, is attributing an intent to codify the Massachusetts rule to states that adopt oppression statutes, and particularly statutes that include the shareholder's reasonable expectations. The majority/minority-rule debate, however, exists only outside those statutes, based on common law fiduciary duty. As discussed above,[308] the majority and minority rules vary widely on the role of judicial legislation, who owes fiduciary duties and the parameters of those duties. The next section, critiquing these two rules, should aid courts in choosing between them.

IV. A CRITIQUE OF THE MAJORITY AND MINORITY RULES

As discussed above,[309] judicial response to the plight of minority shareholders in close corporations varies tremendously, as evidenced by the significant differences between the majority and minority rules. This part will consider four major criticisms of these rules. The first two concern the majority rule, first assailing the logic of appropriating partnership fiduciary duties and then examining the parameters of that partnership fiduciary duty. The last two issues critique the formalism and corporate orientation of the minority rule and consider whether it exposes minority shareholders to abuse by those in control.

A. *The Majority-Rule's Appropriation of Partnership Law is Analytically Faulty*

The Massachusetts Supreme Court's view that "the close corporation bears (a) striking resemblance to a partnership"[310] is superficially logical. Following that logic, courts adhering to the majority rule have reasoned that the small number of owners, lack of a market for the stock and the likely involvement of the owners in management make the close corporation "often little more than an 'incorporated' or 'chartered' partnership,"[311] or "in substance, partnerships by another name."[312] Although partners and close

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[308] *See supra* Part I.E (discussing the differences between the majority and minority rules).

[309] *Id.*

[310] Rodd, 328 N.E.2d at 512.

[311] *Id.* at 511-12.

[312] I.P. Homeowners, Inc. v. Radtke, 558 N.W.2d 582, 589 (Neb. Ct. App. 1997). *See also* Hagshenas v. Gaylord, 557 N.E.2d 316, 323 (Ill. App. Ct. 1990) ("[T]hough Imperial was purchased as a corporation, it clearly was an enterprise closely resembling a partnership."); Daniels v. Thoms, Dean & Hoskins, Inc., 804 P.2d 359, 366 (Mont. 1990) (noting that "the relationship between close corporations closely approximates the relationship between partners"); Walta v. Gallegos Law Firm, P.C., 40 P.3d 449, 456-57 (N.M. Ct. App. 2001) (applying partnership fiduciary duties "[b]ecause of the fundamental resemblance of the close corporation to the partnership"); DOOLEY, *supra* note 26, at 1011 (calling a close corporation a hybrid of a

corporate shareholders are similarly situated, it is evident that they have dissimilar remedies to combat potential problems: partners are armed with both at-will dissolution rights[313] and arguably, heightened fiduciary duties,[314] both of which are unavailable in traditional corporate law. While grafting partnership dissolution rights is clearly problematic,[315] majority-rule courts and some commentators[316] advocate grafting partnership fiduciary duties onto close corporations on the theory that similarly-situated business owners ought to have similar remedies.

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partnership and a corporation).

[313]Uniform Partnership Act (UPA) § 31(b) (1914) (allowing any partner to withdraw and effect a dissolution in an at-will partnership). In an at-will partnership, without a partnership agreement providing for continuation of the partnership, a partnership will be dissolved and terminated upon the withdrawal of a partner. *Id.* Assets are distributed according to the statute's distribution scheme, which allows for partner loans, contributions and profits after liabilities to third parties are satisfied. *Id.* § 38(1). Even if a partnership is not at will, a partner may leave the partnership and pay damages. *Id.* § 38(2). Notably, although the Revised Uniform Partnership Act (RUPA) altered the UPA's rules regarding dissolution by introducing a concept called "dissociation," RUPA retains a partner's right to exit and get payment from a partnership that has no specified term, RUPA §§ 601, 801(1) (1997), and right to withdraw anytime in an at-will partnership. *Id.* § 801(1). In contrast, shareholders cannot exit a corporation and receive payment for their stock absent a buyer for that stock.

Similarly, the grounds for involuntary dissolution of a partnership are broader than those afforded under corporate statutes, and include conduct, financial, and equitable grounds. *See* UPA § 32 (specifying many grounds for involuntary dissolution of a partnership). *Accord* RUPA § 801(5) (specifying similarly broad grounds for involuntary dissolution of a partnership). In contrast, a Delaware corporation can be dissolved by either a resolution adopted by the board of directors and passed by majority of shares or without a board resolution but by the unanimous vote of the shareholders. DEL. CODE. ANN. tit. 8, § 275(a)-(c) (2001). *See generally* Hetherington & Dooley, *supra* note 9, at 41-43 (delineating ways in which a partner's interest is significantly more liquid than a comparable equity interest in the close corporation); Larry A. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357, 382-83 n.84 (1987) (arguing that a statutory right of buyout is necessary because without one, partnership and close corporate interests are illiquid).

[314]J. WILLIAM CALLISON, PARTNERSHIP LAW AND PRACTICE: GENERAL AND LIMITED PARTNERSHIPS § 12.1 (2003) (stating partners owe the highest duties of loyalty, care, fairness, and honesty to the partnership and co-partners). *See also infra* notes 335-49 (questioning whether partnership fiduciary duties are, in fact, heightened).

[315]*See* Siegel, *supra* note 11, at 119 (arguing that partners do not exercise their dissolution rights too easily because upon dissolution, each partner will be personally liable for all partnership debts; in contrast, since shareholders do not have this personal liability, shareholders would be more likely to resolve, or at least to threaten to resolve, their issues by dissolution if they had at-will dissolution rights).

[316]*See* Crago, *supra* note 15, at 10-11 (advocating the application of partnership fiduciary duties in close corporations to require the majority to buy-out the minority interest, because it allows courts to provide the missing liquidity otherwise unavailable to minority shareholders); Van Vliet & Snider, *supra* note 8, at 263-64 (analyzing the development of the partnership-like fiduciary rule in close corporations and arguing that this rule should be fostered and developed). In theory, the majority rule appropriates only the partnership fiduciary duty, although courts following the majority rule may order a buy-out or dissolution as the remedy for a breach of fiduciary duty. *See, e.g.*, *Rodd*, 328 N.E.2d at 518 (requiring an equal opportunity buyout).

Although partners and close corporate shareholders have similar concerns about their potential vulnerabilities, close corporations are not incorporated partnerships. Two critical facts differentiate these two business associations. One is that partners are agents of their partnership.[317] In their capacity as agents for the partnership, partners have the legal ability to bind the partnership for their actions.[318] The second is that all partners have personal, unlimited liability for partnership debts.[319] The power to create partnership obligations, coupled with each partner's personal liability for such obligations, creates a potent, mutual dependency among partners. The UPA recognizes the hazards of this unique, mutual dependency by granting partners at-will dissolution rights[320] and making all partners fiduciaries to each other.[321] In other words, the UPA's structure provides an exit when a partner determines that the risk is too great that the partners are abusing their extraordinary power, an abuse that results in personal liability for all of the partners.[322]

So viewed, it is obvious that close corporate shareholders do not have a relationship that even approaches the interdependency of partners.

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[317]Uniform Partnership Act (UPA) § 9(1) (1914) (stating all partners are agents of the partnership). The UPA incorporates agency law throughout by providing that agency law will be applied in construing the Act. *Id.* § 4(3). References to agency law's apparent authority of partners for particular acts and resulting partner and/or partnership liability run throughout the Act. *See, e.g.*, *id.* §§ 13-14, 16.

[318]*See id.* § 9(1).

> Every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which he is a member binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom he is dealing has knowledge of the fact that he has no such authority.

[319]*See id.* § 15 ("All partners are liable: (a) [j]ointly and severally for everything chargeable to the partnership under §13 [Partnership Bound by Partner's Wrongful Act] and 14 [Partnership Bound by Partner's Breach of Trust]; and (b) [j]ointly for all other debts and obligations of the partnership . . . .").

[320]Uniform Partnership Act § 31 (1997) (giving dissolution at will to any partner).

[321]*Id.* § 21 (1997) (partner accountable as a fiduciary).

[322]*See generally* Paula J. Dalley, *The Law of Partnership Expulsions: Fiduciary Duty and Good Faith*, 21 CARDOZO L. REV. 181, 181 n.1 (1999) ("The reciprocal nature of partnership power and liabilities is generally believed to justify fiduciary duties."); Claire Moore Dickerson, *Is It Appropriate to Appropriate Corporate Concepts: Fiduciary Duties and the Revised Uniform Partnership Act*, 64 U. COLO. L. REV. 111, 149-51 (1993) (noting because each partner normally has management authority and ownership rights, a partner should be subject to fiduciary duties as an agent). *See also* Lawrence E. Mitchell, *The Naked Emperor: A Corporate Lawyer Looks at RUPA's Fiduciary Provisions*, 54 WASH. & LEE L. REV. 465, 481-82 (1997) (describing partnership fiduciary obligation as having a "distinct economic function" in that it provides partners with a legal incentive to forego opportunistic conduct, and finding that the alternative solution of restricting partnership dissolution is unattractive in large part due to the unlimited liability of partners).

Shareholders are not agents of the corporation and therefore cannot cause the corporation to incur liabilities. Even more significant is that unlike partners, shareholders are not liable for the debts of their corporation. These marked differences eviscerate any claim that shareholders in a close corporation are in an "incorporated partnership," or even that these two groups of investors are similarly situated. While all investors in small business associations are interdependent to some extent, agency powers and personal liability make the partnership unique among business associations.

Majority-rule courts, by grafting the partnership fiduciary duty onto the close corporation, have noted only the superficial similarities between a close corporation and a partnership while failing to appreciate that partnership fiduciary duty is tailored to the unique partnership relationship. Both by appropriating the partnership fiduciary duty and by imposing that duty on all shareholders, majority-rule courts have discounted the impact that limited liability has on the business participants. Since limited liability caps the ability of corporate actors to dissipate the personal assets of shareholders, it decreases the need for these stringent fiduciary duties.

Quite apart from the legal differences between partnerships and close corporations, there is a philosophical objection to treating close corporations as incorporated partnerships. The separation of powers doctrine precludes courts from grafting the specifics of the partnership statute onto the corporate statute.[323] Majority-rule courts have attempted to circumvent this doctrine by avoiding the specifics and instead adopting the more amorphous partnership fiduciary duty. Governing a corporation by partnership principles, however, denigrates the basis for the separation of powers doctrine, whether that governance is by the specifics of the partnership statute or by the ambiguous fiduciary duty. As one court summarized:

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[323]The separation of powers doctrine, while not derived from any particular article of the Constitution, is nonetheless derived from our constitutional scheme, which grants limited, enumerated powers to each branch of government. *See* Humphrey's Ex'r v. United States, 295 U.S. 602, 629-30 (1935) (describing the doctrine as "fundamental in our system"). The doctrine recognizes that it is a basic principle of the constitutional division of powers that one branch of the government may not encroach on the province or authority of another branch, either by direct usurpation of power or through indirect or coercive means. *See* Loving v. United States, 517 U.S. 748, 756-58 (1996) (discussing that role of separation of powers is to maintain freedom from tyranny by assigning roles to the most well-suited branch of governance and to provide the citizenry with clarity as to who may answer for specific governmental failures); Leist v. Simplot, 638 F.2d 283, 313 (2d Cir. 1980) ("It is just as much 'judicial legislation' for a court to withdraw a remedy which Congress expected to be continued as to improvise one that Congress never had in mind."). The doctrine applies at the state level as well, and some state constitutions contain an explicit recognition of the separation of powers doctrine. *See, e.g.*, FLA. CONST. art. 2, § 3 (2003) ("The powers of the state government shall be divided into legislative, executive and judicial branches. No person belonging to one branch shall exercise any powers appertaining to either of the other branches unless expressly provided herein.").

> Public policy does not permit a partnership to do business under the guise of a corporation as to the rest of the world while as between themselves the enterprise conducted in the corporate form is in fact a joint venture or partnership. If they 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 stockholders. They cannot be partners *inter sese* and a corporation as to the rest of the world.[324]

As antipathy for judicial legislation is one of the beacons of Delaware law,[325] courts considering the two rules must be cognizant that adopting the majority rule requires supporting such judicial activism.

B. *Majority-Rule Courts Have Ascribed an Inaccurate and Romanticized Content to Partnership Fiduciary Duties*

After incorrectly attributing the fiduciary duty among partners to their intimate relationship—rather than to the unlimited liability each partner can inflict on the other partners—majority-rule courts compound their mistake by ascribing an incorrect content to partnership fiduciary duty. There are two major aspects of this error: first, majority-rule courts confuse fiduciary duties with obligations imposed by either the partnership statute or a partnership agreement; and second, these courts utilize the amorphous partnership fiduciary duty to achieve any result desired, even though there is ample law suggesting that a proper application of partnership fiduciary duties would not support such an outcome.

First, the court in both *Rodd* and *Wilkes* incorrectly claimed that the "higher" partnership fiduciary duty would preclude the respective defendant's conduct. The protection these plaintiffs sought is, in fact, offered by the partnership statute but not by principles of partnership fiduciary duty. Specifically, the Massachusetts Supreme Court in *Rodd* incorrectly reasoned that partnership fiduciary duties would neither allow the minority shareholder to be "frozen out" nor permit the shareholders to be treated dissimilarly.[326] In reality, partnership fiduciary duties serve no such function. Any equality in partner dealings, such as each partner having an equal voice in management, is granted by the

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[324]Olsen v. Seifert, No. 97-6456, 1009 Mass. Super. LEXIS 592 (Mass. Super. Aug. 28, 1998).

[325]*See supra* notes 152-54 and accompanying text.

[326]Rodd, 328 N.E.2d at 512-15 (reasoning because of the resemblance of close corporations to partnerships, partnership fiduciary duties should apply).

partnership statute,[327] not by fiduciary law. Notably, despite this statutorily-created equality, partners retain the right to alter this equality by their partnership agreement,[328] thereby demonstrating that equality among partners is neither an immutable partnership right nor preserved by partnership fiduciary law. Therefore, contrary to the court's reasoning, had Donahue and Rodd been partners, partnership fiduciary duty would not have granted Donahue any right to be bought out or treated the same as other partners. Under the UPA, she could effect a dissolution of the partnership and perhaps receive something for her interest after all partnership obligations have been satisfied.[329] Alternatively, she could use her statutory right to effect a dissolution in order to pressure the owners to buy her out in lieu of termination. This exit right, and the leverage it generates, however, are granted by the partnership statute, not by partnership fiduciary duties. Similarly Wilkes's desire for an equal right to participate in management and profits are granted by the partnership statute, subject to a contrary provision in the partnership agreement.[330] Given that these owners did not have an agreement, Wilkes would have fared well under the partnership statute. As partnership fiduciary duties could not alter these statutory rights or any contradictory contract terms, these duties would be irrelevant to Wilkes's claims, as they were to Donahue's.

