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## Minority Investor Protections as Default Norms: Using Price to Illuminate the Deal in Close Corporations

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# Minority Investor Protections as Default Norms: Using Price to Illuminate the Deal in Close Corporations

## **Abstract**

This Article argues that legal protections for minority investors in close corporations should be interpreted as default rules. Currently, such protections are mandatory and thus impose on investors a uniform norm of conduct that restricts their freedom to bargain. Courts and scholars advocating such protections have so far been unwilling to permit their waiver primarily because of the difficulty of distinguishing between a knowledgeable waiver and an ignorant omission.

A price-based approach solves that puzzle, however, by using the consideration paid by investors to illuminate their intentions. By permitting waiver only where there is clear evidence that the minority received a discounted purchase price, such an approach avoids the risk inherent in a system that treats legal protections as mere default rules: that an ignorant minority will be taken advantage of as a result of accidental waiver. Whether or not the investor was truly ignorant, there can be no injustice if she was adequately compensated for the risk of opportunistic behavior by her fellow shareholders. A price-based approach therefore provides knowledgeable parties with the ability to bargain over their preferred allocation of control while retaining legal protections for unsophisticated investors who fail to do so.

## **Keywords**

Minority, Oppression, Close corporation

# MINORITY INVESTOR PROTECTIONS AS DEFAULT NORMS: USING PRICE TO ILLUMINATE THE DEAL IN CLOSE CORPORATIONS

ROBERT C. ILLIG\*

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## INTRODUCTION

Close corporation law ignores investor intentions. Out of concern for the vulnerable status of minority investors,<sup>1</sup> lawmakers in a majority of jurisdictions have sought to impose on close corporations a uniform allocation of power that places fixed limits on the ability of controlling shareholders to determine corporate policy.<sup>2</sup>

1. For a discussion comparing the law's treatment of vulnerable shareholder minorities with its treatment of racial and ethnic minorities, see Anupam Chander, *Minorities, Shareholder and Otherwise*, 113 YALE L.J. 119, 120 (2003) (arguing that unlike constitutional law, which often requires blinding itself to minority status to achieve equality, corporation law mandates that minority status be taken into account to ensure equality). This analogy is considered in more depth in Part I.D.1.

2. Minority investors are inherently susceptible to attempts by controlling shareholders to misappropriate the value of their investment. *See, e.g.*, *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505, 514 (Mass. 1975) (describing the "true plight of the minority stockholder in a close corporation"). Such opportunistic behavior by controlling shareholders is referred to as "oppression" and comes in many guises. *See, e.g.*, *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App. 1999) (defining "oppression" as conduct that either "substantially defeats the minority's expectations" or is "burdensome, harsh, or wrongful") (citing *Davis v. Sheerin*, 754 S.W.2d 375, 381-82 (Tex. App. 1988)).

Perhaps the most common variations involve abuse of the controlling shareholders' control over the payment of compensation and dividends. Because close corporation shareholders typically serve a dual role as both owners and employees of the company, a controlling shareholder has the power to pay herself a large salary while restricting the payment of salary and dividends to other investors. In this way, she can pay out the corporation's profits only to herself, either on an ongoing basis or as a prelude to eliminating the minority. *See, e.g.*, *Shelstad v. Cook*, 253 N.W.2d 517 (Wis. 1977) (addressing a situation where the controlling shareholders withheld dividends and salaries from forty-six percent minority investors); *Zidell v. Zidell, Inc.*, 560 P.2d 1086 (Or. 1977) (declining to compel the majority shareholders to pay out larger dividend to benefit the minority); *Wilson v. Wilson-Cook Med., Inc.*, 720 F. Supp. 533 (M.D.N.C. 1989) (adjudicating a situation where the majority shareholders forced out a minority shareholder from his position as president of the corporation absent any malfeasance).

Other common variants include: signing sweetheart agreements with unrelated companies that the controlling shareholders also control, *see, e.g.*, *Wometco Enters., Inc. v. Norfolk Coca-Cola Bottling Works, Inc.*, 528 F.2d 1128 (4th Cir. 1976) (discussing how a controlling interest holder in a corporation formed a distinct private company which purchased and leased equipment to the corporation, thereby gaining assured profit); *Street v. Vitti*, 685 F. Supp. 379 (S.D.N.Y. 1988) (examining a situation where the majority shareholder used the corporation's funds to provide a loan to another corporation in which he was also a majority shareholder); causing the corporation to redeem a small percentage of the controlling shareholders' stake for a large price, *see, e.g.*, *Donahue*, 328 N.E.2d at 505 (finding a breach of fiduciary duty where the controlling stockholders allowed the company to purchase a former controlling stockholder's shares for a price much greater than minority stockholders could have sold their shares); and structuring a corporate merger or other

Entrepreneurs and other investors have a variety of risk preferences and investment goals, however, and so differ widely in their ideal investment bargain.<sup>3</sup> Nonetheless, progressive courts and scholars have been unwilling to sanction a scheme that would permit the waiver of shareholder protections in close corporations.<sup>4</sup> Their

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acquisition transaction so that the bulk of the consideration flows to the controlling shareholders, *see, e.g.*, *Landy v. Amsterdam*, 815 F.2d 925 (3d Cir. 1987) (discussing minority shareholders' claim of unfairness in a merger pushed through by majority shareholders); *Carl Marks & Co. v. Universal City Studios, Inc.*, 233 A.2d 63 (Del. Ch. 1967) (denying a minority shareholder petition for appraisal of her shares by the Delaware Court of Chancery in a short-form merger context).

In each of these cases, the abusive conduct may be an end to itself or an attempt to force the minority to sell its shares back to the controlling shareholders for less than fair value, a transaction known commonly as a "squeeze-out." *See generally* 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, *OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS: PROTECTING MINORITY RIGHTS IN SQUEEZE-OUTS AND OTHER INTRACORPORATE CONFLICTS* § 1:1, 1-2 (rev. 2d ed. 2005) (defining the term squeeze-out as "the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants").

For a discussion of the underlying causes of the vulnerability of minority investors to such oppressive conduct, *see infra* Part I.A. For a discussion of the development of the remedy of oppression, *see infra* Part I.B.

3. *See, e.g.*, ROBERT F. BRUNER, *APPLIED MERGERS & ACQUISITIONS* 540 (2004) (explaining that, in some cases, an investor may be willing to "pay more in return for less control dilution"). For a discussion of investor expectations in the venture capital context, *see infra* notes 28-34 and accompanying text.

4. The issue of minority investor vulnerability has received a great deal of scholarly attention over the years. *See, e.g.*, Allen B. Afterman, *Statutory Protection for Oppressed Minority Shareholders: A Model for Reform*, 55 VA. L. REV. 1043 (1969) (examining the strengths and defects of the oppression provisions of the English Companies Act of 1948 and the Uniform Australian Companies Act of 1961 in order to assess their applicability to the United States); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1985-1986) (assessing differences between close and public corporations); J.A.C. Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921 (discussing situations that may obligate minority stockholders to take the interests of other parties into account when they exercise their rights as owners); J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977) (hypothesizing that the problem of exploitation is related to illiquidity and therefore cannot be remedied by contract or judicial decision); Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992) (considering close corporations from the standpoint of a "Coasean Contractual Theory"—"because it is costly to bargain around the law, courts should imply standard form or 'default' contract terms that mimic the terms that most parties would have explicitly included in their contracts"); Lawrence E. Mitchell, *Close Corporations Reconsidered*, 63 TUL. L. REV. 1143 (1989) (examining how limited liability affects agency problems in the structure of close corporations and how unlimited liability in the partnership form induces beneficial monitoring activity); Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675 (1990) [hereinafter Mitchell, *Death of Fiduciary Duty*] (observing that courts are increasingly relying on marketplace morals to define internal corporate conduct); Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989 (2001) (arguing that the doctrine of implied-in-fact contracts is not sufficient to protect minority investors from

response to the threat of oppression, in other words, does not attempt to interpret or enforce the particulars of the parties' initial investment contract.<sup>5</sup> Rather, the legal protections that have evolved to shield minority investors from oppression restrict the parties' freedom to structure their enterprise in a manner that they deem optimal.<sup>6</sup>

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oppression because the parties' bargain is often too indefinite to enforce under contract law and because compensatory damages may not provide an oppressed investor with an adequate remedy); F. Hodge O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 BUS. LAW. 873 (1977-1978) (summarizing close corporation legislation since World War II and making recommendations for additional reforms); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913 (1999) (evaluating the extent to which the law should permit minority shareholders to exit in light of the possible loss of match-specific assets that are of greater value to the firm than to outsiders); Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193 (1988) [hereinafter Thompson, *Corporate Dissolution*] (analyzing the historical development of the reasonable expectations standard and its future implications); Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 BUS. LAW. 699, 699-703 (1993) [hereinafter Thompson, *Shareholder's Cause of Action*] (discussing how legislatures and courts have responded to "squeeze-outs" by majority shareholders).

The issue of the waiver of fiduciary duties has been addressed more broadly as well. See, e.g., Lucien Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989) (arguing that substantial reasons exist for limiting a corporation's ability to opt out of the rules of corporation law after its initial charter has been adopted); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985) (criticizing the idea that private bargaining sufficiently restrains management shirking and self-dealing in the public company context); John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988) (exploring the boundary line that separates areas of corporation law that should be subject to private ordering from those that should be mandatory); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 46 (1990) (providing a "comprehensive response" to critics of the contractual theory of the corporation).

5. But see Bebchuk, *supra* note 4, at 1836 ("The main problem with the shareholder voting mechanism is the lack of information. . . . most voting shareholders do not know whether the proposed amendment is value-decreasing or value-increasing"); Brudney, *supra* note 4, at 1414 ("Insofar as managers' duties and entitlements are expressly defined by agreement, those agreements are rarely, if ever, exhibited to public stockholders, let alone negotiated with stockholder participation."). Characterized by Butler and Ribstein as "anti-contractarian" scholars, Bebchuk and Brudney argued against the enforcement of a waiver of fiduciary duties in the public company context based on, among other things, the presumed ignorance of most investors regarding the nature and content of their investment contract. Butler & Ribstein, *supra* note 4, at 42. Presumably, they would not view the typical close corporation investor as any less ignorant than her public company counterpart. For a discussion of the defects of this approach in the close corporation context, see *infra* Part I.D.4.