Another example of a court intertwining an agreement with partnership fiduciary duties is *A.W. Chesterton Co. v. Chesterton.*[331] In *Chesterton,* the court held that a transfer of stock of a Subchapter S corporation would be a violation of the transferor's fiduciary duty because the transfer would terminate the Subchapter S status that the shareholders had elected.[332] The court noted in its opinion, however, that the shareholders had an implied agreement that they would not do anything to endanger this tax status.[333] Instead of applying this agreement, the court reasoned that the minority's transfer of stock would breach the fiduciary

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[327]*See* UPA § 18(e): "[a]ll partners have equal rights in the management and conduct of the partnership business."

[328]All of the subsections of UPA § 18 are preceded by a preamble, which provides that these governing rules will apply "subject to any agreement between the partners." *Id.* § 18. UPA § 18(e) provides that "[a]ll partners have equal rights in the management and conduct of partnership business," and § 18(h) provides that "no act in contravention of any agreement between the partners may be done rightfully without the consent of all the partners."

[329]*See supra* note 313.

[330]*See* UPA §18(e) (giving all partners equal management rights); *id.* § 18(a) (discussing the right of partner to share equally in profits).

[331]128 F.3d 1 (1st Cir. 1997).

[332]*Id.* at 6 (explaining the minority shareholder was using the sale as leverage to force corporation to repurchase his shares). *See also supra* notes 105-07 and accompanying text (discussing *Chesterton*).

[333]*Id.* at 4.

duty he owed to the other shareholders.[334] Once again, partnership fiduciary duties would not prohibit this transfer simply because this would be disadvantageous to the other partners or the partnership, just as exiting an at-will partnership is not a breach of a partner's fiduciary duty even though it may cause harm.[335]

Second, the imprecision of fiduciary duties, let alone the "higher" fiduciary duties that the majority-rule courts purport to employ,[336] gives these courts even greater flexibility to mandate any outcome desired. The elasticity of the "higher" fiduciary duty has generated criticism,[337] and not just from minority-rule courts.[338] One author criticized the *ad hoc* nature of these higher fiduciary duties, saying: "Both courts and legislatures have noted the vagueness and arbitrariness of applying these enhanced fiduciary duties in the close corporation context, describing the standards as "nebulous" or "off-the-rack" guesses at the intent of the parties."[339]

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[334]*Id.*

[335]*See infra* notes 349-52 and accompanying text.

[336]*See, e.g.*, *supra* notes 115-23 and accompanying text (discussing cases adopting these higher fiduciary duties).

[337]The corporate entire fairness monitor can be criticized for its indeterminacy as well. As the Delaware Court of Chancery accurately noted, "No litmus paper can be found or Geiger-counter invented that will make determinations of fairness objective." Kahn v. Tremont, No. 12,339, 1996 Del. Ch. LEXIS 40, at *27 (Del. Ch. Mar. 21, 1996), *reprinted in* 21 DEL. J. CORP. L. 1161, 1182 (1996), *rev'd on other grounds*, 694 A.2d 422 (Del. 1997). *See also supra* note 228 and accompanying text (discussing that the breadth and depth of criteria that a Delaware court may use in assessing the entire fairness of a transaction make predicting outcomes difficult). The controlling shareholder will bear the burden of establishing the entire fairness of any controlling-shareholder transaction, with the corporation, unless the burden is shifted to the plaintiff to prove unfairness because the controlling shareholder fulfills some procedural device, such as approval by a majority of disinterested shareholders. *See* Weinberger v. UOP, Inc., 457 A.2d 701, 703 (Del. 1983) (stating "where the corporate action has been approved by an informed vote of the majority of the minority shares . . . the burden entirely shifts to the plaintiff to show that the transaction was unfair to the minority); Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 901 (Del. Ch. 1999) (finding transaction was not entirely fair because it lacked independent legal and financial advisors and there was a lack of independent bargaining); Sealy Mattress Co. v. Sealy, 531 A.2d 1324, 1337 (Del. Ch. 1987) (noting that the absence of procedural safeguards, such as an independent representative to negotiate terms of the merger, made it highly persuasive the deal was unfair). *See also* Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994) (noting that approval of the transaction by independent directors or a majority of minority shares does not validate the transaction but instead, shifts the burden to the plaintiff to prove unfairness of the transaction).

[338]*See* Jordan v. Duffs & Phelps, 815 F.2d 429, 436 (7th Cir. 1987) (imposing a fiduciary duty of disclosure in close corporation but stating fiduciary duty is an "off the rack guess at what the parties would agree to if they dickered about the subject explicitly"). *Cf.* Nixon v. Blackwell, 626 A.2d 1366, 1381 (Del. 1993) (rejecting the application of fiduciary duties in close corporations because it is subjective and would lead to ad hoc determinations which would lead to instability in corporate law).

[339]Stevenson, *supra* 14, at 1152. *Cf.* Mitchell, *supra* note 28, at 1688 (arguing that the broad fiduciary language in these Massachusetts cases obscures the philosophical shift away from any true fiduciary obligation).

In describing partnership fiduciary duties, majority-rule courts often begin with Judge Cardozo's statement that this duty requires "[n]ot honesty alone, but the punctilio of an honor most sensitive."[340] Judge Cardozo's description, exhorting fiduciaries to aspire to a demanding code of ethics, has, however, little specific content. Virtually all court opinions purporting to use the higher partnership fiduciary duty do not delineate in what ways partnership fiduciary duty is "higher." There are no caselaw examples that testify to a more rigorous partnership duty, as such a duty would require conduct that is invalid in the partnership context but would not violate corporate fiduciary duty.[341] Moreover, if this higher fiduciary duty had any content, it would presumably require all majority-rule courts to require equal treatment of shareholders[342] and adopt the reasonable expectations

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[340]Meinhard v. Salmon, 164 N.E.545, 546 (N.Y. 1928). *See also* Regina M. Giannini, *"Punctilio of Honor" or "Disintegrating Erosion"? The Fiduciary Duty to Disclose for Partners, Corporate Directors, and Majority Shareholders*, 27 SW. U. L. REV. 73 (1997).

> In this abundantly quoted passage from Meinhard v. Salmon, Justice Cardozo set forth not only the law, but also the rhetorical tone of discussions regarding the fiduciary relationship. This elevated tone has echoed through the decades and has surrounded the fiduciary relationship with an aura of inviolability bordering on the sacrosanct.

Id. (footnote omitted).

[341]One rare example might involve opportunities in the business association's line of business. A corporate director would breach a fiduciary duty if the director did not make a full disclosure and get the approval of a majority of disinterested directors. *See* Thorpe v. CERBCO, Inc., 676 A.2d 436, 442 n.7 (Del. 1996) (disclosure to and informed rejection by a majority of disinterested directors will preclude future liability for a director who thereafter takes the opportunity); Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 157-58 (Del. 1996) (noting that presentation of purported corporate opportunity to board and rejection of the opportunity by a majority of disinterested directors will create a "safe harbor" but there is no per se rule requiring presentation to board prior to acceptance of opportunity); Klinicki v. Lundgren, 695 P.2d 906, 920 n.12 (Or. 1985) (stating "a simple majority of disinterested directors or shareholders is sufficient to authorize or ratify an appropriation of a corporate opportunity by a director or principal executive officer"). In contrast, in *Dixon v. Trinity Joint Venture*, 431 A.2d 1364, 1371 (Md. 1981), a partner in a comparable position was held liable for not getting rejection of the opportunity from all of the partners, including the limited partners. Even this example is perhaps not simply a function of partnership fiduciary duty; the court in *Dixon* likely applied the agency statute, which requires unanimous approval for self-interested transactions, and ascribed this unanimity requirement to partnership fiduciary duty. *See* RESTATEMENT (SECOND) OF AGENCY § 381 (1958).

> If the agent has, or if he represents another who has, interests adverse to the principal as to matters within the scope of agency, or if he is competing with the principal and using information acquired during his agency, he is under a duty to the principal to reveal such facts in accordance with the rules stated [herein] [[herein]. OR [herein] . . . ."

See id. § 383 ("Except when he is privileged to protect his own or another's interests, an agent is subject to a duty to the principal not to act in the principal's affairs except in accordance with the principal's manifestation of consent.").

[342]*See supra* notes 118-20 and accompanying text (discussing state courts that have adopted equal opportunity rule).

doctrine[343] instead of the very few that have adopted either principle.

Furthermore, majority-rule courts assume that the higher partnership fiduciary duty is tantamount to a business "Golden Rule" that would require partners to watch out for each other's best interests. In reality, courts—even in majority-rule jurisdictions—have consistently interpreted partnership fiduciary duties as far more limited than a Golden Rule would suggest. For example, courts typically endorse some form of the "guillotine" approach to partnership law, whereby partnerships can expel partners, even without cause, ending a partner's employment and financial participation in the partnership.[344] Furthermore, such rulings are a direct rebuttal of the assumption, articulated in *Rodd* and *Wilkes*, that partnership fiduciary duties guarantee the minority a right to equal treatment and a presumptive right to full participation, respectively.[345]

Just as majority-rule courts have mistakenly imposed obligations on close corporations under the guise of higher partnership fiduciary duties, majority-rule courts have also misapplied the corollary issue of the fiduciary obligation of an individual partner. In reality, majority-rule courts hold shareholders in close corporations to a higher standard than that applied to partners within partnerships. For example, the court in *Chesterton* precluded the minority shareholder from selling his stock, reasoning that the minority owed and breached his partnership fiduciary duties because his sale would harm the corporation and his co-shareholders.[346] While partners cannot sell their partnership interest, they can leave an at-will partnership without breaching their fiduciary duties, even when their exit is harmful to the partnership and the partners.[347] Similarly, in *Rexford Rand Corp. v. Ancel*, the court applied the majority

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[343] *See supra* notes 79-97 and accompanying text (discussing that Massachusetts is the only majority-rule state that has adopted the reasonable expectations doctrine as a component of fiduciary law).

[344] *See, e.g.*, Leigh v. Crescent Square Ltd., 608 N.E.2d 1166, 1170 (Ohio Ct. App. 1992) (finding partner fiduciary duty applies only when a partner is taking advantage of his position for his own profit and gain, and finding where a partner is expelled to resolve a partnership schism, there is no violation of the fiduciary duty); Holman v. Coie, 522 P.2d 515, 524 (Wash. Ct. App. 1974) ("Once a schism develops [among partners,] . . . expeditious severance is desirable."); Paula J. Dalley, *The Law of Partner Expulsions: Fiduciary Duty and Good Faith*, 21 CARDOZO L. REV. 181, 188 (1999) (arguing that the expulsion of a partner does not constitute a breach of fiduciary duty); Alan W. Nestal, *Law Partner Expulsions*, 55 WASH. & LEE L. REV. 1083, 1088-110 (1998) (describing cases approving the guillotine approach expulsions in Florida, Illinois, Indiana, New York, and Texas).

[345] *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976) (stating the shareholder had a reasonable expectation to continued employment); *Rodd*, 328 N.E.2d at 518-19 (finding the equal opportunity rule required a buyout of minority shares if corporation buys majority's shares).

[346] *See supra* notes 104-06 and accompanying text (discussing *Chesterton*).

[347] *See supra* note 314 (discussing partner's dissolution rights in an at-will partnership).

rule and found that the minority shareholder continued to owe a duty of loyalty to his co-shareholders, even though he was fired from his job.[348] If the parties had formed a partnership instead of a close corporation, the parties would have had to negotiate for a non-competition agreement. In the absence of such an agreement, a partner who was no longer associated with the partnership would be free to start a competing business.[349] Thus, the partnership fiduciary duty that majority-rule courts purport to apply in the corporate context is premised on incorrect and romanticized view of partnership law.

Other questions regarding the purported "higher" partnership fiduciary duty abound. The Massachusetts Supreme Court's assertion in *Rodd* that the partnership fiduciary duty is higher[350] than the corporate standard is curious, because both partnership fiduciary law and the corporate entire fairness monitor require "utmost good faith" and loyalty.[351] Finding the distinction between partnership and corporate fiduciary duties to be vacuous, the Second Circuit, considering self-dealing by a general partner, reasoned that no distinction could be made between duties owed by corporate directors and partners and went on to analyze the partner's actions using the corporate fairness monitor: "New York makes no distinction between the fiduciary duty owed by a general partner and that owed by a corporate director. One is not greater, and the other lesser. Both are bound by the same rule of fair-dealing . . . ."[352]

Finally, in applying partnership fiduciary duties in the corporate context, courts following the majority rule must consider the impact of the Revised Uniform Partnership Act (RUPA) on those duties.[353] RUPA not

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[348]58 F.3d 1215, 1219-21 (7th Cir. 1995).

[349]*See* Uniform Partnership Act § 21 (specifying that the fiduciary relationship among partners covers the "formation, conduct, or liquidation" of the partnership). *See* Langer v. Becker, 608 N.E.2d 468, 470-71 (Ill. App. Ct. 1992) (holding that once a partner has left the partnership, the fiduciary relationship ceases and remaining partner is free to do business on his own under a new name); Chelsea Indus. v. Gaffney, 449 N.E.2d 320, 326 (Mass. 1983) (stating that partners may even plan to compete with their partnership provided that they do not otherwise violate their fiduciary dutes). *See also* RUPA § 404(b)(3) (limiting partner from competing with the partnership "in the conduct of partnership business before dissolution of the partnership . . . a partner is free to compete immediately upon an event of dissolution, unless the partnership agreement provides otherwise").

[350]*Rodd*, 328 N.E.2d at 515-16 ("We contrast this [partnership] strict good faith standard 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.").

[351]*See supra* Part I.E.3 (discussing utmost good faith standard in entire fairness monitor).

[352]Tucker Anthony Realty Corp. v. Schlesinger, 888 F.2d 969, 973 (2d Cir. 1989).