6. See *infra* Part I.B, which explores the objective nature of current approaches to the problem of minority investor vulnerability. See also Charles R. O'Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 NW. U. L. REV. 216, 218-19 (1992) (arguing that many investors rationally prefer the statutory allocation of power in favor of controlling shareholders).

The law regarding oppression is not settled, however. Whereas progressive lawmakers would provide minority investors with protections for which they did not bargain, others would sacrifice legal protections for the most vulnerable investors in order to strengthen private ordering. Delaware courts, for example, have so far declined to extend special protections to minority investors in close corporations, believing instead that investors should protect themselves through contractual means.<sup>7</sup> Similarly, economists and legal scholars of the contractarian school have argued in favor of permitting investors to opt out of fiduciary duties like those that protect minority investors.<sup>8</sup> Although their economic arguments regarding the operation of efficient markets apply only to public corporations, such scholars nonetheless posit that the ability for close corporation investors to deal directly with one another justifies a scheme that maximizes the investors' freedom to bargain.<sup>9</sup>

What is needed, then, is a tool to determine when protections for minority investors should be set aside in favor of private ordering. To the extent courts could determine whether an aggrieved investor had been previously compensated for bearing the risks associated with her minority status, the law would not need to answer the difficult normative question of which minority investors deserve legal

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7. *Nixon v. Blackwell*, 626 A.2d 1366, 1379-81 (Del. 1993) (rejecting a "special rule" applicable only to minority investors). In other states—most notably Massachusetts—controlling shareholders owe the minority the "utmost good faith and loyalty." *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) (holding that the controlling shareholder could not use his position to create a market for only his shares, to the exclusion of the minority shareholder); *Wilkes v. Springside Nursing Home*, 353 N.E.2d 657, 663-64 (Mass. 1976) (holding that the dismissal of a minority stockholder from the payroll with the intention of pressuring the minority stockholder to sell his shares to the corporation at less than fair value constitutes a breach of fiduciary duty). Moreover, even in states that apply such protections, numerous standards abound and the outcome of any particular case is likely to depend in large part on the preconceptions of the trier of fact. Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 825-26 (2000) (stating that whereas a minority-perspective court finds oppression in any action—justifiable or not—that hurts the minority shareholders, a majority-perspective court finds oppression only when the controlling shareholders have taken action that is not justified by a legitimate business interest). As a result, an investor contemplating a minority participation is faced with a great deal of uncertainty as to whether, and to what extent, she can rely on the legal system to protect her investment.

8. See, e.g., Easterbrook & Fischel, *supra* note 4, at 271 (assessing differences between close and public corporations); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 250 (1991); Butler & Ribstein, *supra* note 4, at 46.

9. See, e.g., Butler & Ribstein, *supra* note 4, at 20 ("In closely held corporations and partnerships, in which all owners generally are active in control of the business, monitoring of agents is less of a problem than in public companies, in which ownership is separated from control.").

protection.<sup>10</sup> Rather, the parties' bargain could be enforced as it was intended.

Fortunately, such a tool already exists. The parties' expectations are often visible in the price they paid for their shares when first investing. Certainly, many sophisticated and wealthy investors are likely to engage counsel to identify and allocate with precision the many risks involved in a particular transaction.<sup>11</sup> Unsophisticated investors and those lacking resources, on the other hand, are more likely to take the approach of simply adjusting the purchase price to compensate for the presence of additional risk.<sup>12</sup> Indeed, where resources are few or the size of the investment small, allocating risk through price adjustments may be both economical and efficient.<sup>13</sup> Thus, where the purchase price paid by controlling and minority shareholders is essentially equivalent, one can safely assume that the parties did not expect the minority to bear a disproportionate amount of the investment risk. In such a case, the exercise of undue influence by the controlling shareholders would likely be deemed oppressive. On the other hand, to the extent the purchase prices diverge, it may be possible to infer that the parties intended to allocate a greater degree of influence over corporate policy to the controlling shareholders. In other words, the controlling

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10. Scholars have long debated whether the law should protect minority investors who fail to protect themselves. Compare Hetherington & Dooley, *supra* note 4, at 36-38 (arguing that minority shareholders face great difficulty in contracting for protection against majority shareholders in close corporations; therefore the law should protect minority shareholders with a statute requiring majority holders to purchase minority shares in certain circumstances), with Easterbrook & Fischel, *supra* note 4, at 284-86 (explaining that, because many minority shareholders of close corporations are sophisticated, the terms of their investment contracts are often negotiated, and because many contract terms protecting minority shareholders are expensive, the law should not imply these terms). See also Johnston, *supra* note 4, at 292 (asking "whether the law should imply and enforce limits on opportunistic behavior in cooperative ventures, or instead leave the parties to whatever protection for which they explicitly bargained").

11. See generally Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 253-55 (1984) (arguing that business lawyers create value as "transaction cost engineers" by enabling parties to behave based on the premise that the assumptions of the market are correct).

12. See JAMES C. FREUND, *ANATOMY OF A MERGER: STRATEGIES AND TECHNIQUES FOR NEGOTIATING CORPORATE ACQUISITIONS* 21 (1975) [hereinafter FREUND, *ANATOMY OF A MERGER*] (arguing that all issues in a negotiation, regardless of how sacred, can be reduced to dollars). Though now fairly dated, Freund's explication of the negotiation of corporate mergers and acquisitions remains the best treatise yet written on the subject. For another useful treatment, see generally JAMES C. FREUND, *THE ACQUISITION MATING DANCE AND OTHER ESSAYS ON NEGOTIATING* (1987) [hereinafter FREUND, *MATING DANCE*].

13. Presumably, one does not need to be an expert in the details of corporation law to recognize that a thirty-percent shareholder will be more vulnerable to opportunistic behavior than will a seventy-percent shareholder, and to negotiate the price accordingly.



shareholders in such cases may have purchased the right to exercise control.<sup>14</sup> As a result, the level of discretion the parties intended to allocate to the controlling shareholders will in most cases be evident in the purchase price, thereby enabling price to serve as a window into the parties' bargain.

A better, more nuanced approach to the problem of minority investor vulnerability would therefore retain legal protections for minority investors but treat them as default norms which they are free to waive. The result would be a two-step analysis of alleged instances of oppression. Courts should initially consider whether there is clear evidence in the negotiation of the initial investment contract that the minority investor had been compensated for the risks associated with her vulnerable status. The threshold question, in other words, should not be whether the minority had a complete understanding of the risks associated with her minority status, but whether she was paid to bear them. Even if she were ignorant of the myriad and detailed ways in which she was vulnerable, the presence of compensation would generally indicate the absence of a legally cognizable injury.<sup>15</sup> Admittedly, however, where the parties' intentions remain ambiguous following a close examination of the price, it may still be necessary to impose an objective standard to avoid injustice.<sup>16</sup> Thus, when such an analysis fails to uncover the parties' intentions, courts should continue to apply an objective standard as a second step, prohibiting a range of conduct that appears inconsistent with the typical investor's reasonable expectations.<sup>17</sup>

Part I of this Article briefly reviews the nature of minority investors' vulnerability and the legal doctrines that have evolved to protect them from oppression. It then assesses four possible reasons why progressive scholars and lawmakers prefer to impose mandatory rules rather than structure legal protections for minority investors as default norms: (1) a largely emotional response to the similarities

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14. See BRUNER, *supra* note 3, at 465 (characterizing control as a commodity akin to a financial product such as an option or call that can be valued, purchased and sold as a separable economic good).

15. See E. ALLAN FARNSWORTH, *CONTRACTS* § 12.3, 735-38 (4th ed. 2004) (discussing what happens when one party to a contract "err[s] in calculating the net benefit to be anticipated from performance of the agreement").

16. See, e.g., O'Neal, *supra* note 4, at 881 ("Statutory protection is needed for minority shareholders who fail to bargain for and obtain protective contractual arrangements."); Afterman, *supra* note 4, at 1075-77 (holding up an early South Carolina oppression statute, S.C. CODE ANN. § 12-22.23(b) (Supp. 1968), as improving upon past American protections for aggrieved minority investors).

17. See generally Thompson, *Corporate Dissolution*, *supra* note 4, at 193 (tracing the historical development of the "reasonable expectations" standard for corporate dissolutions).

between the vulnerability of minority investors and the vulnerability of other aggrieved minorities, (2) the structural parallels between close corporations and partnerships, (3) an assumption that each share of a corporation's stock is intended to represent an equivalent investment bargain and, most importantly, (4) the difficulty of distinguishing between a knowledgeable waiver of fiduciary duties and an unfair surprise.

Part II then explores the possibility that a close examination of the consideration paid by each shareholder when initially investing can shed light on the parties' intentions. By borrowing from the literature regarding the valuation of close corporations,<sup>18</sup> Part II argues that the degree of discretion afforded to the controlling shareholders is but one of a host of risks that investors consider when pricing their stock. It concludes by arguing that adjustments to the purchase price, rather than merely representing agency costs associated with the risk of controlling shareholder opportunism, can instead be viewed in the close corporation context as an attempt by unsophisticated investors to directly allocate the risks of such opportunism.<sup>19</sup> Thus, minority investors may already contemplate a privately negotiated resolution to the problem of minority vulnerability—they may simply be paying less to compensate for the greater risks they assume.

Finally, in Part III, the Article tests the proposition that price can illuminate the parties' bargain by revisiting two leading precedents<sup>20</sup> that helped shape the modern cause of action for oppression. In many circumstances, the application of a broad, uniform standard appears to have resulted in an equitable outcome.<sup>21</sup> In others, however, conduct that seems unjust when measured against a uniform norm was actually contemplated by the parties' particular

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18. See generally, e.g., SHANNON P. PRATT, BUSINESS VALUATION DISCOUNTS AND PREMIUMS (2001) [hereinafter PRATT, DISCOUNTS AND PREMIUMS] (exploring the use of discounts and premiums in the appraisal of close corporations); SHANNON PRATT, VALUING A BUSINESS (1981) [hereinafter PRATT, VALUING A BUSINESS] (examining the theory and practice of valuing a business or an interest in a business); ROBERT T. SLEE, PRIVATE CAPITAL MARKETS: VALUATION, CAPITALIZATION, AND TRANSFER OF PRIVATE BUSINESS INTERESTS (2004) (explaining that the key to understanding private capital markets is to examine the interplay between valuation, capitalization, and business transfer). For a comprehensive treatment of the subject that is not limited to the valuation of private corporations, see generally TIM KOLLER, MARC GOEDHART & DAVID WESSELS, VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES (2005).

19. See *infra* Part II.D.

20. *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975); *Ebrahimi v. Westbourne Galleries Ltd.*, [1972] 2 All E.R. 492.

21. See *infra* Part III.A.

bargain.<sup>22</sup> Controlling shareholders, in other words, often purchase the freedom to engage in what otherwise might be considered oppressive conduct.<sup>23</sup> When there is evidence of adequate consideration, courts should not deny them the benefit of their bargain.

#### I. A CHALLENGE: MINORITY INVESTOR VULNERABILITY

Business law scholars are understandably concerned about the vulnerability that is inherent in the status of minority investors in close corporations.<sup>24</sup> Some, in fact, have gone so far as to compare their vulnerability to that which is suffered by racial and ethnic minorities in civil society.<sup>25</sup> As Robert Thompson and Hodge O'Neal have repeatedly stressed, the structure of corporation law seems

22. See *infra* Part III.B.

23. See *infra* notes 28-34 and accompanying text.

24. Some commentators make a distinction between the terms close corporation and closely held corporation. 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, CLOSE CORPORATIONS AND LLCs: LAW AND PRACTICE § 1:4, 1-14 (rev. 3d ed. 2004). In common usage, however, the two terms appear to have essentially the same meaning. *Id.* ("The terms 'close corporation,' 'closed corporation' and 'closely held corporation' are often considered to be synonymous and are used interchangeably."). Although the precise definition of a close corporation varies depending upon the source, it is generally believed to have three distinct elements: (1) few shareholders, (2) a limited market for their securities, and (3) substantial shareholder participation in management. See, e.g., *Donahue*, 328 N.E.2d at 511 (deeming a close corporation to be characterized by a small number of shareholders, no ready market for the corporate stock, and substantial majority shareholder participation in management, direction, and operations); *Galler v. Galler*, 203 N.E.2d 577, 583 (Ill. 1964) ("For our purposes, a close corporation is one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling."); Easterbrook & Fischel, *supra* note 4, at 273 ("Closely held corporations tend to have certain common characteristics. Most importantly, they tend to have relatively few managers, who tend to be the largest residual claimants."). Many state corporation statutes also use these characteristics to define close corporations. See, e.g., DEL. CODE ANN. tit. 8, § 342(a) (2006) (providing a three-part definition for a close corporation that limits the number of shares per shareholder and places restrictions on a shareholder's ability to transfer the shares); MODEL BUS. CORP. ACT STAT. CLOSE CORP. SUPP. § 3(b) (2005) ("A corporation having 50 or fewer shareholders may become a statutory close corporation by amending its articles of incorporation to include the statement" to that effect); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.06 (1994) (defining a close corporation as "a corporation the equity securities of which are owned by a small number of persons, and for which securities no active trading market exists"). Many foreign jurisdictions also have similar requirements. Under the English Companies Act, for example, a private company is one "whose shares were held by few members, were not offered for public subscription, were not traded on the stock exchange, and whose transferability was restricted by the articles of association". Marcus Lutter, *Limited Liability Companies and Private Companies*, in XIII INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 7 (1998).

25. See, e.g., Chander, *supra* note 1, at 120 (contrasting the different approaches taken by corporation law and constitutional law to the "problem" of minority status).

better suited for public companies than for private.<sup>26</sup> The high likelihood in a close corporation that a single shareholder or shareholder group will exercise control over its affairs makes investing in a minority position extremely risky.<sup>27</sup>

At the same time, there are often instances where shareholders voluntarily and deliberately relinquish control over the corporate enterprise and so consciously assume a risky position in exchange for some other benefit.<sup>28</sup> The most common example of this might be the entrepreneur who chooses to finance the growth of her business by attracting a private equity investment from a venture capital fund. Typically, a venture fund that invests in early stage enterprises will

26. See, e.g., I O'NEAL & THOMPSON, *supra* note 24, § 1:14, at 1-88 to -92 ("Even scholars working and writing in the field of corporate law, and most lawyers with a business practice, seem to have been oblivious, until after World War II, to the special needs and problems of the close corporation."); Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 699 ("Corporate statutes and judicial decisions reflect norms designed for publicly held corporations and do not always meet the needs of closely held enterprises."). Larry Ribstein makes a related point when he argues more generally that the law is incapable of crafting a sufficient variety of standard forms of business to meet the needs of every business relationship. Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 409 (1999) (arguing that "there are not, and cannot be, enough business forms to suit all business relationships"). In order to meet this need, he proposes that the law recognize an ultra-flexible "contractual entity." *Id.* at 410.

27. The greater concentration of ownership in close corporations is distinguished from the widely dispersed ownership that is typical among public corporations in the US, as was most famously identified by Berle and Means in their 1933 treatise. ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1933). For more recent works on the subject, see, e.g., MARK J. ROE, *STRONG MANAGERS, WEAK OWNERS: THE POLITICAL ROOTS OF AMERICAN CORPORATE FINANCE* (1994); MARGARET M. BLAIR, *OWNERSHIP AND CONTROL: RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY* (1995). Thus, in most public corporations, the greater risk appears to be that the managers—rather than a block of controlling shareholders—will engage in opportunistic behavior. See, e.g., Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 868-76 (1984) (discussing the application of liability rules as a means to curb agency costs in public corporations). To the extent a public corporation is dominated by a single controlling shareholder or group of controlling shareholders, however, the same limitations on their conduct would apply as in a close corporation. See, e.g., *Shell Petroleum, Inc. v. Smith*, 606 A.2d 112, 115 (Del. 1992) (holding that the majority shareholder of a public corporation owned a duty to "disclose information, within its knowledge, which might assist the minority shareholders in responding to the proposed merger"); *Kahn v. Household Acquisition Corp.*, 591 A.2d 1666 (Del. 1991) (same). But see *Kahn v. Sprouse*, 842 F. Supp. 423 (D. Or. 1993) (refusing to extend fiduciary duties to a majority shareholder in a public corporation).

28. See, e.g., JEAN TIROLE, *THE THEORY OF CORPORATE FINANCE* 392 (2006) (arguing that, from an economic point of view, an investor should always relinquish any control rights that other investors value more highly than does the investor); see also O'Kelley, *supra* note 6, at 218 (arguing that minority investors sometimes "rationally choose and prefer" to adopt the statutory allocation of control that favors the controlling investors); Rock & Wachter, *supra* note 4, at 913-14 (noting that close corporations include not only "the traditional 'mom and pop' businesses," but also "high-tech start-ups, and mature publicly held corporations post leveraged buyouts").

require control over the corporation's affairs as a condition to its investment.<sup>29</sup> In fact, it is typical for the parties to agree *ex ante* that this control will include the ability to terminate the employment of the very entrepreneur who founded the corporation.<sup>30</sup> In other circumstances, the presence of a high level of trust or of strong market forces could empower some investors to forgo additional protections in favor of obtaining more favorable investment terms.<sup>31</sup> Thus, it is not always the case that the private allocation (and subsequent exercise) of a high degree of control by a particular party amounts to an injustice.<sup>32</sup> Rather, control is often exchanged for other forms of consideration.<sup>33</sup> In the case of an early stage venture

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29. In many cases, venture investors require a controlling stake in the corporation before making an early stage investment. *See* CONSTANCE E. BAGLEY & CRAIG E. DAUCHY, *THE ENTREPRENEUR'S GUIDE TO BUSINESS LAW* 191 (1998) (explaining that venture funds that invest in early stage companies typically negotiate for forty to sixty percent of the equity); BRIAN E. HILL & DEE POWER, *INSIDE SECRETS TO VENTURE CAPITAL* 42 (2001) (noting that entrepreneurs sometimes expect to give up as much as seventy or eighty percent of their equity in order to attract venture funding). Alternatively, control can be maintained just as easily by controlling the board of directors. *See* JOSEPH W. BARTLETT, *FUNDAMENTALS OF VENTURE CAPITAL* 94 (1999) (explaining that the founders, even if they remain in control of management, are ultimately subservient to the board). By negotiating for a charter amendment that fixes the number of board seats allocated to the venture capital fund, for example, the fund can ensure that its control will be maintained through subsequent rounds of financing. ALEX WILMERDING, *TERM SHEETS & VALUATIONS: A LINE BY LINE LOOK AT THE INTRICACIES OF TERM SHEETS & VALUATIONS* 37 (2005).

30. BARTLETT, *supra* note 29, at 124-26 (discussing the balance that is typically negotiated by venture funds between incentivizing the entrepreneurs to remain engaged during the early stages of the corporation and retaining the ability to terminate the entrepreneurs after the firm matures). In fact, even if the entrepreneur has an ironclad employment agreement with a fixed term, principles of agency permit the board to terminate the employee provided they are willing to pay damages. *Id.* at 125.

31. In any multi-issue negotiation, including an investment in a close corporation, the parties engage in numerous trade-offs, frequently compromising on one issue in order to "win" on another. *See* HOWARD RAIFFA, *THE ART & SCIENCE OF NEGOTIATION* 131 (1982) (introducing multi-issue "integrative" bargaining); BRUNER, *supra* note 3, at 927 (urging deal lawyers to take a "whole deal" approach to complex business transactions). In such cases, then, each "win" can be assumed to have cost the winning party some other concession. Therefore, where a party judges a particular risk (such as the risk of oppression) to be relatively minor, she may choose to bear the risk rather than to make a costly concession in order to have it removed or eliminated. In other words, if market forces and/or societal norms of trust are working to remove the threat of oppression, the minority investor may prefer to cede control in order to negotiate for some other right or concession that they value more highly.

Economists have also argued that parties may cede control rights as a substitute for a weak balance sheet and "necessarily limited cash-flow rights." *See* TIROLE, *supra* note 28, at 388 (citing the work of Aghion and Bolton, Hart, and Hart and Moore).

32. *See* BARTLETT, *supra* note 29, at 94 (explaining that, even in successful venture-backed companies, it is often common for the founders to be "fired, retired, or otherwise relieved of their duties" by the venture capital investors).