[353]For a majority rule state that has adopted RUPA, see, e.g., MONT. CODE ANN. §§ 35-10-101 to -616 (Supp. 1994) (adopting RUPA).

only limits fiduciary duties to those of care and loyalty,[354] but also allows such duties to be modified by agreement, subject to some limitations.[355] In addition, RUPA explicitly states that a partner "does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner's conduct furthers the partner's own interest."[356] The Reporter for RUPA posited that an abundance of caselaw language suggesting that partners are held to a loftier standard required RUPA to clarify that the law protects the "legitimate pursuit of self-interest" by partners.[357] Ironically, some commentators posit that RUPA has made the partnership fiduciary duty lower than the corporate fiduciary duty.[358] Therefore, courts that follow the majority rule, but whose legislature has adopted RUPA, must consider the contradiction between RUPA's contraction of fiduciary duties and the majority rule's claim of applying the "higher" partnership fiduciary duty to close corporations.

C. *Is Requiring an Election to Close Corporate Status Too Formalistic?*

As noted above,[359] some legislatures, including Delaware's, have attempted to address the problems unique to close corporate shareholders by granting statutory authority for such shareholders to contract around the

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[354]All partnership fiduciary duties are defined comprehensively and exclusively in RUPA § 404, entitled, "General Standards of Partner's Conduct." Section 404(a) declares that "[t]he only fiduciary duties a partners owes to the partnership and the other partners are the duty of loyalty and the duty of care." Section 404(b) defines the duty of loyalty in RUPA as the duty to account for profits received (in language very similar to the language of § 21 of UPA), to refrain from dealing with the partnership as or on behalf of a party having an adverse interest to the partnership, and to refrain from competing with the partnership. RUPA also specifies a duty to provide information in § 403, and the duty of good faith and fair dealing in § 404(d), but does not characterize either of them as fiduciary duties.

[355]*See* Uniform Partnership Act § 103 (stating the partnership agreement may not "eliminate the duty of loyalty and unreasonably reduce the duty of care, but also allows such duties to be defined in ways that will decrease their potency). *See also* Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready For Prime Time*, 49 BUS. LAW. 45, 52-61 (1993) (arguing against RUPA's revisions requiring a new obligation to be unselfish and mandatory fiduciary duties, because this is contrary to existing partnership law allowing partners to contract around fiduciary duties).

[356]Revised Uniform Partnership Act § 404(e).

[357]*See* Donald J. Weidner, *Three Policy Decisions Animate Revision of Uniform Partnership Act*, 46 BUS. LAW. 427, 462 (1991) (recognizing that RUPA protects the legitimate pursuit of self-interest by partners).

[358]*See* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence From LLCS*, 73 WASH. U.L. Q. 369, 423 (1995) (stating that "LLC statutes should provide for a partnership level of fiduciary duties rather than a higher corporate level").

[359]*See supra* notes 35-41 and accompanying text (discussing statutory framework for close corporations).

norm that had been devised for public corporations. As a result, Delaware courts insist that their role is neither to write the contracts themselves nor to allow the permitted deviations without such contracts.[360] In contrast, majority-rule courts respond to the failure of shareholders to engage in this *ex ante* contracting by using the amorphous partnership fiduciary duty to fashion outcomes consistent either with the shareholder's reasonable expectations or with the court's perception of what this higher duty requires.[361]

Commentators criticize the Delaware solution for two reasons.[362] First, statutory schemes like Delaware's require the corporation to formally elect close-corporate status in order to be able to contract out of the statutory norm.[363] Critics argue that it is form over substance to differentiate closely-held corporations from statutory close corporations because most eligible corporations simply do not go through the formal process of electing close corporate status in Delaware or elsewhere.[364] Second, even when the corporation formally becomes a statutory close corporation, shareholders usually receive no added protection unless they so provide by contract.[365] Critics contend that it is simply unrealistic to expect investors to make the permitted contracts.[366] Therefore, to the extent minority

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[360]*See supra* notes 154-57 and accompanying text (discussing Delaware Supreme Court's reasoning in *Nixon* that legislatures, but not courts, can create special rules for shareholders). *See also* Stevenson, *supra* note 14, at 1150 (discussing the position of Judge Frank H. Easterbrook and Dean Daniel R. Fischel that courts should not write contracts for shareholders *ex post*).

[361]*See supra* notes 122-26 and accompanying text; *see also* Stevenson, *supra* note 14, at 1149-50 (stating that since minority shareholders largely do not make contracts to protect themselves, some courts protect them by imposing enhanced fiduciary duties on all shareholders).

[362]*See infra* notes 364, 366.

[363]*See supra* notes 38-39 and accompanying text.

[364]*See, e.g.*, Drumm, *supra* note 5, at 1180-82 (arguing that the Delaware court's justification for differentiating between closely-held corporations and statutory close corporations is faulty because it fails to account for the number closely-held corporations that do not understand the necessity of electing close-corporate status); Ragazzo, *supra* note 4, at 1130-31 (stating that since the majority of close corporations do not formally elect close corporation status, it is necessary to equate these closely-held corporations with statutory close corporations because these closely-held corporations lack the necessary access to lawyers to formulate protective contracts for the minority shareholders); Meinhardt, *supra* note 13, at 292 (criticizing Delaware's reliance on contractual protections because the small percentage of eligible corporations that elect close corporation status shows that there is a dearth of legal advice used by these investors).

[365]*See supra* notes 40-41.

[366]There are many reasons that shareholders in statutory close corporations do not write contracts to deal with some of the issues that often arise in close corporations. For example, minority shareholders often have little bargaining power or a low level of sophistication. *See* Richard A. Booth, *Fiduciary Duty, Contract, and Waiver in Partnerships and Limited Liability Companies*, 1 J. SMALL & EMERGING BUS. L. 55, 59 (Spring 1997) (noting the dangers faced when fiduciary duties can be reduced and waived and the greater likelihood that unsophisticated investors would be disadvantaged); Meinhardt, *supra* note 13, at 307 (explaining the disadvantages of relying on contracts to protect minority interests in close corporations and

shareholders do not foresee their needs or are simply unable to order their relationships through contract, the Delaware close corporate provisions and other similar statutes offer only a theoretical solution.

The arguments against this aspect of the minority rule have grown increasingly weak. First, with the vast array of business associations available, each with its own attributes, it seems improbable that investors choose the corporate form but are then unable to go the added step of formally electing close corporate status if that is what they want. Second, while it is obvious that investors cannot contract to protect themselves from every form and possibility of abuse, investors can foresee—and therefore, can protect by contract—the most recurrent issues about which they sue: financial benefits, position, and an exit strategy. In other words, the close corporate litigation largely does not present novel, cutting-edge issues that could not have been anticipated. Because these issues are largely foreseeable, the excuses for not creating such contracts seem limited to situations where (i) the parties are unwilling to write contracts due to their harmonious relationship, (ii) the minority is too unsophisticated to appreciate the need for protection, or (iii) the minority could not get the majority to agree to such provisions. Just as it seems disingenuous to assume that investors are sophisticated enough to choose among competing business associations but thereafter cannot elect close corporation status, it seems equally implausible that investors are similarly incapable of effectuating contracts. Quite to the contrary, it is arguable that investors will be attracted to investment vehicles, such as close corporations, only if they can embody their investment concerns in the form of a contract.[367] Finally, if the contracts remain unmade because the minority and majority are unable to come to terms, then the minority's expectations for relief are unreasonable.

Furthermore, although majority-rule courts assume that close corporate shareholders view each other "like partners," it instead seems quite improbable that investors choose the corporate form and yet expect

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arguing that applying partnership law duties to close corporations alleviates many of the concerns facing minority interests that contract provisions fail to address); Stevenson, *supra* note 14, at 1149 (noting that critics argue that changes in the business and in the relationship among shareholders make it difficult to protect oneself by contract, as well as close corporate shareholders being more likely to be legally unsophisticated dissipate the protection thought to be afforded by freedom of contract).

[367] *See* EASTERBROOK & FISCHEL, *supra* note 9, at 273 (acknowledging that investors in both public and close corporations will invest only in those corporations that present the best opportunities for investment, and those opportunities include contractual provisions that protect the interests and investments of minority shareholders).

their relationship to be governed by partnership principles.[368] Both minority and majority shareholders might be quite horrified to learn that despite choosing the corporate form, majority-rule courts could impose unforeseen and demanding restrictions on all shareholders.[369] Indeed, transposing partnership fiduciary duties onto the corporate form might well defeat the expectations of these shareholders. Rather than viewing the minority rule as too formalistic, minority shareholders may instead appreciate the rule's clarity and predictability.

Finally, some argue that Delaware's position is misguided in insisting that close corporate shareholders protect themselves solely by contract.[370] This criticism is baseless, because Delaware—like all states—imposes fiduciary duties on directors, officers and controlling shareholders. In fact, the minority rule is directly analogous to partnership law: both allow the owners by contract to obviate the statutory rules, but all conduct must conform to an overlay of fiduciary duties. Whether corporate fiduciary duties provide an adequate level of protection will be discussed in the next part.

D. *Does the Minority Rule Allow the Minority Shareholder to Be Abused?*

Some commentators argue that minority shareholders in close corporations in Delaware and other minority-rule states are vulnerable because these courts refuse to recognize the problems unique to these shareholders.[371] The lack of expansive protective doctrines and more

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[368] *See id.* at 249-50 (arguing that in choosing to incorporate, there is no reason to believe investors did not consciously trade off the partnership liquidity for the organizational stability of a corporation). *Contra* DOOLEY, *supra* note 26, at 1066 (arguing that the limited liability offered by the corporate form is so attractive that the decision to incorporate may say nothing about whether the investors decided to trade off liquidity for stability).

[369] *See infra* Part IV.E-F (discussing whether minority and majority shareholders are better off in a majority-rule jurisdiction).

[370] *See* Drumm, *supra* note 5, at 1182 (arguing that both fairness and efficiency are undermined when a court insists that all rights maintained by the minority must be provided by contract); Ragazzo, *supra* note 4, at 1129-1130 (explaining that because there are limits on minority's ability to protect itself by contract, close corporation shareholders need protection from fiduciary law); Van Vliet & Snider, *supra* note 8, at 243-44 (stating that contractual provisions often fail to address the unique problems associated with close corporations and therefore the minority-rule courts fail to adequately address these problems by adhering to the statutory norm absent contractual protections).

[371] *See* Ragazzo, *supra* note 4, at 1101, 1147 (stating that Delaware refuses to acknowledge the problems associated with closely-held corporations by refusing to apply special fiduciary duties and relying solely on corporate monitors); Meinhardt, *supra* note 13, at 289-90 (arguing that Delaware courts have reduced common-law protections for minority shareholders in close

limited fiduciary obligations in minority-rule jurisdictions arguably expose the minority shareholder to greater risk. These charges are accurate, but only to a limited extent.

It is true that the minority rule does not recognize several protective doctrines that have been adopted by some majority-rule jurisdictions, such as the equal opportunity rule and the reasonable expectations doctrine. It is clear from Delaware caselaw that a minority shareholder in a Delaware corporation has no right to an equal opportunity to participate in all transactions.[372] As one scholar has written, "A *Rodd* complaint framed as a denial of 'equal opportunity' gets nowhere in Delaware."[373] There are a few majority-rule jurisdictions that continue to follow *Rodd*'s equal opportunity rule and thereby equate the exclusion of the minority shareholder with a per se breach of fiduciary duty.[374] In those jurisdictions, equality is the required *result*; in contrast, inequality is simply a factor to be considered in the *process* of reviewing transactions in Delaware,[375] and, as *Nixon* demonstrates, inequality of treatment will not necessarily make a court deem the transaction unfair. Similarly, minority shareholders will receive added protection in any state that has adopted the reasonable expectations doctrine, given that the doctrine does not require any contract, is focused on the shareholder's expectations instead of on the best interests of the corporation, and is violated by conduct that does not necessarily rise to the level of a breach of fiduciary duty.[376] Massachusetts, however, is the only majority-rule jurisdiction that recognizes the doctrine,[377] although, as discussed above, [378] many states have incorporated the doctrine into their dissolution statutes, either in the statutory language itself or by judicial

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corporations by refusing to adopt the majority rule's special fiduciary duties); Van Vliet & Snider, *supra* note 8, at 243-44 (arguing that by relying solely on statutory and contractual protections, minority-rule courts fail to account for those situations in close corporations that fall outside the scope of these protections and, as a result, minority shareholders are better served when courts adopt majority-rule principles).

[372]*See Nixon*, 626 A.2d at 1366 (rejecting explicitly the application of the equal opportunity rule to close corporations); *Weinberger*, 457 A.2d at 701 (allowing majority shareholder to remain a shareholder while freezing out the minority shareholders if the transaction is entirely fair).

[373]*See* DOOLEY, *supra* note 26, at 1057.

[374]*See supra* note 118.

[375]*See Nixon*, 626 A.2d at 1379 (reasoning that the unequal treatment of shareholders required the transaction to withstand scrutiny under the entire fairness test); *see also* Jedwab v. MGM Grand Hotel, Inc., 509 A.2d 584 (Del. Ch. 1986) (applying entire fairness analysis to a transaction where majority and minority shareholders received different consideration); Siegel, *supra* note 149, at 68 (discussing generally triggers of the entire fairness test).

[376]*See generally supra* note 52 (discussing the vague and loose criteria of the reasonable expectations doctrine).

[377]*See supra* note 123 and accompanying text.

[378]*See supra* note 297.

interpretation.[379] Therefore, while minority-rule jurisdictions do not recognize these doctrines, only a handful of majority-rule states continue to adhere to these doctrines as a matter of fiduciary law.

Other, less obvious, factors also contribute to minority shareholders in close corporations receiving less protection in minority-rule jurisdictions than these shareholders get in majority-rule jurisdictions. The right of shareholders in Delaware corporations to act and vote in their own self interest,[380] even when those interests are contrary to the interests of the corporation, makes minority shareholders more vulnerable to the majority's self-interested conduct. For example, while shareholders in Delaware corporations could sell their shares freely, some majority-rule jurisdictions have prevented shareholders from selling their shares.[381] This could bring both new, unwanted shareholders into the corporation, as well as impose financial hardship on all shareholders if, for example, the sale caused the corporation to lose its Subchapter S tax election.[382] Moreover, a minority shareholder who could prove that a freeze-out transaction lacked a valid business purpose would win under *Wilkes* because Massachusetts caselaw requires a legitimate business purpose, even for freeze-outs.[383] In contrast,

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[379]*See, e.g.*, *Kiriakides*, 541 S.E.2d at 265-66 n.25 (determining that oppression can include reasonable expectations).

[380]*See generally supra* note 177 and accompanying text (discussing cases that allow shareholders in Delaware corporations to act in their own self interest when acting in their personal capacity).