33. BRUNER, *supra* note 3, at 540 (describing situations in which a buyer may be willing to "pay more in return for less control dilution").

capital investment, for example, entrepreneurs often sell control in order to obtain risk capital that may not be available from any other source.<sup>34</sup> Investors, in other words, frequently opt for a lopsided allocation of control.

The following sections briefly describe the nature of the problem of minority investor vulnerability and the legal responses that have evolved to attempt to ameliorate such vulnerability. They conclude that the assumptions supporting the existing scheme of mandatory, objective standards rely themselves on four underlying misconceptions.

#### A. *The Nature of the Challenge*

Minority investors occupy an inherently vulnerable position in close corporations.<sup>35</sup> As a result of the corporation law norms of centralized control and majority rule, a shareholder or shareholder group that holds a controlling block of shares can dictate corporate policy through its control of the board of directors.<sup>36</sup> In general, the

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34. See BARTLETT, *supra* note 29, at 96 (noting that much of the power that venture capital investors wield comes informally from the fact that they are often the only source of funds available to the entrepreneur); BAGLEY & DAUCHY, *supra* note 29, at 191 (explaining that one downside of raising money from venture capital investors is that they are likely to require the ability to take over control "if the entrepreneur stumbles").

35. See *infra* note 2. Oppression can also work to the disadvantage of controlling shareholders. O'Kelley, *supra* note 6, at 219 (explaining that, as the adaptability of minority investors is enhanced, "so is the risk of minority opportunism"); Hetherington, *supra* note 4, at 946 (arguing that "the policies underlying the fiduciary responsibilities imposed on those who have control should be applicable to any shareholder whose vote or other conduct as a shareholder is in fact controlling" in a particular situation," including a minority investor). For example, if a corporation's charter documents require a supermajority vote to take a particular action, a minority investor with a sufficiently large share of the stock could use her ability to block such action as a sword with which to extract value from the other shareholders. See, e.g., *In the Matter of the Voluntary Dissolution of Radom & Neidorff, Inc.*, 207 N.Y. 1 (1954) (addressing a shareholder dispute where a fifty percent shareholder used her blocking interest to prevent the other fifty percent shareholder from paying himself a salary); see also Easterbrook & Fischel, *supra* note 4, at 279 (noting that high percentage voting requirements increase the possibility of deadlock and make it more difficult for those in control to act without the consent of minority shareholders).

36. See, e.g., DEL. CODE ANN. tit. 8, § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors"); MODEL BUS. CORP. ACT § 8.01(b) (2005) ("All corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of its board of directors"). See also, generally, 1 O'NEAL & THOMPSON, *supra* note 24, § 1:2, at 1-3 to -4 (discussing the traditional pattern of corporation management through examination of the "majority rule" principle: those with a majority of shares have the voting power to control the entire corporation); O'Kelley, *supra* note 6, at 216-17, 219

holders of fifty-one percent of the stock have the power to make one-hundred percent of the decisions.<sup>37</sup> Moreover, shareholders in close corporations typically serve simultaneously as both owners and managers.<sup>38</sup> Thus, the value of the minority's investment depends directly on the level of diligence, competence and honesty displayed by the controlling shareholders.<sup>39</sup> Acquiring a minority participation means relying upon, and to a large degree trusting, the controlling shareholders.<sup>40</sup>

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(characterizing the vulnerability of minority investors as being the result of the fact that "the typical closely held corporation [contract] is mostly gaps").

37. Although the fifty-one percent mark is sometimes used in this and other examples throughout the text to indicate a controlling stake, the exact percentage necessary to exercise control over a corporation's affairs will vary depending upon its capital structure. See BRUNER, *supra* note 3, at 467-68 (noting that control is relative). Indeed, under certain circumstances, it might be possible to exercise effective control with less than a majority of the outstanding shares. This might be the case, for example, if a significant percentage of the shares were not voted, thereby increasing the impact of those shares that were voted, or if the shareholders with smaller percentage holdings were divided in their preferences. Similarly, if the corporate charter included supermajority voting requirements, such that a higher percentage than a simple majority were necessary to take a particular action, then it might be necessary to hold more than fifty-one percent in order to exercise control. As late as 1985, for example, fully half of the corporation statutes in the US required supermajority approval for a merger, with about one-third of states currently retaining the requirement. 1 O'NEAL & THOMPSON, *supra* note 2, § 5:2, at 5-7 n.11. See, e.g., KY. REV. STAT. ANN. §§ 271B.12-210 to -220 (2006). The same would be true in the event the parties had entered into a shareholders' agreement that directly allocated control in some manner other than through the mechanism of simple majority voting. See *infra* Part II.C. With this in mind, this Article uses the term "controlling shareholders" rather than the more typical reference to majority shareholders.

38. See, e.g., Robert Kramer, *Foreword to Symposium, The Close Corporation*, 18 LAW & CONTEMP. PROBS. 433, 433 (1955) (stating that shareholders in close corporations often serve a dual role as owners and officers, thus essentially controlling the business). Typically, either the stockholders themselves are the directors, or they so closely dominate and control the directors that the latter are in fact little more than their agents. *Id.*; see generally 1 O'NEAL & THOMPSON, *supra* note 24, § 1:9, at 1-35 (describing common management structures in close corporations).

39. Economists refer to any individual conduct that is not in the interests of the firm as "shirking." See STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 35-36 (2002). The most common forms of shirking include "not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes." *Id.* Thus, minority investors are at risk not only from intentional misappropriation of their investments but also from other forms of residual loss as well.

40. This reliance on, and hence vulnerability to, one's fellow investors is one of the core justifications for the imposition of fiduciary duties, both in general, see, e.g., *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty."), and in the particular context of close corporations, see, e.g., *Crosby v. Beam*, 548 N.E.2d 217, 220 (Ohio 1989); *Orchard v. Corvelli*, 590 F. Supp. 1548, 1556 (W.D. Pa. 1984), *aff'd* 802 F.2d 448 (3d Cir. 1987). Not coincidentally, the concept of reliance on the efforts of others also lies at the heart of what it means to be a regulated security under federal law. An "investment contract," for example—the catchall for instruments that fit within the definition of a "security" under section 2(a)(1) of the Securities Act of 1933, 15 U.S.C.A. § 77 *et seq.* (2005)—is defined as a

The vulnerability of minority investors in close corporations is exacerbated because, unlike investors in public corporations, they have no easy means of exit. By definition, no active trading market exists for shares of a close corporation.<sup>41</sup> Moreover, minority blocks of shares, being less desirable than controlling blocks, are even less liquid.<sup>42</sup> Thus, minority investors who desire to exit may find themselves unable to find a buyer willing to pay a reasonable price for their shares. Whereas a dissatisfied public company shareholder can usually exit quickly and at minimal cost, a minority investor in a close corporation who disagrees with management policy has no choice but to acquiesce and hope for a positive outcome.<sup>43</sup>

Control in any organization, of course, must be allocated in some manner. Some individual or group must have the ultimate authority to make a particular set of decisions, or some mechanism for joint decision-making must be established. Otherwise, all decisions would

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contract, transaction or scheme whereby (1) a person invests money, (2) in a common enterprise and (3) is led to expect profits, (4) solely from the efforts of others. *SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946).

41. The lack of a trading market for the corporation's shares is typically understood to be one of the defining characteristics of a close corporation. *See, e.g.*, *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505, 511 (Mass. 1975) (identifying the lack of a market as one of the defining elements of a close corporation); *Galler v. Galler*, 203 N.E.2d 577, 583-84 (Ill. 1964) (explaining that no ready markets exist for close corporation shares); DEL. CODE ANN. tit. 8, § 342 (stating that a close corporation "shall make no offering of any of its stock of any class which would constitute a 'public offering'"); MODEL BUS. CORP. ACT STAT. CLOSE CORP. SUPP. § 11(a) ("An interest in shares of a statutory close corporation may not be voluntarily or involuntarily transferred"). A public corporation, by contrast, generally provides its investors with an exit by dint of the fact that its securities are listed on a securities exchange for trading by the general public. *See BLACK'S LAW DICTIONARY* 1267 (8th ed. 2004) (defining a public corporation as one "whose shares are traded to and among the general public").

42. *See infra* Parts II.B.2 and II.B.3. *But see* BRUNER, *supra* note 3, at 471-72 (explaining that even control positions can sometimes be illiquid, such as when they are relatively large in size).

43. As a matter of corporate governance theory, it is sometimes said that public company shareholders who disagree with management's policies are better off exercising their exit rights by selling their shares rather than taking action to influence or change management. This ability of public company shareholders to exit at minimal cost is known informally as the "Wall Street Rule" and is distinguished from the close corporation context where no such exit is typically available. *See, e.g.*, Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 619 (2006) (arguing against the expansion of shareholder democracy because, among other reasons, "[m]any investors, especially institutions, rationally prefer liquidity to activism. . . . the so-called 'Wall Street Rule'"). One of the earliest uses of this term in a law review article appears in Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1278 (1982) ("The ability freely to sell one's shares, therefore, the so-called 'Wall Street Rule,' is without question the single most important safeguard to all shareholders that managers will act in their best interests.").



result in deadlock.<sup>44</sup> In a close corporation, as we have seen, the default allocation of power places near-complete control in the hands of any shareholders who hold more than fifty percent of the shares.<sup>45</sup> There are, however, any number of other ways for control over the future management of a corporation to be divided among its shareholders. Depending on its capital structure, for example, different levels of influence over a close corporation's affairs might include (in order, from the highest level of control to the lowest):

- One-hundred percent ownership;
- Supermajority ownership sufficient to overcome any supermajority voting requirements contained in the corporation's charter documents;
- Simple majority ownership insufficient to overcome any such supermajority voting requirements;
- Shared control (fifty percent) where another shareholder owns the other fifty percent;
- Swing vote potential (a minority interest where no other single shareholder controls a majority of the shares, such as when there are three equal shareholders);
- Minority veto interest sufficient only to reject any proposal requiring a supermajority vote; and

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44. Deadlock is, in fact, one of the most important grounds for judicially determined dissolution. *See, e.g.*, DEL. CODE ANN. tit. 8, § 226(a)(2) (authorizing the Court of Chancery to appoint a receiver to dissolve a corporation if its business "is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote for action by the board of directors cannot be obtained and the stockholders are unable to terminate this division"); MODEL BUS. CORP. ACT § 14.30(a)(2)(i) (authorizing the appropriate court to dissolve a corporation where "the directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered"). Courts, however, appear to be highly reluctant to grant dissolution based solely on the presence of a deadlock. *See, e.g.*, *In the Matter of the Voluntary Dissolution of Radom & Neidorff, Inc.*, 307 N.Y. 1, 2 (1954) (rejecting a claim for voluntary dissolution where the corporation was operating profitably); *In re Lakeland Dev. Corp.*, 152 N.W.2d 758, 766 (Minn. 1967) (holding that dissension and deadlock among the shareholders of a corporation are grounds for involuntary dissolution only where the resulting deadlock is irreconcilable and where, as result of such deadlock, the corporation's business can no longer be conducted with advantage to the shareholders); *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 632 P.2d 512, 517 (Wash. 1981) (holding that, when determining whether a corporation should be dissolved, the court should consider the seriousness of the deadlock, whether the corporation is able to conduct its business profitably despite the deadlock, and whether dissolution will be beneficial or detrimental to the shareholders and/or injurious to the public).