[381]*See* Bodio v. Ellis, 513 N.E.2d 684, 689 (Mass. 1987) (preventing shareholders from selling their shares because the transfer froze out the minority shareholders); A.W. Chesterton Co. v. Chesterton, 128 F.3d 1 (1st Cir. 1997) (preventing shareholder from selling his shares because the sale would cause adverse tax consequences to the corporation).

[382]*See generally supra* note 8 (explaining tax consequences to shareholders in Subchapter S corporations).

[383]*See* Coggins v. New England Patriots Football Club, Inc. 492 N.E.2d 1112 (Mass. 1986) (invalidating the transaction after finding that there was no valid business purpose for the freeze-out of the minority and instead related entirely to the personal interests of the majority); Leader v. Hycor, Inc., 479 N.E.2d 173 (Mass. 1985) (holding that evidence that the main reason behind a recapitalization was not to eliminate the public shareholders, but was instead related to the poor price of the stock, demonstrated that the recapitalization by means of a reverse stock split was designed to achieve a legitimate business purpose). *Accord* Alpert v. 28 Williams St. Corp., 473 N.E.2d 19 (N.Y. 1984) (holding that freeze-out must not only be entirely fair but it must also advance a corporate purpose other than eliminating the minority shareholders). In contrast, some courts have followed Delaware and held that a valid business purpose is not required in a freeze-out merger. *See, e.g.*, Lerner v. Lerner, 750 A.2d 709, 722-23 (Md. Ct. Spec. App. 2000) (finding that a valid business purpose is not required in a freeze-out merger that has the effect of eliminating minority interests); *In re* Hesston Corp., 870 P.2d 17, 43-45 (Kan. 1994) (rejecting minority shareholder's argument that the majority breached its fiduciary duty in effectuating a cash-out merger that eliminated the minority's interests and holding that a valid business purpose is not required); Persinger v. Carmazzi, 441 S.E.2d 646, 654 (W. Va. 1994) (accepting Delaware's view that a legitimate purpose is not necessary for a freeze-out and holding that the majority did not breach any fiduciary duty to minority shareholders in a closely-held corporation when it choose to perform a freeze-out solely for the purpose of gaining more control over the

the purpose for the freeze-out would be irrelevant to the entire fairness of the transaction in Delaware, even if the transaction were a conflict-of-interest transaction.[384] A dissident shareholder in Delaware has no vested right to remain a shareholder and can be forced out of the corporation as long as there is fair dealing and fair price.[385] As discussed above,[386] however, the demands of entire fairness test are stringent.

Often, the greater worry for a minority shareholder is not a freeze-out but rather a "freeze-in" or a "financial freeze-out," where shareholders retain their stock but are denied any financial participation in the corporation: they are not employed, do not receive dividends, and are unable to sell their stock. While neither the *Nagy* nor the *Nixon* plaintiffs argued to the Delaware Supreme Court that they had been financially frozen out of the corporation,[387] the Delaware Supreme Court in *Nagy* opined, *in dictum*, that the majority may owe fiduciary duties to minority shareholders who are fired from their employment and otherwise financially squeezed out.[388]

Despite the dictum in *Nagy*, it is difficult to predict with certainty how minority-rule courts would respond to such claims by minority shareholders in close corporations. Since *Nixon* held there were no special rules for close corporations, the critical question is whether existing corporate rules can successfully monitor complaints typically made by such shareholders. It is clear that a plaintiff would need more than a claim for reasonable expectations, but it is less clear whether Delaware and other minority-rule courts would monitor such claims under the deferential business judgment rule or the more rigorous entire fairness test. Nevertheless, there are some examples that frame the analysis that a minority-rule court might undertake.

As decisions on whom to hire, whether to declare dividends or repurchase stock are matters that are entrusted to the board's discretion, minority-rule courts would begin by viewing each decision alone or the

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corporation). For a discussion of the evolution of the entire fairness standard and the Delaware Supreme Court's decision that a valid business purpose is not required for a freeze-out merger, see Mary Siegel, *Tender Offer Defensive Tactics: A Proposal for Reform*, 36 HASTINGS L.J. 377, 401-07 (1985).

[384] *Weinberger*, 457 A.2d at 715. *See also* Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 YALE L.J. 1354, 1356-57 n.9 (1978) (reasoning that there is no role for business purpose as a doctrine in filtering permissible from impermissible freeze-outs in close corporations").

[385] If the freeze-out is effectuated through a merger, the frozen-out shareholders will have appraisal rights. *See* DEL. CODE ANN. tit. 8, § 262 (2001).

[386] *See generally supra* notes 228-32 and accompanying text.

[387] *See* discussion of *Nagy*, *supra* note 164, and accompanying text. In *Nixon*, the plaintiff did not appeal the denial of dividends, i.e., the issue of being de facto squeezed out by being denied a financial participation in the corporation. *Nixon*, 626 A.2d at 1366.

[388] *Nagy*, 683 A.2d at 40.

decisions in their totality under the business judgment rule. Majority-rule courts attack the deference that the business judgment rule accords to directors, noting that perfectly legal action can be a disguised usurpation of the minority's interest.[389] Quite obviously, the business judgment rule would be disturbingly insufficient if the court reflexively deferred to the board. Even the business judgment rule, however, is not a license for boards to exercise unlimited discretion; boards are given great leeway, but they must not commit fraud or grossly abuse their discretion.[390] Indeed, Delaware courts look carefully at the context for board actions, even under the business judgment rule, to determine whether the board of directors has exceeded these boundaries. For example, in *Gabelli & Co. Profit Sharing Plan v. Liggett Group, Inc.*,[391] the Delaware Supreme Court, using the business judgment rule, nevertheless carefully considered the plaintiff's claim that the controlling shareholder caused the board of directors to deviate from its historical plan under which the corporation had paid quarterly dividends, and instead withheld dividends in order to allow the majority shareholder to retain the minority's share of the dividend funds in the subsequent cash-out merger into the controlling shareholder's corporation.[392] Similarly, in *Baron v. Allied Artists Pictures Corp.*,[393] the Delaware Court of Chancery closely examined plaintiff's request that the court order a new election for directors because the current board, elected

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[389]*See, e.g.*, Smith v. Atlantic Props., Inc., 422 N.E.2d 798, 804 (Mass. App. Ct. 1981) (acknowledging that a judgment ordering directors to pay dividends correctly disregards the traditional rule which avoids interfering with a corporation's dividend policy based on the business judgment of the directors because in a close corporation, such deference would protect otherwise legal action that in reality appropriated some of the minority's interest); Fox v. 7L Bar Ranch, 645 P.2d 929, 935 (Mont. 1982) ("When it is also considered that in close corporation dividend withholding may be used by controlling shareholders to force out minority shareholders, the traditional judicial restraint in interfering with corporation dividend policy cannot be justified." (internal quotation omitted)).

[390]*See* BALOTTI & FINKELSTEIN, *supra* note 152, § 4.35 (stating that it is well settled that absent fraud or bad faith, the business judgment rule applies).

[391]479 A.2d 276 (Del. 1984). The court in *Gabelli* stated:

> It is settled law in this State that the declaration and payment of a dividend rests in the discretion of the corporation's board of directors in the exercise of its business judgment; that, before the courts will interfere with the judgment of the board of directors in such matter, fraud or gross abuse of discretion must be shown, . . . Gabelli has not alleged fraud; and it has made no showing that the failure of Liggett's Board to declare a third-quarter dividend, under the undisputed facts and circumstances of this case, is explicable only on the theory of a gross or oppressive abuse of discretion.

Id. at 280. *See also* Siegel, *supra* note 149, at 52 n.120 (noting *Gabelli* as an example of the Delaware court's willingness to carefully scrutinize board actions to determine whether the board or controlling shareholders abused their positions).

[392]*Gabelli & Co.*, 479 A.2d at 277.

[393]337 A.2d 653 (Del. Ch. 1975).

by the preferred shareholders, was able to perpetuate itself in power by refusing to pay dividends to those shareholders.[394] Rather than summarily dismiss plaintiff's claim because directors have great leeway in deciding to declare or withhold dividends, the court instead examined the corporation's uneven financial history to satisfy itself that there were ample business reasons for the board to withhold dividends, despite the existence of a legal source of funds from which dividends could be paid.[395] Although ultimately denying plaintiff's request, the court nevertheless admonished the board that it does have a fiduciary duty to pay the preferred dividend as soon as prudently possible so as to return the control of the corporation to the common shareholders.[396] Thus, even granting a board of directors broad discretion under the business judgment rule, Delaware courts might critically examine otherwise ordinary decisions that were, in reality, designed to starve out the minority shareholder.

More likely, in the context of a close corporation, the controlling shareholders will also be officers and directors, setting their own salaries and making business decisions regarding transactions that the minority shareholder claims amount to a freeze-out. While corporate statutes specifically require officers' salaries to be set by disinterested directors,[397] any conflict-of-interest transaction must also withstand analysis by the entire fairness monitor instead of the business judgment rule, absent a procedural device that might shift the burden to the plaintiff to prove unfairness.[398]

Several recent cases, some involving closely-held corporations, demonstrate the efficacy of the entire fairness monitor. In *Boyer v. Wilmington Materials, Inc.*,[399] the shareholder claimed that in order to eliminate him from his management and ownership positions, the defendants approved the sale of all the assets of this corporation to a second corporation that defendants, but not plaintiff, would own. The defendants had followed the law to the letter: they meticulously complied with the corporation's bylaws, their stockholders' agreement and Delaware law for calling a meeting of directors.[400] Even though the transaction appeared to be legal, the Delaware Court of Chancery nevertheless held that the

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[394] *Id.* at 659 (noting that pursuant to the corporation's charter, the preferred shareholders were entitled to elect a majority of the board of directors if the corporation did not pay dividends to the preferred for a specified period of time).

[395] *Id.* at 659-60.

[396] *Id.* at 660.

[397] DEL. CODE ANN. tit. 8, § 141(h) (2000); 2 MODEL BUS. CORP. ACT ANN. § 8.11 (3d ed. 1996).

[398] *See* BALOTTI & FINKELSTEIN, *supra* note 152, § 4.6.

[399] 754 A.2d 881 (Del. Ch. 1999).

[400] Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 900 (Del. Ch. 1999).

transaction was not entirely fair because there was neither fair dealing nor fair price.[401] Similarly, the Delaware Court of Chancery in *Wilderman v. Wilderman*[402] ruled that the business judgment rule would not apply to executive compensation because it had not been set by a disinterested board. Instead, because the defendant/president set his salary "by his own fiat,"[403] the court required him to show the entire fairness of his compensation, a burden which defendant was unable to meet.[404] Finally, in *In re Tri-Star Pictures, Inc., Litigation*,[405] the Delaware Supreme Court refused to be pigeon-holed into examining each step of a multi-step transaction in isolation,[406] and instead pierced through each legal step to examine the total impact of the alleged transgressions on the minority shareholders.[407] The Delaware Supreme Court concluded that these directors with significant stock ownership were self-dealing, reasoning that when the cash value of minority shares is diluted for benefit of the controlling shareholder, the transaction is not entirely fair.[408]

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[401]The defendants conceded entire fairness applied. *Boyer*, 754 A.2d at 898. The court found that there was no fair dealing because defendants sought to keep plaintiff uninformed about their plans, and no fair price because the sale price did not reflect the corporation's going concern value. *Id.* at 901-02.

[402]315 A.2d 610 (Del. Ch. 1974).

[403]*Id.* at 615.

[404]*Id.* at 615. While the court also required the defendant to pay the corporation excess payments made to defendant's pension plan that were tied to the defendant's excessive compensation, the court refused to order the payment of dividends from the reconstructed net profits, finding the dividend decision should be made by the board. *Id.* *See also* Garza v. TV Answer, Inc., No. 12,784, 1993 Del. Ch. LEXIS 40, at *19 (Del. Ch. Mar. 11, 1993), *reprinted in* 19 DEL. J. CORP. L. 290, 304 (1994) (denying defendants' motion to dismiss, reasoning that although many of plaintiff's claims would ordinarily be governed by the business judgment rule, where directors grossly or fraudulently abuse their discretion, directors will be required to prove the entire fairness of their actions). The complaint alleged that the majority shareholders issued watered-down stock to themselves at the expense of the minority shareholder.

[405]634 A.2d 319 (Del. 1993).

[406]*See id.* at 331 (reasoning that it must review the "cumulative impact of the Combination on the minority" rather than examining each transgression in isolation).

[407]The court determined that all shareholders had not suffered equally and recognized that every dilution is a part of a transfer of minority equity to the controlling shareholder: "The practical effect of cash-value dilution is to increase the value of the controlling shareholder's interest at the sole expense of the minority." *Id.* at 330. The challenged sale of assets by the controlling shareholder had given it substantial stock that allowed it to effect a merger with the seller from which the controlling shareholder obtained huge profits. *Id.* In contrast, the Delaware Court of Chancery had dismissed most of plaintiff's claims that alleged that claims that the controlling shareholder had received a premium price for assets it sold to the corporation, reasoning that plaintiff's claim would, at most, be a claim for waste of corporate assets, a claim which the chancery court held was extinguished by the subsequent merger of the corporation. *Id.* at 332.

[408]*Id.* at 333; *see also* Stahl v. Apple Bancorp, 579 A.2d 1115, 1122 (Del. Ch. 1990) (recognizing that the directors' legal exercise of power may nevertheless be inequitable and subject to court remedies, but holding in case at hand that actions by directors did not impair or impede

In addition to the rigors of the entire fairness monitor, other cases highlight Delaware's strong commitment to fiduciary duties. First, there are several Delaware cases that have invalidated entirely legal transactions on the grounds that they were simply inequitable.[409] For example, in *Rabkin v. Hunt*,[410] the purchaser of the majority of Hunt's common stock also contracted to pay $25/share if it bought the remaining common stock within one year. Although the new majority shareholder had no legal obligation to buy the remaining stock within the year, it proposed a cash-out merger at $20 just days outside the timeframe that would have triggered the $25 price.[411] The Delaware Supreme Court held that the majority failed the entire fairness test because it dealt unfairly with the minority shareholders.[412] The court, rejecting defendant's claim that it had no legal obligation to effect the cash-out merger within the one year period, stated that "inequitable conduct will not be protected merely because it is legal."[413] Similarly, in *Fulk v. Washington Service Assoc., Inc.*,[414] the Delaware Court of Chancery examined carefully the defendant's conduct, as the defendant used his voting power to block any proposed sale and threatened to compete unless his family trust was allowed to buy the corporation.[415] The court reasoned that although defendant's conduct was technically legal, it was designed to force the other shareholder to sell his stock at a low price, thereby "improperly diverting the economic interest"[416] of the other shareholder. The Delaware Court of Chancery, ruling under the statute's dissolution provision, found that it had equitable powers to prevent a breach of fiduciary duties and to fashion remedies not specified by the statute in order

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shareholders' right to vote). *Cf.* Blasius Ind. v. Atlas Corp., 564 A.2d 651, 663 (Del. Ch. 1988) (finding that the directors' legal actions, while in good faith, were nevertheless invalid due to interference with the shareholders' vote).