45. *See supra* notes 36-39 and accompanying text. Bruner defines control as "the right to direct the strategy and activities of the firm, to allocate resources, and to distribute the economic wealth of the firm." BRUNER, *supra* note 3, at 465.

- True minority interest without any ability to control or influence corporate decisions.<sup>46</sup>

Minority oppression occurs when the conduct of the controlling shareholders exceeds the discretion allocated to them.<sup>47</sup> There is nothing inherently wrong with majority shareholders wielding a greater or lesser degree of control over the corporation's policies and direction.<sup>48</sup> After all, centralized control is often considered one of

46. See PRATT, VALUING A BUSINESS, *supra* note 18, at 28 (examining different definitions of value); SLEE, *supra* note 18, at 43-49 (analyzing four levels of private ownership—enterprise, control, shared control, and minority interest); see also TIROLE, *supra* note 28, at 393-94 (noting that, in practice, “there are *multiple control rights* to be divided between insiders and outsiders”). The parties’ preferred allocation of control can be implemented by means of any of a variety of well-known strategies. For examples, see *infra* Part II.C.

47. Typically, conduct constituting “oppression” is contemplated by the statute and so is technically permissible. For example, it is solely within the discretion of the board of directors to determine whether and when to declare dividends. See, e.g., DEL. CODE ANN. tit. 8, § 170(a) (“The directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock”); MODEL BUS. CORP. ACT § 6.40 (“A board of directors may authorize and the corporation may make distributions to its shareholders”). Therefore, it is not impermissible on its face for the board, at the direction of the controlling shareholders, to withhold dividends. Rather, otherwise lawful conduct rises to the level of oppression only when its goal or effect is to misappropriate the value of the minority’s investment. But see *Dodge Bros. v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (ordering Ford to declare a special dividend where there was evidence the controlling shareholder was operating the business for the “merely incidental benefit” of the investors and for “the primary purpose of benefiting others”).

48. The power to determine the compensation of corporate officers, for example, presents ample opportunity for tax planning, and employee salaries and benefits should presumably be adjusted periodically to take into account the impact of such factors as inflation and the changing outlook for the corporation. For example, the Internal Revenue Code allows deductions for all “ordinary and necessary expenses” paid in “carrying on a trade or business.” I.R.C. § 162(a) (2006). A reasonable allowance for salaries is included among these expenses, while dividends are not. *Id.* § 162(a)(1). Therefore, close corporations have an incentive to characterize any distributions they make to their shareholders as salaries rather than as dividends so as to avoid the effects of the double tax. See *Elliotts, Inc. v. C.I.R.*, 716 F.2d 1241, 1243 (9th Cir. 1983) (discussing the issue of the deductibility of payments ostensibly made by a corporation as compensation for an employee who is also a shareholder). To take advantage of the deductibility of employee salaries, close corporations typically pay out a large percentage of their profits in the form of salaries. See *id.* In order to accomplish this, the corporation hires the shareholders as officers and pays them salaries while withholding (otherwise taxable) dividends. See *id.* at 1245-47 (assessing the reasonableness of the shareholder manager’s duties as compared to her salary in determining the legality of withholding dividends). Other methods for distributing profits while avoiding double taxation include: establishing an employee stock ownership plan, see, e.g., Michael McEvoy, *Getting Money out of the Closely held Corporation*, in 1993 A.B.A. SEC. OF TAX’N ANN. ADVANCED STUDY SESSIONS 119, 162 (explaining how employee stock ownership plans are particularly useful in close corporations); paying rent, see I.R.C. § 162(a)(3) (2006) (allowing a deduction for trade or business rentals); and paying interest on loans, see I.R.C. § 163 (2006) (allowing a deduction for all interest paid or accrued within the taxable year). See generally Matthew G. Dore, “Tax Planning Comparison Table,” 5 IA. PRAC. SERIES, BUSINESS ORGANIZATIONS § 2:10 (2006). If controlling shareholders are

the chief benefits of the corporate form.<sup>49</sup> However, when the controlling shareholders use their control to opportunistically benefit themselves at the expense of the minority, such conduct is likely to violate the parties' implicit bargain.<sup>50</sup>

Minority oppression therefore appears to operate on a sliding scale. Where the business deal is that the controlling shareholders will be entitled to exercise wide latitude over corporate policy, only a significant departure from the norm would seem oppressive. On the other hand, where the parties negotiated for tight limits on managerial discretion, even slightly opportunistic behavior would appear to contravene their bargain. In other words, the parties have the ability to negotiate for the allocation of control that is optimal for their own particular needs and the needs of their corporate enterprise.<sup>51</sup> Depending on dynamics such as their mutual level of trust<sup>52</sup> and the impact of market forces on the business,<sup>53</sup> investors can negotiate to share power over the corporation's management and affairs in whatever manner is most appropriate for their unique circumstances. Therefore, before deeming conduct to be oppressive, policymakers should compare such conduct to the standards set by

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given wide discretion to craft one of these structures, however, they could benefit themselves by, among other things, firing the minority investors from their positions as salaried employees, thereby removing the only way in which they are able to withdraw funds from the corporation. *See, e.g.,* *Wilson v. Wilson-Cook Med.*, 720 F. Supp. 533, 541 (M.D.N.C. 1989) (adjudicating a situation where majority shareholders forced out a minority shareholder from his position as president of the corporation absent any malfeasance).

49. *See, e.g.,* ROBERT C. CLARK, *CORPORATE LAW* § 1.1, 2 (1986) (describing centralized management as one of the four key characteristics of the corporate form that "serve the positive functions of greatly facilitating the efficient aggregation of very large amounts of capital").

50. *See generally* Moll, *supra* note 4, at 989 (comparing the doctrine of minority oppression to implied-in-fact contracts); *see also* BRUNER, *supra* note 3, at 468 (explaining that "[o]ne reason control might be valuable is that it presents the opportunity for the majority to expropriate wealth of the minority").

51. *See, e.g.,* ZVI BODIE, ALEX KANE & ALAN J. MARCUS, *ESSENTIALS OF INVESTMENTS* 149-50 (2007) (explaining how the different risk-tolerances of investors can be used to design an appropriate portfolio of investments); *see also* BRUNER, *supra* note 3, at 540 (explaining that control can be exchanged for an increase in price).

52. For an overview of the important role that social norms such as trust play in corporate governance, *see generally* Symposium, *Norms & Corporate Law*, 149 U. PA. L. REV. 1607 (2001) (exploring how societal norms, such as trust, are critical in corporate governance because corporate relationships are often non-contractual).

53. *See generally* Butler & Ribstein, *supra* note 4, at 33-53 (considering the "Adequacy of Market Constraints on Contract Terms"). Butler and Ribstein confine their discussion of market forces to public corporations. However, they present a helpful overview of how such forces might impact the structure of power between owners and managers generally. *See id.*

the parties, not to some uniform norm established by the trier of fact.<sup>54</sup>

The historical development of corporation law further exacerbated the problem of minority investor vulnerability. Whereas the 19th Century norm was to treat the corporate charter as a contract that could be amended only with the unanimous consent of all of the investors, the early 20th Century witnessed a general movement toward the norm of majority rule.<sup>55</sup> The effect of this trend was to streamline decision-making by removing the minority's veto power over most corporate decisions, leaving the majority firmly in control of corporate policy.<sup>56</sup> At the same time, other devices that had previously served to limit the ability of controlling shareholders to engage in opportunistic behavior, such as cumulative voting and preemptive rights, also ceased to be the statutory norm.<sup>57</sup>

54. For an argument in favor of permitting investors the freedom to structure the corporation for the unique needs of their own particular circumstances, see *id.* at 32 (advocating "a presumption in favor of private ordering in the corporation").

55. See HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS 668 (1946) (noting that the requirement of unanimous consent for the sale of a corporation's assets has been changed by statute in nearly all the states); CLARK, *supra* note 49, § 10.6, 443-58 (stating that appraisal rights have been given to shareholders in replacement of the abandoned rule that major corporate changes require unanimous consent of the shareholders); Barry M. Wertheimer, *The Shareholders' Appraisal Remedy and How Courts Determine Fair Value*, 47 DUKE L.J. 613, 614 (1998) (discussing the move away from the requirement of unanimous shareholder consent); Brett W. King, *The Use of Supermajority Voting Rules in Corporate America: Majority Rule, Corporate Legitimacy, and Minority Shareholder Protection*, 21 DEL. J. CORP. L. 895, 909-13 (1996) (tracing the development to the ascendance of the theory of the corporation as a "real entity"); see also *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518, 636 (1819) (characterizing a corporation as a contract among the state, the corporation, and the investors).

56. See Wertheimer, *supra* note 55, at 614-15 (describing the loss of a minority shareholder's veto power over corporate changes).

57. See JAMES D. COX & THOMAS LEE HAZEN, COX AND HAZEN ON CORPORATIONS § 13.22 (2d ed. 2003) (explaining that, in most jurisdictions, cumulative voting rights are permissive, not mandatory); FRANKLIN A. GEVURTZ, CORPORATION LAW § 2.1.3, 136 (2000) ("At common law, preemptive rights existed as a matter of course. Statutes now generally make this subject controlled by the corporation's articles. . . . Most statutes exclude preemptive rights unless the articles expressly provide them.") (citations omitted).