[409] *See, e.g.*, Schnell v. Chris Craft Indus., 285 A.2d 437, 439 (Del. 1971) (awarding shareholder equitable relief despite directors following the corporate statute and corporate by-laws, reasoning that "inequitable action does not become permissible simply because it is legally possible"); Aprahanian v. HBO, 531 A.2d 1204 (Del. Ch. 1987) (granting an injunction to prevent directors from using their power to postpone a shareholder meeting because the court found that the incumbent board manipulated the election process in bad faith). *Cf.* VGS v. Castiel, No. 17,995, 2000 Del. Ch. LEXIS 122, at *1, *7-*14 (Del. Ch. Aug. 31, 2000) (explaining that although defendants had the legal right to force a merger under the Delaware Limited Liability Company Act and their agreement, their actions were nevertheless a breach of their duty of loyalty).

[410] 498 A.2d 1099 (Del. 1985).

[411] *Id.* at 1102.

[412] *Id.* at 1106.

[413] *Id.* at 1107.

[414] No. 17,747-NC, 2002 Del. Ch. LEXIS 78, at *1 (Del. Ch. June 21, 2002).

[415] *Id.* at *26.

[416] *Id.*

to protect the plaintiff's investment.[417]

Second, the Delaware Supreme Court has emphasized the importance of fulfilling fiduciary duties, even if the beneficiary is not harmed. In *Oberly v. Kirby*,[418] the court reasoned:

> It is an act of disloyalty for a fiduciary to profit personally from the use of information secured in a confidential relationship, even if such profit or advantage is not gained at the expense of the fiduciary. The result is nonetheless one of unjust enrichment which will not be countenanced by a Court of Equity.[419]

Similarly, the court in *In re Tri-Star Pictures, Inc.* found that the beneficiary needs to prove only that the directors and majority shareholders breached their fiduciary duty and does not need to show that the beneficiary was specifically harmed by this breach.[420]

These examples of Delaware's strong commitment to fiduciary duties should not be misunderstood. While cognizant of its equitable power, and determined not to facilitate inequitable conduct merely because it is done in a technically legal manner, the Delaware Supreme Court is equally sensitive to the dangers of disregarding legal conduct under the guise of equity. For example, in *Nixon*, the Delaware Supreme Court opined: "We are mindful of the elasticity inherent in equity jurisprudence . . . yet one must be wary of equity jurisprudence which takes on a random or ad hoc

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[417]The solution, recommended by a court-appointed custodian pursuant to DEL.CODE ANN., tit. 8, § 226 (2001), was that either shareholder could buy out the other, with a non-competition covenant imposed on the shareholder who sold. *Fulk*, 2002 Del. Ch. LEXIS 78, at *2. *Cf.* Moore v. Maine Indus. Servs., Inc., 645 A.2d 626, 628-29 n.3 (Me. 1994) (finding that the since the majority shareholders acted as directors, the business judgment rule was the appropriate mechanism to analyze their actions). The Maine Supreme Court, in overruling a summary judgment in favor of the majority shareholders, utilized the business judgment rule but nevertheless analyzed whether the majority breached a duty to the minority shareholder by attempting to fire him and by refusing to pay dividends. *Id.*

[418]592 A.2d 445 (Del. 1991).

[419]*Id.* at 463. The court in *Oberly*, however, refused to find that the director breached his fiduciary duty to the foundation by replacing the board with members of his own family because his secret activities did not financially harm the foundation and he did not financially benefit from the transactions. *Id.*; *see also Thorpe*, 676 A.2d at 445 (holding that the scope for recovery for breach of duty of loyalty should not to be determined narrowly); *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d at 334 ("The absence of specific damage to a beneficiary is not the sole test for determining disloyalty by one occupying a fiduciary position."); Boyer v. Wilmington Materials, Inc., 754 A.2d 881, 906 (Del. Ch. 1999) ("Once disloyalty has been established, the standard involved in *Oberly v. Kirby* and *Tri-Star* require that a fiduciary not profit personally from his conduct, and that the beneficiary not be harmed by conduct.").

[420]*In re Tri-Star Pictures, Inc. Litig.*, A.2d at 334.

quality."[421] Factored into those situations where the court might refuse to apply its equitable powers surely would be situations, as in *Nixon*, where the court believed the transaction had a valid corporate purpose, rather than self-aggrandizement of the majority shareholder at the minority's expense. In addition, the court would likely differentiate between those routine situations, where the shareholder could have protected its financial interests by contract, from those transactions, as in *Tristar* and *Rabkin*, which are beyond a minority shareholder's contractual control. While a minority shareholder in Delaware would be protected from abuse, categorizing all corporate decisions that deprive minority shareholders of all financial benefits from the corporation as *per se* abusive is unlikely in Delaware or other minority-rule jurisdictions. In sum, while shareholders in minority-rule jurisdictions will not have their reasonable expectations or mere preferences satisfied, it is a gross exaggeration to assume that courts in these states would permit these shareholders to be abused.

E. *Are Minority Shareholders Better off in a Majority-Rule Jurisdiction?*

Some commentators[422] and courts[423] tout the majority rule as necessary to protect minority shareholders in close corporations. These commentators further argue that these shareholders want, or even perhaps expect, heightened fiduciary duties among all shareholders because of their partnership-like relationship.[424] Furthermore, some proponents of the majority rule advocate that applying a partnership-like fiduciary duty to all

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[421] *Nixon*, 626 A.2d at 1378 n.17.

[422] *See, e.g.*, Heatherington & Dooley, *supra* note 9, at 6 (stating that unique position of minority shareholders in a close corporation often requires added protection because the minority faces significant hazards such as illiquidity and exclusion from decision making by the majority); Rock & Wachter, *supra* note 28, at 916 (finding that minority shareholders in close corporations are particularly vulnerable due to the lack of public market locking the parties into their investment and therefore require enhanced fiduciary duties to protect them from adverse actions by the majority); Van Vliet & Snider, *supra* note 8, at 258 (noting that because minority shareholders in close corporations are vulnerable to freeze-outs by the majority, additional protections are necessary in order to prevent the minority shareholders from receiving a diminished value for their stock).

[423] *See, e.g.*, *Rodd*, 328 N.E.2d at 513 (noting that minority shareholders are particularly vulnerable to oppressive actions by the majority, such as freeze-outs, and therefore finding that it is necessary to provide the minority with added protections, such as enhanced fiduciary duties); *Walta*, 40 P.3d at 456 (explaining that enhanced fiduciary duties are applied in the close corporation context in order to combat the ability of the majority to apply tactics that are especially harmful to minority interests).

[424] *See, e.g.*, Van Vliet & Snider, *supra* note 8, at 255-58 (arguing that the unique relationships among shareholders in close corporations often cause shareholders to expect application of higher fiduciary duties since the relationship closely resembles a partnership).

shareholders in close corporations should be the default rule because the principles of the majority rule promote efficiency.[425]

While majority-rule jurisdictions empower minority shareholders with added litigation weapons, this empowerment has its own costs to the very shareholders whom the rule purports to protect. The following section highlights these costs and therefore questions the assumption that minority shareholders are better off in a majority-rule jurisdiction.

1. Minority Shareholders Have Liability for Inside Trading

There are currently two theories under which individuals will be liable for inside trading under the anti-fraud provision, Rule 10b-5, of the Securities Exchange Act of 1934.[426] One theory, the "classic" theory, holds individuals liable if they trade on material, nonpublic information in breach of a fiduciary duty to the person on the other side of the trade.[427] The second theory, the "misappropriation" theory, holds individuals liable if they misappropriate material confidential information in breach of a fiduciary duty to the source of that information, and then used it in connection with the purchase or sale of a security.[428] By predicating the inside trading violation under both theories on the existence and breach of a fiduciary duty, the United States Supreme Court dictated that the applicability of the federal inside trading law depends on fiduciary law. As

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[425]*See* Drumm, *supra* note 5, at 1182 (arguing that fairness and efficiency require application of enhanced fiduciary duties in close corporation context and therefore, the reliance by minority-rule jurisdictions on parties' ability to contract for their own protections is misplaced).

[426]Securities Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (2002). While a breach of fiduciary duty is clearly one requirement for liability under Rule 10b-5, it is currently unclear whether any fiduciary duty is required under Securities Exchange Act Rule 14e-3, 17 C.F.R. § 240.14e-3 (2002), which prohibits inside trading in the context of tender offers. While the SEC has argued that Rule 14e-3 does not require any fiduciary duty, in *United States v. O'Hagan*, 521 U.S. 642, 676 (1998), the Supreme Court equivocated by stating that a fiduciary duty was not required in a case like *O'Hagan*. Since the defendant in *O'Hagan* did, in fact, owe and breach a fiduciary duty, the *O'Hagan* decision left open the possibility that a fiduciary duty may be required under Rule 14e-3. The majority of circuits have not addressed this issue, but both the Second and Third Circuits have interpreted *O'Hagan* as stating that the government does not have to show a breach of fiduciary duty under Rule 14e-3. *See, e.g.*, Brody v. Transitional Hosp. Corp., 230 F.3d 997, 1004 (3d Cir. 2002) (quoting *O'Hagan* and *United States v. Chestman* for the proposition that a fiduciary duty is not required under 14e-3); SEC v. Warde, 151 F.3d 42, 47 (2d Cir. 1997) (relying on *Chestman* for the proposition that Rule 14e-3 does not require proof of a fiduciary relationship).

[427]*See* Chiarella v. United States, 445 U.S. 222, 227-28 (1980) (refusing to find the defendant liable for insider trading because he was not in a position of trust and confidence to the person on the other side of the trade).

[428]*See O'Hagan*, 521 U.S. at 652 ("[A] person commits fraud 'in connection with' a securities transaction, and thereby violates [section] 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information.").

one scholar wrote:

> Someone violates the federal insider trading prohibition only if his trading activity breached a fiduciary duty owed either to the investor with whom he trades or to the source of the information. From a securities law perspective, the federal prohibition thus is an empty shell. It has no force or substance until it has been filled with fiduciary duty concepts.[429]

Thus, who owes fiduciary duties under state law has enormous implications under the federal securities laws. The Supreme Court's analysis of inside trading issues seems to assume that the category of corporate fiduciaries is self evident, and further assumes that officers, directors, and controlling shareholders are the only corporate fiduciaries.[430] Yet given that minority shareholders in close corporations in majority-rule states are deemed to be fiduciaries, they too have potential liability for inside trading under the federal securities laws.

A recent case, *SEC v. Sargent*,[431] demonstrates this potential liability. Shepard and Aldrich were the sole owners of a Massachusetts corporation. The Securities and Exchange Commission (SEC) sued Shepard and his dentist, Sargent, alleging that Shepard misappropriated material, nonpublic information from Aldrich about Aldrich's other business venture.[432] The SEC alleged that Shepard's misappropriation was in breach of a fiduciary duty that Shepard owed Aldrich,[433] and that Shepard further passed this information to his dentist, Sargent.[434] Defendants contended that neither Shepard nor Sargent could be liable as Shepard did not owe a fiduciary duty to Aldrich.[435] Citing Massachusetts caselaw, the SEC presented, and the court accepted, evidence of the requisite fiduciary duty "arising out of their status as sole shareholders of their closely-held business corporation."[436]

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[429]Stephen Bainbridge, *Incorporating State Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1190 (1995).

[430]*See Chiarella*, 445 U.S. at 222, 227-29 (assuming that state law holds only officers, directors and controlling shareholders are fiduciaries in a corporation). The Court also assumed that state law uniformly considered inside trading by officers or directors to violate their fiduciary duty, when in fact, state law is far from uniform. *Id.* at 230; *see also* Ray Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U.L. REV. 467, 472-473 (2002) (discussing the three predominant views in state law regarding liability for inside trading).

[431]229 F.3d 68 (1st Cir. 2000).

[432]*Id.* at 73.

[433]*Id.* at 75-76.

[434]*Id.* at 72.

[435]*Sargent*, 229 F.3d at 75.

[436]*Id.* at 76.

Had Shepard been a non-controlling shareholder in a minority-rule jurisdiction, he would not have owed any fiduciary duty; without a fiduciary duty to keep this information confidential, Sargent's trading on the information could not result in liability for inside trading under Rule 10b-5.[437] Similarly, since control in minority-rule jurisdictions is defined with reference to the ability to dictate a corporate transaction,[438] it is difficult to imagine scenarios whereby non-corporate information—as was used in *Sargent*—could qualify a shareholder in a minority-rule jurisdiction as controlling with a concomitant fiduciary duty.[439] While it would be true that an informational disparity would exist between the traders if such shareholders could trade on the basis of this information, the Supreme Court has unequivocally rejected that trading based on an information disparity alone will violate the federal securities laws.[440]

The SEC's recent enactment of Rule 10b5-2,[441] however, has diminished the importance of the difference between the majority and minority rules regarding who owes fiduciary duties because Rule 10b5-2—by federal rule—broadens the group who will be deemed to be fiduciaries for purposes of the misappropriation theory. Rule 10b5-2 creates three groups who are fiduciaries: (1) anyone who agrees to keep information confidential; (2) parties who have a history of sharing confidences so that the recipient of the information would know that confidentiality is expected; and (3) immediate family members, namely spouses, siblings, parents and children.[442] Thus, under the facts in *Sargent*,

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[437]In *Dirks v. SEC*, 463 U.S. 646 (1983), the United States Supreme Court established several criteria under which a tippee, like Sargent, would be liable under Rule 10b-5 for inside trading. Among these criteria, a tipper, like Shepard, must breach a fiduciary duty in disclosing confidential information to the tippee, Sargent. *Id.* at 660. Thus, if Shepard did not breach a fiduciary duty, Sargent's liability as a tippee is foreclosed.

[438]*See supra* notes 197-99 and accompanying text.

[439]In *Sargent*, the information related to the source's other business venture. *Sargent*, 229 F.3d at 71. The court in *Sargent* nevertheless rejected this argument by citing to *SEC v. Peters*, 735 F. Supp. 1505 (D. Kan. 1990), where the defendant misappropriated from his partner confidential information that, like in Sargent, did not relate to the partnership. The court in *Sargent* reasoned that, like the defendant in *Peters*, a jury could reasonably find that the shareholder "expected that confidential business matters, even those unrelated to the . . . firm, would be held in trust," and that the defendant owed a fiduciary duty to safeguard this information. *Sargent*, 229 F.3d at 76. Given that the shareholders in Sargent were fiduciaries under the majority rule, the court had no reason to consider the more basic question of how non-corporate information could make an otherwise noncontrolling shareholder into a controlling shareholder, with concomitant fiduciary duties.

[440]*See Chiarella*, 445 U.S. at 227-28.

[441]17 C.F.R. § 240.10b5-2 (2002).

[442]*Id.* Members in the third group are presumptive fiduciaries and can rebut the inference by demonstrating

> that no duty of trust or confidence existed with respect to the information, by establishing that he or she neither knew nor reasonably should have known that

since Shepard both agreed to keep the information confidential and had a history of keeping confidential any information learned in his office,[443] Shepard would have been covered under Rule 10b5-2 under either of the first two subsets even if he had been a noncontrolling shareholder in a corporation in a minority-rule jurisdiction.

Rule 10b5-2, however, will not compensate completely for the differences between the majority and minority rules regarding the potential liability of shareholders. Shepard would not be a fiduciary under either state law or Rule 10b5-2 if, as a noncontrolling shareholder in a corporation governed by the minority rule, Shepard was not an immediate family member of Aldrich's and Shepard neither agreed to keep information confidential nor had any history of keeping information confidential. A non-confidential relationship among shareholders in a close corporation would not be unusual where the minority shareholder had become disaffected with the corporation and the other shareholders. Additionally, Rule 10b5-2, which applies solely to the misappropriation theory,[444] would not be relevant if such a shareholder were prosecuted instead under the classic theory because he bought stock in his own corporation based on inside information.

The Supreme Court's decision to predicate the federal cause of action on fiduciary relationships and duties, without even the most basic acknowledgment of the differences between the majority and minority rules, has established the important doctrine of inside trading on a base of quicksand. As a Second Circuit opinion indicated, most fiduciary obligations are "anything but clear" and feared its decisions could "lose method and predictability"[445] because of the nexus between inside trading and fiduciary law. Given the centrality of the fiduciary duty requirement for inside trading liability, the differences between the majority and minority rules under state law regarding who owes fiduciary duties are critical to the federal law on inside trading.

> the person who was the source of the information expected that the person would keep the information confidential, because of the parties' history, pattern, or practice of sharing and maintaining confidences, and because there was no agreement or understanding to maintain the confidentiality of the information.

Id. § 240.10b5-2(b)(3).

[443] *Sargent*, 229 F.3d at 76.

[444] Both the title and preliminary note to Rule 10b5-2 state that the rule defines circumstances in which a person has a duty of trust or confidence for purposes of the misappropriation theory of inside trading. *See* 17 C.F.R. § 240.10b5-2 (2002).

[445] *See* United States v. Chestman, 947 F.2d 551, 564-67 (2d Cir. 1991) (*en banc*), *cert. denied*, 503 U.S. 1004 (1992) (noting that the Rule 10b-5 precedents provide little guidance for determining whether there are fiduciary obligations).

2. Uncertainty Created by Equating Closely-Held Corporations with Statutory Close Corporations

As discussed above,[446] majority-rule courts equate closely-held corporations with statutory close corporations, and further equate these corporations with partnerships for purposes of imposing and interpreting fiduciary duties. Some courts further cloud the issue by reasoning that they will equate closely-held corporations with statutory close corporations only if the shareholders so intend.[447] When investors incorporate in a majority-rule jurisdiction, they face added uncertainties about their rights and obligations as *de facto* partners. These ambiguities are further compounded when courts recognize the reasonable expectations doctrine as a component of fiduciary law.

Fiduciary obligations impact on all close corporate shareholders in majority-rule jurisdictions. While most defendants in close corporate cases are controlling shareholders, this is certainly not universally true. As discussed above,[448] because all shareholders are fiduciaries under the majority-rule, these courts have forbidden minority shareholders from selling their stock,[449] competing with their corporation,[450] and using their veto power to prevent the corporation from declaring dividends.[451]

Moreover, it is not difficult to posit other scenarios for future litigation. For example, Massachusetts courts might invalidate shareholder voting agreements and voting trusts because they might violate the reasonable expectations of the excluded shareholders regarding voting power in the corporation. Consider, for example, three shareholders who own an equal amount of stock. Each shareholder began the venture knowing that any two shareholders could decide an issue on which shareholders vote. When two of these shareholders form a voting agreement or voting trust, however, these two will decide all issues and be able to exclude the non-participating shareholder—clearly contrary to the excluded shareholder's reasonable expectations. Moreover, the *dictum* in

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[446] *See supra* notes 109-18 and accompanying text.

[447] *See, e.g.*, Lawton v. Nyman, 327 F.3d 30, 38-39 (1st Cir. 2003) (emphasizing that shareholders may owe enhanced fiduciary duties if the facts of the case indicate that such a duty exists and there is no contrary agreement); A. Teixeira & Co. v. Teixeira, 699 A.2d 1383,1387 (R.I. 1997) (finding that actions of the shareholders indicated on intent to run the corporation as a close corporation and therefore, the corporation could be equated with statutory close corporations).

[448] *See supra* Part I.C (discussing that majority-rule courts apply fiduciary duties to all shareholders, including minority shareholders).

[449] *See* A.W. Chesterton Co. v. Chesterton, 128 F.3d 1, 7 (1st Cir. 1997).

[450] *See* Hagshenas v. Gaylord, 557 N.E.2d 316, 323-24 (Ill. App. Ct. 1990).

[451] *See* Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 798 (Mass. App. Ct. 1981).

Rodd that urges courts to defer to a contract among the shareholders would likely be inapplicable because that *dictum* assumed all shareholders are parties to the contract.[452] Majority-rule courts have already invalidated fact patterns only slightly different from this voting agreement scenario. In *Bodio v. Ellis*,[453] a Massachusetts court found one of three shareholders violated his fiduciary duties in transferring shares to a second shareholder so as to give the transferee voting control, contrary to the third party's expectations. Similarly, in *Hallahan v. Haltom Corp.*,[454] a Massachusetts appellate court held that when additional shares were issued to one of two families, such issuance frustrated the reasonable expectations of the two families that they would be equal shareholders.[455]

In sum, minority shareholders face added liability in majority-rule jurisdictions for breaching their fiduciary duties and for inside trading. They also face uncertainty about their obligations, given the disparity of views about each aspect of the majority rule. Furthermore, the fiduciary obligation is indisputably amorphous and being required to fulfill other shareholder's reasonable expectations only compounds the imprecision. Minority shareholders thus might very well conclude that they would be better off not being shareholders in a majority-rule jurisdiction if they could embody their deal and their expectations in a contract and the minority rule offered sufficient protection for unforeseeable issues.

F. *Implications of the Majority Rule for Controlling Shareholders*

The most obvious implication of being a controlling shareholder in a majority-rule state is that these shareholders will owe potentially broader and deeper fiduciary duties if the partnership duty that governs is, in fact, higher than the corporate duty.[456] Certainly, in Massachusetts, fiduciaries have the added burden of meeting the reasonable expectations of the minority shareholders.[457] Moreover, controlling shareholders will likely be managers. Majority-rule courts do not necessarily defer, under the business

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[452] *See supra* note 70. While the court in *Rodd* discussed the contract exception in the context of the equal opportunity rule, see *id.*, other majority-rule courts have expanded the context. *See id.*

[453] 513 N.E. 684 (Mass. 1987).

[454] 385 N.E.2d 1033 (Mass. App. Ct. 1979).

[455] *Id. Cf.* Cressy v. Shannon Continental Corp., 378 N.E.2d 941, 945-46 (Ind. Ct. App. 1978) (ruling that fiduciary duties required two equal shareholders to act in accordance with their reasonable expectations of equal control and both parties breached this duty by failing to disclose intent to sell their shares).

[456] *See supra* Part IV.B (questioning whether the partnership fiduciary duty is higher).

[457] *See supra* notes 122-23 and accompanying text (stating that Massachusetts is the only majority-rule jurisdiction that recognizes the doctrine of reasonable expectations as a component of fiduciary law).

judgment rule, to decisions the managers make.[458] More concretely, while controlling shareholders have complete freedom in minority-rule jurisdictions to vote in their own self-interest as shareholders, in majority-rule jurisdictions they are also fiduciaries in their personal capacity and are thus constrained in their voting.[459] Thus, the freedom that goes with corporate control will be severely limited.

It is not difficult to posit scenarios where being able to vote selfishly as a shareholder could have important consequences. In *Wilkes*, for example, the court thwarted the majority's right to vote as shareholders for whomever they wanted to serve as directors in order to satisfy Wilkes's reasonable expectations that he would be employed.[460] Moreover, majority-rule jurisdictions would not permit, as did the Delaware Supreme Court in *Thorpe v. CERBCO, Inc.*,[461] controlling shareholders as directors to recommend a transaction for approval by the shareholders if the transaction were arguably in the corporation's best interest, and then veto the transaction as shareholders if the transaction were not in the controlling shareholder's best interest.[462] Similarly, in minority-rule jurisdictions, controlling shareholders could, as shareholders, approve an exculpatory provision[463] limiting the liability of the directors—who would also likely be these shareholders. Massachusetts courts would invalidate this self-interested voting unless the controlling shareholders prove, under *Wilkes*, a legitimate business purpose for the exculpatory clause.

While controlling shareholders have added burdens in majority-rule jurisdictions, these shareholders get the benefit of having all of their co-shareholders owe fiduciary duties as well. As noted above,[464] this fiduciary duty prevents minority shareholders from acting in their own self interest. Moreover, even majority-rule jurisdictions will honor contracts that all

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[458] *See also* Gigax v. Repka, 615 N.E.2d 644, 648-49 (Ohio Ct. App. 1992) (thwarting the majority's effort to fire an employee of the corporation that was also a minority shareholder).

[459] *See supra* notes 243-46 and accompanying (discussing that both corporate and personal actions must be consistent with the shareholders' fiduciary duties in majority-rule jurisdictions).

[460] *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 661 (Mass. 1976) (awarding money damages to Wilkes from the majority shareholders according to the salary he would have received if he remained an officer and director of corporation).

[461] 676 A.2d 436 (Del. 1996).

[462] *Id.* at 440 (holding that the controlling shareholder could vote as a shareholder any way it wanted).

[463] *See* DEL. CODE ANN., tit. 8, § 102(b)(7) (creating six exceptions demarcating activity for which there cannot be exculpation). *Cf.* RMBCA § 202(b)(4) (allowing shareholders to authorize exculpation from liability for all activities except for four examples of extreme behavior).

[464] *See supra* Part I.E.3 and accompanying text (discussing implications of majority rule imposing fiduciary duties on minority shareholders).

shareholders have made.[465] This may undercut at least some of the added burdens that the majority rule imposes on controlling shareholders, particularly because these shareholders may well have been instrumental in fashioning the terms of these contracts.

V. LESSONS FROM THE FUTURE

The 1990s saw many developments in business law. Two new business associations, the Limited Liability Company (LLC) [466] and the Limited Liability Partnership (LLP),[467] were created, combining favorable tax treatment, limited liability and freedom of contract.[468] In addition, both the UPA[469] and the ULPA were revised.[470]

There are three trends that run through these new business associations and statutory revisions. First, the newer business associations are more contract-oriented, and require the courts to provide maximum enforceability of the contracts investors make among themselves.[471] This is why RUPA has very few mandatory rules that cannot be altered by a partnership agreement,[472] and why the Delaware Limited Liability Company

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[465] *See supra* note 70 and accompanying text (discussing the contract exception in *Rodd*).

[466] *See* UNIFORM LIMITED LIABILITY COMPANY ACT (1996) (ULLCA).

[467] REVISED UNIFORM PARTNERSHIP ACT § 1001 (1997) (RUPA).

[468] *See generally* Treas. Reg. § 301.7701 (as amended in 1997) (creating the "check the box regulations"). As these regulations allow any unincorporated business association to choose its desired tax treatment, they eliminated the tax motivation for the creation of LLCs and LLPs.

[469] *See* REVISED UNIFORM PARTNERSHIP ACT (1997).

[470] REVISED UNIFORM LIMITED PARTNERSHIP ACT (1985) (RULPA). Many substantive changes were made to the UPA in 1994 in the first version of RUPA. The 1997 amendments to RUPA incorporated provisions for a Limited Liability Partnership.

[471] *See, e.g.*, UNIFORM LIMITED LIABILITY COMPANY ACT § 103 (1996); REVISED UNIFORM PARTNERSHIP ACT § 1001 (1997) (addressing limited liability partnerships); *id.* § 103; UNIFORM PARTNERSHIP ACT § 18 (1914) (UPA); UNIFORM LIMITED PARTNERSHIP ACT § 110 (2001) (Re-RULPA). *See also* Sandra K. Miller, *What Buy-out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Corporation?* 38 HARV. J. ON LEGIS. 413, 451 (2001) (investors want their agreements enforced and not vulnerable to "fuzzy notions of fiduciary duty"); Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 450 (1999) (advocating a purely contractual remedy, arguing that even the minimal default fiduciary duty in LLCs are counterproductive).

[472] *See* Weidner, *supra* note 357, at 454:

> The Drafting Committee wanted to make clear that all but a very few of the rules governing the relations among partners are merely *default* rules. It was only in rare situations that the Committee felt that the rules should be *mandatory*. Mandatory rules governing the relations among partners are essentially parentalistic, and the Committee felt that, with only very limited exception, adults in nonconsumer transactions should be held to their agreements.

Id. at 454-55 (emphasis added).