Cumulative rights allow each share to receive one vote for each director to be elected. *Id.* Where more than one director is to be elected, these votes may be cast cumulatively for a single director, thereby providing the minority shareholder with a better chance at securing representation on the board of directors. *Id.* State corporation statutes often address when shareholders can use cumulative voting. See, e.g., DEL. CODE ANN. tit. 8, § 214 (2006) (stating that the certificate of incorporation may provide for cumulative voting); MODEL BUS. CORP. ACT § 7.28(b) (2005) (stating that shareholders do not have a right to cumulate their votes for directors unless the articles of incorporation explicitly say so).

Preemptive rights allow existing shareholders to purchase their pro rata share of any newly issued stock by the corporation. GEVURTZ, *supra* note 57, § 2.1.3, at 135-37. These rights are meant to protect the minority shareholder against dilution when the corporation issues new stock. *Id.* Many state statutes exclude preemptive rights

Even as the architecture of corporation law no longer allocated power in a manner that was favorable to minority investors, courts were becoming hostile to private attempts to change the default allocation of control by contract.<sup>58</sup> Courts frequently voided contracts, for example, in which a group of shareholders attempted to protect the minority by agreeing to elect each other as directors and then, as directors, to appoint each other as officers.<sup>59</sup> The stated reason for such decisions was to protect minority investors by requiring that the directors exercise unfettered their best business judgment.<sup>60</sup> The effect, however, was to limit private efforts to restrain the controlling shareholders' discretion over the corporation's conduct and affairs.<sup>61</sup> Thus, courts (perhaps

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unless they are specifically included in the corporation's charter. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(3) (mandating that no shareholder shall have a preemptive right unless the corporation specifies this right in its certificate of incorporation); MODEL BUS. CORP. ACT § 6.30(a) (stating that the shareholders do not have a preemptive right to acquire the corporation's unissued shares unless the articles of incorporation so provide).

58. *See generally* Lutter, *supra* note 24, at 7-8 ("Before World War II, American corporation laws did not provide much flexibility to accommodate the needs of private companies. . . . Courts were inclined not to interpret [the law] in a permissible and adaptable way, causing quite a few planners to conclude that for small enterprises, the partnership, despite its risks, was the suitable vehicle.") (citations omitted).

59. *See, e.g.*, *Abercrombie v. Davies*, 123 A.2d 893, 898 (Del. Ch. 1956) ("[O]ur corporation law does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy."); *Long Park v. Trenton-New Brunswick Theatres Co.*, 77 N.E.2d 633, 635 (N.Y. 1948) (holding that an agreement by shareholders to restrict the power of directors violated applicable statutes); *McQuade v. Stoneham*, 189 N.E. 234, 236 (N.Y. 1934) ("[S]tockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them by virtue of their office to elect officers and fix salaries."); 1 O'NEAL & THOMPSON, *supra* note 24, § 5:20, at 5-104 to -105 (noting judicial decisions that prohibit shareholders' agreements from controlling the appointment of directors). With respect to agreements limiting the discretion of shareholders to vote their shares as they choose, many early courts held that the voting power of stock could not normally be separated from the other incidents of ownership (although exceptions were often made when the voting agreement was revocable or coupled with an interest in the shares). *Id.* at 5-102. Likewise, early court decisions frequently rejected agreements that purported to limit the discretion of the directors—for example, by requiring the board to appoint the shareholders or their designees to corporate offices. *Id.* at 5-103 to -104.

60. *See, e.g.*, *McQuade*, 189 N.E. at 236 (holding that "stockholders may not, by agreement among themselves, control the directors in the exercise of the judgment vested in them, by virtue of their office"); 1 O'NEAL & THOMPSON, *supra* note 24, § 5:20, at 5-103 to -104. *But see* *Clark v. Dodge*, 199 N.E. 641, 642 (N.Y. 1936) (upholding a shareholders' agreement where all of the shareholders were parties and thus "the enforcement . . . damages nobody—not even, in any perceptible degree, the public").

61. Even in those instances where courts appeared willing to uphold a private allocation of power among the shareholders, they were generally loathe to impose the remedy of involuntary dissolution. *See* *Hetherington & Dooley*, *supra* note 4, at 26 ("Courts traditionally have regarded dissolution as a drastic remedy to be invoked only as a last resort."); Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 721

unwittingly) imposed a fixed allocation of power—strongly in favor of controlling shareholders—by striking down private agreements that attempted to restrain the free exercise of that power.

The coalescing of these two trends meant that minority investors were losing their traditional veto power while also being blocked from negotiating privately for a contractually based veto right. As a result, minority investors were both unprotected by the law and legally prohibited from protecting themselves through private ordering.<sup>62</sup> The situation practically invited overreaching by the controlling shareholders.<sup>63</sup>

### B. *The Nature of the Response*

Faced with the problem of oppression, corporation law has adjusted in several important ways to ameliorate the vulnerability imposed on minority investors. In the first place, courts have become far more liberal in enforcing private shareholders' agreements that seek to trump the law's default allocation of power, especially when all of a corporation's shareholders are parties to the agreement.<sup>64</sup>

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("Often, a court expressly will choose a buyout over dissolution as a less harsh remedy."). This reluctance appears to have survived even to today, with courts demonstrating a distinct preference for remedies that do not disrupt the perpetual life of the corporation. *See id.* at 721-22 ("The recognition of the possibility of a buyout as a less drastic remedy undoubtedly has contributed to the breakdown of the traditional judicial and legislative resistance to granting relief where there is dissension among shareholders.").

62. *See generally* Wertheimer, *supra* note 55, at 705 (discussing the need of minority investors for protection from overreaching by controlling shareholders).

63. *See, e.g.,* Wilson v. Wilson-Cook Medical, Inc., 720 F. Supp. 533 (M.D.N.C. 1989) (providing an example of a controlling shareholder's dismissal of the president of a corporation who was a minority shareholder where there was no evidence of any wrongdoing); Shelstad v. Cook, 253 N.W.2d 517 (Wis. 1977) (addressing a situation where a controlling shareholder withheld dividends and salaries from the minority shareholders).

64. The modern view is that shareholders' agreements should be respected to the extent they do not cause harm to third parties. *See, e.g.,* 1 O'NEAL & THOMPSON, *supra* note 24, § 5:6, at 5-25 to -26 ("Since at least 1960 courts and legislators have shown an increased sensitivity to the need of close corporations to depart from the traditional statutory norms. Court decisions reflect a definite trend toward greater judicial readiness to uphold shareholder control agreements, at least in close corporation settings."). This appears to be the case, in fact, even when the shareholders' agreement conflicts in some respect with the statutory law. The New York Court of Appeals, for example, in an early decision favoring the ability of investors to bargain freely, declared that "[i]f the enforcement of a particular [shareholders'] contract damages nobody . . . one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27" of the New York Business Corporation Law. *Clark*, 199 N.E. at 642. Similarly, the Illinois Supreme Court noted in 1964 that "there has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*," and even some "shareholder-director agreements that have technically

Investors now retain for themselves a great deal of freedom to craft an allocation of power that they deem optimal for their own particular circumstances and, at least in cases where that allocation is express, courts will generally uphold their agreement.<sup>65</sup> Indeed, most corporation statutes now include specific language authorizing shareholders to depart from the statutory default rules by contract, even in cases where such departures conflict with express statutory provisions.<sup>66</sup>

More importantly, policymakers have also adopted remedies specifically aimed at minimizing minority investor vulnerability.<sup>67</sup> For example, in addition to the protections afforded by the traditional fiduciary duties of loyalty and care, and by traditional notions of

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‘violated’ the letter of the [Illinois] Business Corporation Act have nevertheless been upheld in the light of the existing practical circumstances.” *Galler v. Galler*, 203 N.E.2d 577, 584 (Ill. 1964). *But see* 1 O’NEAL & THOMPSON, *supra* note 24, § 5:6, at 5-19 to -23 (cataloguing early cases where a shareholders’ agreement was invalidated because it was found to be in conflict with the applicable statute).

The law’s evolution toward increased acceptance of private shareholders’ agreements can be viewed as part of a larger trend toward viewing the corporate relationship as one based in contract. *See, e.g.*, Butler & Ribstein, *supra* note 4, at 64 (arguing that “the dominant trend in corporate law over the last 200 years has been to free corporate law from its state concession origins and treat it as a contractual relationship”).

65. *See, e.g.*, *Clark*, 199 N.E. at 642 (upholding a shareholders’ agreement where all of the shareholders were parties and thus “the enforcement ... damages nobody—not even, in any perceptible degree, the public”). *But see* O’Neal, *supra* note 4, at 884 (noting that a minority investor’s lawyer, “if he has one, may not have the knowledge, experience and skill necessary to draft effective protective arrangements”).

66. Beginning first in the 1960s in Florida, Delaware, and Maryland, state legislatures began to adopt specific statutory authority for the enforcement of shareholders’ agreements in the close corporation context. *See* 1 O’NEAL & THOMPSON, *supra* note 24, § 5:27, at 5-139 (“Most general corporate codes now permit organizers of a corporation to depart from the statutory norms of director control and majority rule by appropriate provisions in the corporation’s charter. The special close corporation statutes generally make it even easier to implement alternative control arrangements in statutory close corporations by expressly authorizing shareholder control agreements.”). Section 7.32 of the current version of the Model Business Corporation Act, for example, expressly states that “[a]n agreement among the shareholders of a corporation that complies with this section is effective among the shareholders and the corporation even though it is inconsistent with one or more other [listed] provisions of this Act.” MODEL BUS. CORP. ACT § 7.32(a) (2005). However, section 7.32(a) ceases to apply to any corporation that has a class of stock registered for trading on a national stock exchange. *Id.* The Delaware Code contains a similar provision. It states:

A written agreement among the stockholders of a close corporation holding a majority of the outstanding stock entitled to vote, whether solely among themselves or with a party not a stockholder, is not invalid, as between the parties to the agreement, on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors.

DEL. CODE ANN. tit. 8, § 350 (2006). In fact, in modern legal practice, the adoption of a shareholders’ agreement appears to be common practice when organizing a new entity. *See infra* notes 172, 309 and accompanying text.