See REVISED UNIFORM PARTNERSHIP ACT § 103 (1997) (listing ten matters that are not waivable by partnership agreement, including the fiduciary duties of loyalty and care prescribed

Act (DLLCA) explicitly states, "It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements."[473] Second, the move to increasing contract rights has led to a concomitant ability among investors to decrease their fiduciary obligations. For example, both the ULLCA[474] and RUPA[475] permit investors to curtail fiduciary duties.[476] In describing these newer business associations, one author wrote:

> Vague broad statements of a powerful duty of loyalty cause too much uncertainty. . . . Even if there are no bad holdings, overly broad judicial language has left practitioners uncertain about whether their negotiated agreements will be voided. . . . Attorneys and their clients want to be able to negotiate transactions, reduce their agreements to writing, and have some comfort that those agreements will not be undone by "fuzzy" notions of fiduciary duties.[477]

Third, there is a trend toward eliminating at-will dissolution rights in limited liability entities.[478] This trend demonstrates that granting investors

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in section 104(b) and (c) and the duty of good faith and fair dealing prescribed in section 404(d)). Section 103 provides that these duties may be modified by agreement if the modifications are not manifestly unreasonable, but they cannot be waived entirely. *Id.*

[473]DEL. CODE ANN. tit. 6, § 18-1101 (1999).

[474]*See* UNIFORM LIMITED LIABILITY COMPANY ACT § 4009 (1996) (stating the only two fiduciary duties owed by members of a member-managed company are the duty of loyalty and the duty of care).

[475]*See* REVISED UNIFORM PARTNERSHIP ACT § 404 (1997) (stating the duty of loyalty and duty of care are the "only" fiduciary duties of a partner).

[476]*Cf.* discussion *supra* notes 468-73 and accompanying text (noting other states, like Delaware, go even further and permit investors by contract to decrease the standard for fiduciary duties in LLC's beyond what the Uniform Law permits).

[477]Miller, *supra* note 471, at 450. *Contra*, Drumm, *supra* note 5, at 1186 (reasoning that without default fiduciary duties, more uncertainties exist which may discourage investment). Notably, the ULLCA mirrors the Delaware close corporation rule in assigning fiduciary duties only to managers. *Compare* Nixon v. Blackwell, 626 A.2d 1366, 1377 (Del. 1993) (stating that the only shareholders who owe fiduciary duties are those that control the corporation), *with* UNIFORM LIMITED LIABILITY COMPANY ACT § 409(h) (1996) (stating that in a manager-managed company "a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member"). *See also* UNIFORM LIMITED LIABILITY COMPANY ACT § 409 (1996) (confining fiduciary duties to those of loyalty and care, defines the standard of care as gross negligence and making fiduciary duties mandatory, all similar to RUPA).

[478]While the ULLCA and RUPA retain the right to at-will dissolution, several state LLC statutes eliminate these at-will exit rights. *Compare* REVISED UNIFORM PARTNERSHIP ACT §§ 601, 801 (1997), *and* UNIFORM LIMITED LIABILITY COMPANY ACT § 701(a), (f) (1996), *with* ALA. CODE § 10-12-30 (1998); ALASKA STAT. § 10.50.185 (Michie 1998); ARIZ. REV. STAT. § 29-707 (1999); CAL. CORP. CODE § 17252 (West 1999); COLO. REV. STAT. ANN. § 7-80-603 (West 1999); DEL. CODE ANN. tit. 6, § 18-603 (1998); FLA. STAT. ch. 608.427 (1999); GA. CODE ANN. § 14-11-

at-will dissolution rights is linked to unlimited liability, rather than tied to any sense of fiduciary duties.[479]

These three trends appear to break with the majority rule and instead emulate the pattern delineated in the Delaware close-corporate statute and reaffirmed in *Nixon*. Rather than being an isolated aberration from business law, *Nixon* appears to have presaged these national developments.[480] In fact, one author stated that legislatures used the LLC statutes to express their displeasure with judicial meddling in the affairs of close corporations, with *Rodd* being the chief culprit.[481]

Moreover, although critics depict *Nixon* as outside the mainstream of business associations law regarding the lesser degree of protection it offers to minority shareholders,[482] the trend among the statutes of newer business associations is to offer minority owners even less protection than does the Delaware corporate statute, and instead to require them to protect

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601 (Harrison 1998); OHIO REV. CODE ANN. § 1705.16 (Anderson 1998); R.I. GEN. LAWS § 7-16-29 (1998); VA. CODE ANN. § 13.1-1032 (Michie 1999). *See also* Miller, *supra* note 471, at 415 n.4 and accompanying text (noting there is a growing trend to eliminate at-will exit rights under state LLC acts.) The trend against at-will dissolution rights in LLCs accelerated once the IRS no longer required LLCs to have partnership characteristics in order to gain partnership tax status. *Id.* at 429-30. The RULPA allows only a general partner to retain at-will dissolution rights, while a limited partner may withdraw only pursuant to the partnership agreement. REVISED UNIFORM LIMITED PARTNERSHIP ACT §§ 603-604 (1985). If the agreement is silent regarding time or events of withdrawal, only then may the limited partner withdraw, and then only after giving at least six months notice to the general partners. *Id.* § 603. The proposed revisions to the RULPA, Re-RULPA, would eliminate the general partner's right to at-will dissolution. *See* Proposed Revisions of ULLPA (1976) with 1985 Amendments § 505.

[479]Thus, under the RULPA, a general partner has liberal withdrawal rights but a limited partner does not. REVISED UNIFORM LIMITED PARTNERSHIP ACT §§ 602-603 (1985). *See* Miller, *supra* note 471, at 422-23 (arguing that the exposure that unlimited liability creates is still an insufficient reason to grant at-will dissolution rights when balanced against the harm that these rights create, such as instability in the partnership and abuse by the partners).

[480]*See* David L. Cohen, *Theories of the Corporation and the Limited Liability Company: How Should Courts and Legislatures Articulate Rules for Piercing the Veil, Fiduciary Responsibility and Securities Regulation for the Limited Liability Company?* 51 OKLA. L. REV. 427, 475-76 (1998) (stating that "legislative intent behind Delaware's LLC act seems to be maintain Delaware's competitiveness as a place to charter business entities"). *But see* Jonathan R. Macy, *The Limited Liability Company: Lessons for Corporate Law*, 73 WASH. U. L. Q. 433, 444 (1995) (arguing that as many of the disputes involving limited liability corporations are analogous to those facing close corporations, Delaware is not likely to become the dominant state because Delaware's statute is focused on public companies).

[481]*See* Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Court to Restructure the Internal Affairs of Small Businesses,* 66 U. COLO. L. REV. 881, 884 (1995) (stating that "[s]everal states, in their LLC statutes, attempt to restrict, or even constrict the trend" of expanding protections for the minority owners).

[482]*See supra* note 11 (noting under Delaware law that courts will govern all corporations by the same corporate norms, and will enforce contracts shareholders have made for themselves only if their corporation is a statutory close corporation).

themselves by contract.[483] For example, the ULLCA grants members the ability to contract to decrease fiduciary obligations,[484] while investors in a Delaware statutory close corporation do not have that right, even by contract. Moreover, while both the statutory close corporation and LLC allow investors' agreements to specify grounds for dissolution of the business association, the corporate statute, but not the LLC, provides grounds for involuntary dissolution.[485] As a result, minority members in an LLC may be locked into their business association even more than shareholders are in their statutory close corporation.[486]

While the national business trend is to support the concepts embodied in *Nixon*, actions by the Delaware legislature also suggest that it wholeheartedly endorses the holding in *Nixon*. For example, while the ULLCA has default fiduciary duties that cannot be waived by contract,[487] the DLLCA allows parties flexibility to contract away fiduciary duties.[488]

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[483] *See, e.g.*, Miller, *supra* note 471, at 431 (noting that minority members in an LLC may be even less protected than are minority shareholders in a close corporation).

[484] *See* UNIFORM LIMITED LIABILITY COMPANY ACT § 103 (1996) (allowing members to reasonably reduce the duty of care and identify activities that will not violate the duty of loyalty if they are "not manifestly unreasonable").

[485] *See, e.g.*, DEL. CODE ANN., tit. 8, § 273 (2001) (specifying grounds for involuntary dissolution).

[486] *See* Miller, *supra* note 471, at 431 ("These restrictions on withdrawal and/or distribution rights effectively 'lock in' the LLC owner whose agreement lacks a provision expressly bestowing buy-out rights or a provision addressing deadlocks or disputes.").

[487] *See generally* UNIFORM LIMITED LIABILITY COMPANY ACT § 103, 409 (1996) (describing the fiduciary duties that apply to members and managers in a LLC). While the ULLCA explicitly prohibits the elimination of the duty of loyalty, the unreasonable reduction of the duty of care, and the elimination of the obligation of good faith and fair dealing, it does permit modification of these duties. *Id.* § 103(b). For example, the ULLCA allows the operating agreement to define specific categories of activities that the parties to the agreement will not consider violations of the duty of loyalty. *Id.* § 103(b)(2)(i). Arguably, the ability to define what is and is not a violation of the duty of loyalty provides a substantial opportunity to constrict the duties owed. The ULLCA limits the ability to modify the duty of loyalty only by saying the modifications cannot be unreasonable. *Id.* The ULLCA permits similar modification of the duty of care and obligation of good faith, disallowing only unreasonable modifications. *Id.* § 103(b)(3)-(4).

[488] *See* DEL. CODE ANN. tit. 6, § 18-1101 (1999) (allowing parties to define the nature of the duty of loyalty by contract, but stops short of allowing the total elimination of duty of loyalty by contract). The DLLCA § 18-101 states in part:

> (b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements. (c) To the extent that, at law or in equity, a member or manager has duties (including fiduciary duties) . . . (1) [a]ny such member or manager . . . shall not be liable . . . for the member or manager's good faith reliance on the provisions of the limited liability company agreement; and (2) [t]he member's or manager's . . . duties may be expanded or restricted by provisions in a limited liability company agreement.

See LARRY E. RIBSTEIN & ROBERT R. KEATINGE, RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES, App. 9-1, at 11 (2001) (providing a chart entitled, "Waiver of Fiduciary Duties" that

Similarly, RUPA does not allow parties to eliminate their fiduciary duty of loyalty,[489] whereas DRUPA permits the elimination of this duty.[490] These departures from the respective uniform codes demonstrate the penchant of the Delaware legislature to have shareholders in small business associations protect themselves by contract, rather than by fiduciary duties.[491] Furthermore, Delaware is one of a handful of states that has linked dissolution in an LLC to provisions in the LLC agreement, rather than to events that would cause a dissolution in a partnership.[492] Given its increasing inclination for having parties in any business association define their relationship by contract, it is highly unlikely that the Delaware legislature would have supported judicial rulings that imposed partnership fiduciary duties on all shareholders.

Moreover, as discussed above, critics have long argued that the Delaware close corporation scheme is flawed in requiring shareholders to contract to provide for special dividend, employment, repurchase or dissolution rights. The criticism is that investors in these small business associations do not expend the resources to protect themselves by

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compares the different LLC statutes among the states and notes how much flexibility each state provides to contract out of fiduciary duties).

[489]*See* REVISED UNIFORM PARTNERSHIP ACT § 103(b) (1997) (expressly prohibiting the elimination of the duty of loyalty while allowing reasonable modifications of the duty of care and the obligation of good faith and fair dealing).

[490]*See* DEL. CODE ANN. tit. 6, § 15-103 (2002) (Delaware Revised Uniform Partnership Act (DRUPA) (prohibiting the elimination of the obligation of good faith and fair dealing by partnership agreement, but not prohibiting the elimination of the duty of care or the duty of loyalty).

[491]*See* Miller, *supra* note 471, at 456:

> [T]he position of the minority LLC owner is seriously compromised in Delaware, which prohibits the LLC member from resigning prior to the dissolution and winding up of the LLC unless the LLC agreement provides to the contrary. The Delaware LLC statute lacks even the most basic of provisions that normally protect minority owners. It fails to contain any minimum standards of good faith or fiduciary duty, but rather leaves the parties free to expand or contract the member's or manager's duties and liabilities. It is silent regarding the manner in which an operating agreement may be amended, possibly leaving the door open to adverse majority-driven changes in the fundamental rights and duties of the minority. Further, it is conceivable that under the Delaware LLC statute, a merger could be approved by a majority of the LLC members, leaving the minority without dissenter's rights, because the Delaware LLC statute offers only contractual appraisal rights, and not all minority owners may possess the foresight, resources, and/or negotiating power to obtain contractual appraisal rights in the operating agreement.

[492]*See* Miller, *supra* note 471, at 429-30 (noting that states such as Alabama, Alaska, Arizona, California, Colorado, Delaware, Florida, and the District of Columbia do not link dissolution to an event such as death, as does a partnership). *See also* DEL. CODE ANN. tit. 6, § 18-801(a) (1999) (presuming that an LLC has perpetual existence, like a corporation).

contract.[493] While the Delaware close corporate statute requires investors to contract to increase their protection, the opposite is true in a Delaware LLC, where a contract is needed to decrease fiduciary duties.[494] Yet when investors in a LLC create such a contract, critics abandon their argument that investors do not expend resources to create contracts and instead criticize the statute's granting investors this contractual power.[495] This hypocrisy exposes that the real concern is not whether shareholders will expend the effort to protect themselves by contract but rather disagreement over the choices that shareholders make by contract.

More than failing due to this hypocrisy, and more than failing due to arrogating legislative functions, the majority rule should fail because it is intellectually dishonest. The majority rule inaccurately portrays partnership law by mixing the statute, partnership agreements and a romanticized view of partnership fiduciary duties. The majority rule then transposes this souped-up version of partnership law onto close corporations, disregarding that each business association is designed with its own attributes, shorn with advantages and disadvantages. Similarly, the fiduciary label that the *Rodd* court gratuitously and perhaps unthinkingly conferred on all shareholders deserves reexamination. With so many incongruities, it is not surprising that the majority rule never actually attained that status and today represents only a thin coalition of states.

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[493]*See, e.g.*, Meinhardt, *supra* note 13, at 291-92 (criticizing Delaware's reliance on contractual protections because the small percentage of eligible corporations that elect close corporation status shows that there is a dearth of legal advice used by these investors).

[494]DEL. CODE ANN. tit. 6, § 18-1101(c) (2003).

[495]*See* Claire Moore Dickerson, *Equilibrium Destabilized: Fiduciary Duties Under the Uniform Limited Liability Company Act*, 25 STETSON L. REV. 417, 419-20 (1995) (criticizing the policy choice of the drafters of the ULLCA allowing the option, through contract, to eliminate or decrease fiduciary duties); Meinhardt, *supra* note 13, at 302 (stating that "[w]ithout baseline fiduciary duties, the controlling shareholders can inequitably allocate wealth within the enterprise"). *See also* Dent, *supra* note 13, at 87-88 (arguing increased fiduciary duties is more efficient).

APPENDIX (CHART)

True Majority		Partial Majority, Partial Minority		Minority			Too Close to Call	Neither Majority Nor Minority: Apply Statute		Have Not Decided
1. Majority Rule Based on Cases, No Statute	2. Majority Rule Based on Cases, Statute Not Dominant	3. State Accepts Some Majority Rule Principles, But Not All	4.Applying Heightened Duty, but Only to Directors, Officers and Controlling Shareholders or Vice Versa	5. Minority Rule Based on Cases, No Statute	6. Minority Rule Based on Cases, Statute Seldom Used	7. Minority Rule Based on Cases Decided Outside Statute; Statute Still Important	8. Applying Majority Rule in One or Two Cases, but Not Clear State Will Continue to Follow or Apply	9. Ruling Solely/Primarily Under Oppression Statute, Where Statute Defines Oppression	10. Ruling Largely Under Oppression Statute, Where No Statutory Definition of Oppression	11. Either Have Not Considered or Have Not Reached A Conclusion Regarding the Debate
Mass.[1]	Montana[2]	California[3]	Colorado[4]	Delaware[5]	Idaho[6]	Iowa[7]	Alabama[8]	Minnesota[9]	New Jersey[10]	Alaska[11]
	Nebraska[12]	Indiana[13]	Illinois[14]	Kansas[15]	Maryland[16]	South Dakota[17]	Georgia[18]	North Dakota[19]		Arizona[20]
	New Mexico[21]		North Carolina[22]	Louisiana[23]	Missouri[24]	Texas[25]	Michigan[26]	Oregon[27]		Arkansas[28]
	Rhode Island[29]		Ohio[30]	Florida[31]	West Virginia[32]	Virginia[33]	Nevada[34]	Pennsylvania[35]		Hawaii[36]
			Tennessee[37]		Connecticut[38]		Vermont[39]			Kentucky[40]
					Mississippi[41]		Wisconsin[42]			New Hampshire[43]
					Maine[44]		District of Columbia[45]			New York[46]
										Oklahoma[47]
										South Carolina[48]
										Utah[49]
										Washington[50]
										Wyoming[51]

[1]With no oppression statute, all shareholder complaints in Massachusetts are brought as breach of fiduciary duty cases. Massachusetts is considered the leader of the majority rule, even though its supreme court in *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976), eliminated the equal opportunity rule first adopted in *Donahue v. Rodd*, 328 N.E.2d 505 (Mass. 1975). *See Wilkes*, 353 N.E.2d at 663; *Donahue*, 328 N.E.2d at 515-16 & n.17 (all shareholders in close corporations owe partnership fiduciary duties to each other). In addition, Massachusetts' courts recognize that a violation of a shareholder's reasonable expectations may constitute a breach of fiduciary duty. *Wilkes*, 353 N.E.2d at 664 (stating that the fiduciary duty of the majority requires consideration of shareholder expectations and long standing policies among shareholders).

[2]Montana's close corporation oppression statute, in place since 1987, provides for a number of remedies in addition to dissolution. *See* MONT. CODE ANN. § 35-9-501-04 (1992). While no rulings appear to have been made under the current statute, the state supreme court indicated that oppression would continue to be interpreted with regard to the reasonable expectations of shareholders, as was done, albeit rarely, under the former statute, which provided only for dissolution. *See* Daniels v. Thomas, Dean & Hoskins, Inc., 804 P.2d 359, 368-69 (Mont. 1990) (describing precedent finding that violation of reasonable expectations of remuneration and voice in management constituted oppressive conduct). Outside the statute, Montana courts have adopted the *Wilkes* ruling's rebuttable legitimate business purpose test, and impose heightened fiduciary duties on all shareholders in close corporations. *See, e.g.*, Sletteland v. Roberts, 16 P.3d 1062, 1067 (Mont. 2000) (all shareholders in a close corporation owe fiduciary duties and cannot be limited where minority shareholder can adversely affect the corporation); *Daniels*, 804 P.2d at 366 (holding that the fiduciary duty among stockholders of a close corporation is one of the utmost good faith and loyalty, and that the legitimate business purpose test applies).

[3]While California does not have an oppression statute, it does provide numerous grounds for involuntary dissolution including persistent unfairness toward any shareholders, and specifically provides that in a corporation with 35 or less shareholders, grounds also include liquidating if it is "reasonably necessary for the protection of the rights or interests of the . . . shareholders." CAL. CORP. CODE § 1800 (West 1990). *See* Bauer v. Bauer, 54 Cal. Rptr. 2d 377, 381-84 (Cal. Ct. App. 1996) (rejecting "reasonable expectations" approach for interpretation of "persistent unfairness" but referring to shareholder expectations in the subsection allowing for dissolution where "reasonably necessary for protection of the rights or interests" of shareholders in close corporations). Outside the statute, the single majority rule principle followed by California courts is the equal opportunity rule. In 1969, before the Massachusetts rulings on which the majority rule has been based, a California court determined that majority shareholders' fiduciary duties included an equal opportunity rule very much like the one imposed by the court in *Rodd*. *See* Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 471 (Cal. 1969).

> Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately and must not conflict with the proper conduct of the corporation's business.

Id. Notably, however, this California ruling is based on its own state precedent, which interprets its Supreme Court's discussion of the duty owed by a majority shareholder. *See* Pepper v. Litton, 308 U.S. 295 (1939). *See Jones*, 460 P.2d at 471-72. California courts continue to apply the equal opportunity rule, but there has been no subsequent indication that California courts intend to follow any other majority rule principles. *See, e.g.*, Stephenson v. Drever, 947 P.2d 1301, 1307-08 (Cal. 1997) (describing fiduciary duties as applicable to majority shareholders and requiring good faith, inherent fairness, and equal opportunity); Biren v. Equality Emergency Med. Group, Inc., 125 Cal. Rptr. 2d 325, 331-32 (Cal. App. 2002) (describing fiduciary duty of a director in a close corporation and suggesting that business judgment rule applies absent evidence of conflict of interest, fraud, oppression, or corruption).

[4]Colorado has an oppression statute, COLO. REV. STAT. § 7-114-304 (1994), which Colorado courts have interpreted to be intertwined with fiduciary duties. *See* Polk v. Hergert Land & Cattle Co., 5 P.3d 402, 404-05 (Colo. Ct. App. 2000) (discussing oppression as including reasonable expectations, but "closely related to a breach of fiduciary duty"); Colt v. Mt. Princeton Trout Club, Inc., 78 P.3d 1115 , 1118 (Colo. Ct. App. 2003) (citing *Polk* for principle that the definition of oppression is flexible, but intertwined with fiduciary duty). Outside of the statute, Colorado cases have adopted enhanced fiduciary duties in close corporations, but have never suggested that all shareholders owe duties, instead finding that duties are only owed by officers, directors, and controlling shareholders. *See* Wisehart v. Zions Bancorporation, 49 P.3d 1200, 1204 (Colo. Ct. App. 2002) ('[I]n the context of close corporations, as here, [fiduciary] duty is enhanced and requires corporate directors to 'fully disclose all material facts and circumstances surrounding or affecting a proposed [stock] transaction' with a shareholder.") (quoting Van Schaack Holdings, Ltd. v. Van Schaack, 867 P.2d 892, 897-98 (Colo.1994)); Pueblo Bancorporation v. Lindoe, Inc., 37 P.3d 492, 499 (Colo. Ct. App. 2001) (using customary corporate language to describe the duty of good faith that directors, officers, and controlling shareholders owe, and noting that in close corporations, "the relationship between directors and shareholders is treated like the relationship between partners"). Further, the *Wisehart* court did not consider the possibility that a corporate officer/shareholder owed a duty to another officer/shareholder simply by virtue of shareholder status. *Wisehart*, 49 P.3d at 1207 (discussing the plaintiff's allegations that the duty to disclose could be based only on the purported oral agreement between the two).

[5]With no oppression statute, all shareholder complaints in Delaware are brought as breach of fiduciary duty cases. In the leading case, representing the minority rule, the Delaware Supreme Court explicitly rejected every principle in the *Rodd* case. *See* Nixon v. Blackwell, 626 A.2d 1366, 1381 (Del. 1993) (stating that corporate monitors will govern all issues regardless of whether the corporation is public, closely held, or a statutory close corporation).

[6]While Idaho has an oppression statute, it requires a plaintiff to prove not only oppression, but also that irreparable injury will result from the objectionable conduct. *See* IDAHO CODE § 31-1-1430 (Michie 1997). Given the difficulty of proving these standards, it is not surprising that few cases have been brought under the statute. *Cf. Id.* (noting that the irreparable injury requirement was retained in the 1997 revisions to the statute due to concerns "that shareholders have other protective actions such as derivative or class action suits and that dissolution should not be ordered solely on a showing of improper conduct, but should require a further showing of irreparable injury."). Outside the statute, at least one Idaho case suggests that Idaho courts are aware that other jurisdictions may apply partnership duties in close corporations. *See* Steelman v. Mallory, 716 P.2d 1282, 1285 (Idaho 1986) (citing a well-known treatise on close corporations and precedent from other jurisdictions, the court acknowledged an awareness that some other jurisdictions applied heightened fiduciary duties in close corporations). *See also* Jenkins v. Jenkins, 64 P.3d 953, 957-58 (Idaho 2003) (holding that a duty to disclose was not an issue in the case because there was no corporate opportunity, and rejecting precedent from other states implying the application of partnership principles of disclosure and unanimity). Subsequent cases make clear that Idaho has not applied partnership duties, or otherwise adopted majority-rule concepts, as allegations of breach of fiduciary duty in closely held corporations have been addressed through typical corporate language, and where directors are involved, through discussion of the business judgment rule. *See, e.g., Jenkins*, 64 P.3d at 957-59 (discussing claims for breach of fiduciary duty in four-shareholder corporation where other shareholder/officers/directors effectively dissolved corporation to develop a new project and applying traditional corporate opportunity doctrine); McCann v. McCann, 61 P.3d 585, 590 (Idaho 2002) (noting that while directors in close corporations owe duties to one another, the corporation and all shareholders, the business judgment rule "immunized" the directors' actions if they acted in good faith and with honest business judgment); *see also* Jordan v. Hunter, 865 P.2d 990, 995-96 (Idaho Ct. App. 1993) (discussing fiduciary duties owed by officer/shareholder under agency principles and without mention of close corporation context). Further, one case suggests there are no duties between shareholders absent special circumstances, such as a purchase of shares. *See*

Hines v. Hines, 934 P.2d 20, 23-24 (Idaho 1997) (holding that while there is no general fiduciary duty between shareholders, majority shareholders negotiating purchase of minority shareholder's stock owes fiduciary duty to minority).

[7]There are no cases under Iowa's current dissolution statute. IOWA CODE ANN. §§ 490-1430 (West 1991). The scant precedent under Iowa's former dissolution statute, which did not define oppressive conduct, suggested that the state's courts will define oppression to include a breach of fiduciary duties and the reasonable expectations of shareholders. *See* Maschmeier v. Southside Press, Ltd., 435 N.W.2d 377, 380 (Iowa Ct. App. 1988).

> Alleged oppressive conduct by those in control of a close corporation must be analyzed in terms of 'fiduciary duties' owed by majority shareholders to the minority shareholders and 'reasonable expectations' held by minority shareholders in committing capital and labor to the particular enterprise, in light of the predicament in which minority shareholders in a close corporation can be placed by a "freeze-out" situation."

There is no indication, however, that the *Maschmeier* court considered fiduciary duties enhanced in close corporations, and was clear that it considered these duties to be owed only by the majority to the minority, rather than all shareholders. *Id.* Outside of the statutory context, only one state opinion has indicated that the court may have considered the majority rule. *See* Connolly v. Bain, 484 N.W.2d 207, 211 (Iowa Ct. App. 1992) (citing *Wilkes* for proposition that "[c]ourts are disinclined to interfere in internal corporate operations involving management decisions, subject to the principle of majority control"). Again, that opinion did not analogize close corporations to partnerships, nor did it discuss any majority rule precedent other than Wilkes. *Id.* Other state precedent indicates that Iowa courts will apply traditional corporate monitors in the close corporation context. *See* Lange v. Lange, 520 N.W.2d 113, 120-22 (Iowa 1994) (considering majority shareholders' fiduciary duties in connection with corporate opportunities, share repurchase, and issuance of common stock without mention of close corporation context); Cookies Food Prods., Inc. v. Lakes Warehouse Distrib., Inc., 430 N.W.2d 447, 451 (Iowa 1988) (describing fiduciary duties as owed only by directors, officers, and majority stockholders, and noting that the defendant owed no fiduciary duty based on shareholder status until moment he acquired control, and analyzing officer/director/majority shareholder actions based on corporate principles); Holden v. Construction Mach. Co., 202 N.W.2d 348, 358 (Iowa 1972) ("From all this flows the conclusion, officers and directors of a corporate entity, particularly management controlling directors of closely held corporations occupy a fiduciary, or at least a quasi-fiduciary position as to the corporation and its stockholders. They are thus required to at all times act in utmost good faith . . . .").

[8]Although Alabama has an oppression statute, ALA. CODE § 10-2B-14.30 (1994), scant case law under it seem to interpret "oppression" as analogous to "squeeze-outs," which includes being "deprived of [a] fair share of corporate gains, such as salaried employment, dividends, or other corporate privileges [the shareholder] reasonably might have expected to receive by virtue of his position as a stockholder." *See* Brooks v. Hill, 717 So.2d 759, 767-68 (Ala. 1998) (describing intent of the statute as providing remedy where minority has been deprived of financial benefits but is unable to withdraw from the corporation). In *dictum*, the court in *Brooks* spoke approvingly of majority rule principles. *Id.* at 764 (quoting O'NEAL & THOMPSON, *supra* note 41, § 8.07: "Where several owners carry on an enterprise together (as they usually do in a close corporation), their relationship should be considered a fiduciary one similar to the relationship among partners. The fact that the enterprise is incorporated should not substantially change the picture."). In an earlier ruling, the court determined that a separate cause of action was available for a squeeze out, but it is unclear if the court limited this action to the dissolution statute. *See* Burt v. Burt Boiler Works, Inc., 360 So.2d 327, 332 (Ala.1978) (recognizing cause of action where majority shareholders "acting through the board and corporate officers, which they control, deprive the minority stockholders of their just share of the corporate gains"). Outside the statute, despite rhetoric suggesting that the state follows all of the majority rule precepts, the state courts describe the level of fiduciary duties owed by majority shareholders as the corporate standard of fairness. James v. James, 768 So.2d 356, 358 (Ala. 2000) (describing majority shareholders'