67. *See infra* Parts I.B.1 and I.B.2.

contract law, many jurisdictions now provide aggrieved minority investors with a specific cause of action for oppression.<sup>68</sup> Other protections, most notably the statutory right of appraisal, have also evolved to protect minority investors.<sup>69</sup> The following sections describe the underpinnings and operation of these two important protections afforded to minority investors.

1. *The remedy of oppression*

As Robert Thompson has carefully described, minority investors in close corporations now generally have a direct, yet still evolving, cause of action for oppression.<sup>70</sup> The corporation statutes in a growing number of states—though not Delaware<sup>71</sup>—as well as judicial

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68. See generally Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 699 (tracing the development of the evolving cause of action for oppression). For a more detailed discussion of the remedy, see *infra* Part I.B.1. Notably, however, a number of jurisdictions have resisted this trend. In particular, Delaware has failed to recognize an increased level of fiduciary duties owed by the majority in the oppression context. See *Nixon v. Blackwell*, 626 A.2d 1366, 1366 (Del. 1993) (rejecting a "special rule" applicable only to minority investors); Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099 (1999) (explaining that Delaware's treatment of fiduciary duties in the context of close corporations differs, not only from Massachusetts, but from the majority of jurisdictions). Given Delaware's prominent role in creating corporation law, its failure to follow the trend might appear to suggest that the remedy of oppression constitutes only a relatively minor protection. Certainly, a disproportionate number of close corporations are incorporated in Delaware. Unlike the overwhelmingly dominant position it maintains with respect to public companies, however, Delaware is not nearly as dominant in the realm of private corporations. Thus, a significant majority of close corporations probably operate in jurisdictions that recognize some form of the remedy.

69. Other legal provisions that might be viewed as protective of minority investors—such as the SEC's "all-holders, best-price" rule that governs public company tender offers, as well as the more general duty of loyalty—apply only to public companies or are otherwise beyond the scope of this Article. The duty of loyalty would come into play where the controlling shareholders cause the corporation to enter into an agreement with a party in which they have an interest. See, e.g., *Wometco Enters., Inc. v. Norfolk Coca-Cola Bottling Works, Inc.*, 528 F.2d 1128 (4th Cir. 1976) (discussing a purchase and lease contract between two close corporations where the controlling interests in both corporations were the same and the contract gave one corporation the advantage of assured profits at the possible expense of the other); *Street v. Vitti*, 685 F. Supp. 379 (S.D.N.Y. 1988) (analyzing a situation where a controlling shareholder used corporate funds to provide a loan to another corporation in which he was also a controlling shareholder). The "all-holders, best-price" rule was promulgated by the SEC under section 14(d) of the Securities Exchange Act of 1934 for third party tender offers and under section 13(e) for issuer tender offers. 17 C.F.R. §§ 240.13e-4, 240.14d-10 (2006). Generally, the rule requires that the tender offer be extended to all shareholders of the specific security and that the per share consideration paid pursuant to the tender offer be equal among all the shareholders. See generally 2 THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* § 11.14, 298-99 (3d ed. 1995) (stating that the SEC adopted a "best price" rule that requires equal treatment for all shareholders).

70. Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 699.

71. See *supra* notes 7 and 68.



decisions in many others, now contemplate a variety of fiduciary-based remedies for oppressed minority investors.<sup>72</sup> These include not only the traditional remedy of dissolution, but also court-ordered buyouts of the minority's position, mandatory dividend payments, the appointment of a receiver, and other forms of equitable relief.<sup>73</sup> In addition, courts are increasingly willing to permit minority investors to bring their claims in the form of a direct action, thereby allowing them to avoid many of the legal and practical hurdles typically associated with derivative suits.<sup>74</sup> In fact, much of the current scholarship regarding minority oppression has moved beyond the question of whether such a cause of action is uniformly advisable and is focused instead on its proper scope and operation.<sup>75</sup>

Although the grounds for relief are seldom defined in corporation statutes, courts applying the remedy of oppression most commonly employ one of three standards (which are each variously described as being either a subset of, or an addition to, traditional fiduciary

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72. See Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 699 (addressing how legislatures and courts have responded to the "squeeze out" situation).

73. See *id.* at 718-24 (discussing various ways in which legislatures and courts have provided remedies for oppressed minority investors).

74. See *id.* at 735 (explaining that courts are increasingly likely to allow direct suits in a close corporation setting whereas in a public corporation the suit would usually have to be brought as a derivative action). Under normal corporation law rules, a claim for breach of fiduciary duty by the controlling shareholders would generally be made in the name of the corporation and would be subject to the usual limitations on derivative lawsuits. See, e.g., *Aronson v. Lewis*, 473 A.2d 805 (Del. Super. Ct. 1984), *overruled by* *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) (providing an example of a shareholder derivative suit brought by investors claiming that the company breached its fiduciary duty by approving a large severance package for its former president); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. Super. Ct. 1981) (providing an example of a shareholder derivative lawsuit brought against ten officers and/or directors of the company to recover damages). In the event the allegedly oppressive conduct involved a failure to pay dividends, however, merely requiring the majority to fill the corporation's coffers without simultaneously requiring that the corporation share its treasure with the minority would seem to miss the point. Given this obvious flaw in the use of a derivative action as the basis for a remedy for oppression, courts have increasingly been willing to allow the claim to proceed in the name of the minority investors, with the proceeds of any damages award therefore being paid directly to the minority. Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 735-38. An oppressed minority investor, therefore, no longer needs to bootstrap her claim of mistreatment to a cause of action for fraud or waste. *Id.*

75. See, e.g., Ragazzo, *supra* note 68, at 1099 (comparing the approach of Delaware, which makes no distinction between public and close corporation shareholders, and the approach of those states for which such distinction is central to their oppression jurisprudence); Thompson, *Corporate Dissolution*, *supra* note 4, at 194 (analyzing the historical development of the reasonable expectations standard for resolving conflicts within close corporations). *But see* Moll, *supra* note 4, at 989 (analyzing whether the oppression doctrine is necessary or whether contract law provides all of the tools that minority investors need).

duties).<sup>76</sup> The most important of these—certainly the one that has garnered the most scholarly attention—prohibits conduct that exceeds the minority’s “reasonable expectations” as to the future management of the corporation.<sup>77</sup> Courts or legislatures have adopted this cause for relief in approximately one-third of the states.<sup>78</sup> In other states, policymakers equate oppression with conduct that is “burdensome, harsh and wrongful,”<sup>79</sup> while still others link the cause of action to the controlling shareholders’ fiduciary duty of good faith.<sup>80</sup> While the latter two remedies are based in part on a determination of the wrongfulness of the controlling shareholders’ conduct, the reasonable expectations standard omits considerations of fault and instead focuses only on whether the conduct departs from a particular norm.<sup>81</sup>

What each of these standards has in common is that they are all for the most part objective in their analysis. They each operate by comparing the alleged misconduct to a fixed notion of the proper

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76. Thompson, *Shareholder’s Cause of Action*, *supra* note 4, at 711-12; *see also* Moll, *supra* note 4, at 1001-02.

77. Hodge O’Neal argued for this standard in his 1975 treatise, and Robert Thompson, his co-author, has picked up the mantle of his argument. *See* F.H. O’NEAL, “SQUEEZE-OUTS” OF MINORITY SHAREHOLDERS (1975); Thompson, *Corporate Dissolution*, *supra* note 4, at 193; *see also* Afterman, *supra* note 4, at 1063 (arguing in 1969 that oppression was best understood under English law “in terms of the reasonable expectations of the minority shareholders”).

78. The states that have applied the reasonable expectations standard include Alaska, Colorado, Delaware, Iowa, Montana, New Jersey, New Mexico, New York, North Carolina, North Dakota, Rhode Island, Texas, Washington, West Virginia and Wisconsin. 1 O’NEAL & THOMPSON, *supra* note 2, § 7:15, at 7-106 to -107. Massachusetts has applied the reasonable expectations standard to grant relief based on breach of fiduciary duties. *Id.* at 7-107 n.20. Also, the South Carolina Supreme Court and the oppression statute of Minnesota consider the parties’ reasonable expectations as a factor in determining whether relief should be granted. *Id.* at 7-107.

79. *Id.* § 7:13, at 7-96. These states include Arkansas, Missouri, Montana, New York, Virginia and Wisconsin. *Id.* at 7-96 n.12.

80. *Id.* These states include Mississippi and Oregon. *Id.* at 7-96 to -97 n.13.

81. When applying the reasonable expectations test, a court will consider the aggrieved minority shareholder’s expectations and not focus on the wrongful acts or fault of the controlling shareholders. *See* Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares*, 65 NOTRE DAME L. REV. 425, 465 (1990) (explaining that “the crux is not identifying a traditional wrong but rather identifying the basis of the bargain—what were the explicit or implicit conditions pursuant to which the parties associated themselves together in the corporate form”); *see also* Thompson, *Corporate Dissolution*, *supra* note 4, at 219-20 (“[T]he reasonable expectations standard reflects a move away from an exclusive search for egregious conduct by those in control of the enterprise and toward greater consideration of the affect of conduct on the complaining shareholder, even if no egregious conduct by controllers can be shown.”). *But see* Mitchell, *Death of Fiduciary Duty*, *supra* note 4, at 1677 (“The new tests, while often couched in fiduciary language, require proof of some form of affirmative bad faith or intentional misconduct by the fiduciary.”).

allocation of control and to a uniform set of expectations about what conduct is reasonable, rather than to the allocation selected in each case by the parties themselves. Policymakers—not investors—determine what conduct is burdensome, harsh and wrongful, for example, or not in good faith, and investors are not free to deviate from these norms.<sup>82</sup>

The reasonable expectations standard, for example, treats all minority investors as uniformly vulnerable and equally deserving.<sup>83</sup> Admittedly, it appears on the surface to constitute a subjective inquiry in that it purports to look at the parties' expectations. In fact, however, it contemplates an examination of the typical minority investor's *reasonable* expectations, not her *actual* bargain.<sup>84</sup> Moll, for example, characterizes the standard as requiring evidence that the controlling shareholders' conduct fits "a common pattern of behavior" and understands the economic rationale that leads "a typical close corporation shareholder" to invest.<sup>85</sup> Thus, questions regarding the particular investor's complicity in

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82. In other words, the statutory allocation of control, interpreted in light of the remedy of oppression, is a mandatory rule, rather than a default position that the parties may opt out of. See Butler & Ribstein, *supra* note 4, at 17 (arguing that "it is one thing to propound a default rule to cover situations not covered in the parties' contract, and another thing to state a general rule applicable irrespective of contract") (citations omitted).

83. See Moll, *supra* note 4, at 1012 (noting that "courts seem to appreciate that a rational minority stockholder would not invest in a close corporation without reaching a shared understanding of continued employment and management participation with the majority stockholder"). But see O'Kelley, *supra* note 6, at 218 (arguing that minority investors sometimes "rationally choose and prefer" to adopt the statutory allocation of control that favors the controlling investors). For examples of situations where investors choose to invest without guarantees of continued employment, see *supra* notes 28-34 and accompanying text.

84. The objective nature of the remedy can even be seen in the particular choice of language in the caselaw. Rather than describe the "true plight" of the plaintiff—a woman—by referring to her with a feminine pronoun, for example, the opinion in the leading case of *Donahue v. Rodd Electrotape Co. of New England, Inc.*, 328 N.E.2d 505 (Mass. 1975), chose to use the masculine pronoun, presumably as a placeholder for an idealized everyman minority investor:

The stockholder may have anticipated that *his* salary from *his* position with the corporation would be *his* livelihood. Thus, *he* cannot afford to wait passively. *He* must liquidate *his* investment in the close corporation in order to reinvest the funds. . . . *He* cannot easily reclaim *his* capital.

*Id.* at 591 (emphasis added). For the *Donahue* court, then, all minority shareholders are the same—hence the use of the generic masculine pronoun—and the individual characteristics of a particular investor are for the most part unimportant. Minority investors, in the court's view, constitute a uniform category, not a collection of unique individuals.

85. Moll, *supra* note 4, at 1004. Moll describes the requirement that the aggrieved investor show specific evidence that her claim fits within the general pattern as "slight at best." *Id.* at 1010-11 (noting that "the liability inquiries of many oppression courts seem to turn in large part on general evidence of a behavioral pattern in close corporations").

shaping her vulnerability and the degree to which she was previously compensated for bearing the risk of her minority status typically are not part of the analysis. Moreover, the test is predicated on the notion that the parties did not have any discernable bargain with respect to the allocation of control. Indeed, if the parties had agreed on a private allocation of control, either expressly or implicitly, the remedy of oppression would not be needed. In such a case, principles of contract law would be sufficient to ensure a just result.<sup>86</sup>

Thus, the reasonable expectations standard can best be understood as providing minority investors with the bargain that the trier of fact believes they *should* have negotiated. The court's function, in other words, is not to attempt to uncover the parties' unique bargain, but to reason logically toward an imagined realm of permissible conduct.<sup>87</sup> The particular intentions of the parties are expressly ignored in favor of a more generalized understanding of what constitutes a fair bargain between close corporation investors. Like the other standards for oppression, the reasonable expectations test presumes the uniformity of all minority investors in close corporations and so imposes a mandatory, judicially determined threshold of acceptable commercial behavior that the parties may not cross.<sup>88</sup> Under this standard, what is oppressive for one reasonable minority investor is oppressive for all, for all are presumed to have the same (reasonable) expectations.

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86. A contract may sometimes be said to be implied-in-fact where the presence of an agreement is not stated expressly but rather is inferred from the conduct of the parties. FARNSWORTH, *supra* note 15, § 3.10, at 129-30. Thus, where a bargain can reasonably be inferred from the conduct of the parties to a close corporation, an allegedly oppressed party has recourse to a contract law remedy and so does not require the presence of an additional corporation law cause of action. *See id.* But see Moll, *supra* note 4, at 1017-25, 1027-35 (arguing that the doctrine of oppression is superior to the contract law doctrine of an implied-in-fact bargain because the latter fails to provide an adequate remedy and also requires a level of definiteness that is generally absent from the typical close corporation contract).

87. *See* Moll, *supra* note 4, at 1006-07 ("To ascertain the reasonable expectations of close corporation shareholders, one could gather empirical evidence by asking a large number of stockholders about the entitlements they expected to receive as a result of their investments in close corporations. Short of this empirical approach, however, one could simply observe what many close corporation shareholders do in fact receive once they commit capital to a venture. . . . In oppression disputes, this latter approach is mimicked to a great degree.").

88. *See id.* at 1007 (discussing the investment expectations of "typical close corporation shareholders"); *Pedro v. Pedro*, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990) (noting generally that "the primary expectations of minority shareholders include an active voice in management of the corporation and input as an employee").

The refusal by Delaware and some judges<sup>89</sup> to provide special protections for minority investors is also essentially objective in its approach. The Delaware approach does not attempt to compare the parties' conduct to their particular bargain.<sup>90</sup> Rather, it interprets contractual silence in all cases as a deliberate choice to elect the default allocation of control, just as jurisdictions like Massachusetts interpret contractual silences in all cases as indicative of oversight.<sup>91</sup> Both extremes impose a fixed norm of acceptable conduct—one low and the other high—instead of attempting to uncover the range of permissible conduct the investors themselves actually preferred.

The use of these standards therefore appears to represent a policy decision to ignore the particulars of the investors' privately negotiated allocation of power and instead establish a fixed realm of prohibited conduct.<sup>92</sup> The question for the court is not whether the parties agreed to permit the controlling shareholders to take a certain action, but whether such action is within the bounds of what the courts and legislatures mandate as proper.<sup>93</sup> Over time, the accumulation of caselaw will define the range of conduct that (in the opinion of the trier of fact) is not permissible under any circumstance.<sup>94</sup> The use of objective standards therefore imposes a uniform allocation of control as the obligatory norm. Shareholders

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89. See Moll, *supra* note 7, at 825-26 (noting that, even in jurisdictions that recognize a remedy for oppression, the preconceptions of the judge are often outcome determinative and thus may make the remedy unavailable in practice).

90. See *supra* notes 7 and 68.

91. See *Nixon v. Blackwell*, 626 A.2d 1366, 1366 (Del. 1933) (rejecting a "special rule" applicable only to minority investors).

92. See generally, e.g., Bebhuk, *supra* note 4, at 1820 (providing arguments that certain corporation law rules should not be waivable); Brudney, *supra* note 4, at 1403 (arguing against a view that accepts corporation law as a contract that can be endlessly waived and mutated); see also *infra* Part I.D (exploring the possible bases for such a policy decision to prefer the protection of vulnerable minorities over the promotion of private ordering).

93. Note that widespread skepticism over the competence of courts to rule on complicated business matters is the basis for the business judgment rule, which presumes the good faith, loyalty and due care of corporate directors. See *Dodge Bros. v. Ford Motor Co.*, 170 N.W. 668, 684 (Mich. 1919) (expressing concern that "judges are not business experts"); *Brehm v. Eisner (In re Walt Disney Co. Derivative Litig.)*, 906 A.2d 27, 52 (2006) ("Our law presumes that 'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'") (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)). For a general discussion of the business judgment rule and its application to corporate governance, see CLARK, *supra* note 49, § 3.4, at 123-24.

94. See Mitchell, *Death of Fiduciary Duty*, *supra* note 4, at 1680 (describing a process by which the accretion of additional case law serves to codify particular fiduciary standards).

are blocked from privately negotiating an allocation of control that differs from the legal default unless they do so expressly.<sup>95</sup>

## 2. *The dissenters' right of appraisal*

In addition to the remedy of oppression, minority investors are also protected by the dissenters' right of appraisal. This right, which is contained in the corporation statutes of most states,<sup>96</sup> allows investors to seek a court-supervised appraisal of the fair value of their shares in the event they dissent from a corporation's decision to merge or enter into some other fundamental transaction.<sup>97</sup> If the appraised price turns out to be greater than that received by the complaining minority investor, then the corporation must make up the difference in cash.<sup>98</sup> Although often thought of in the context of public corporations, the appraisal right is also available as a remedy for minority investors in close corporations.<sup>99</sup>

95. See *supra* notes 64-66 and accompanying text.

96. 2 O'NEAL & THOMPSON, *supra* note 24, § 9:5, at 9-22.

97. See *id.* (explaining that the appraisal right is triggered in all states by statutory mergers and consolidations and in most states when the corporation sells the majority of its assets, with Delaware being a notable exception). In addition, approximately half of the states provide appraisal rights for charter amendments and for asset sales comprising "substantially all" of the assets of the selling corporation. See *id.* Several states even provide appraisal rights in situations where shareholders have no voting rights, such as in the case of a sale of a controlling block of a corporation's shares. See, e.g., MICH. COMP. LAWS ANN. § 450.1799 (West 2006); S.C. CODE ANN. § 35-2-111 (2006).

98. See, e.g., DEL. CODE ANN. tit. 8, § 262(i) (2006) ("The Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or resulting corporation to the stockholders entitled thereto"); MODEL BUS. CORP. ACT § 13.30(e) (2005) (entitling each dissatisfied shareholder to the amount of the fair value of the shares, as determined by the court, that exceeds the amount already paid to the shareholders). The Model Act requires the corporation to advance its estimated fair value to a dissenting shareholder who demands payment. MODEL BUS. CORP. ACT § 13.24(a). If the court later determines that this estimated amount was less than the true fair value of the shares, the corporation would then be ordered to pay the difference. MODEL BUS. CORP. ACT § 13.30(e). The Delaware statute, in contrast, only requires that payment be made upon the resolution of the dispute. DEL. CODE ANN. tit. 8, § 262(d)-(i).

99. See 2 O'NEAL & THOMPSON, *supra* note 24, at § 9:5, 9-21 to -22 (noting that appraisal rights is one technique for minority investors in a close corporation to mitigate possible abuse by controlling shareholders). For examples of appraisal rights cases in the public corporation context, see, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983); *In re Valuation of Common Stock of Libby, McNeill & Libby*, 406 A.2d 54 (Me. 1979); *Oakridge Energy, Inc. v. Clifton*, 937 P.2d 130 (Utah 1997). It is worth noting, however, that many corporation statutes include a "market exception" that makes the appraisal right unavailable with respect to corporations whose shares are listed on a national securities exchange or held of record by more than a specified number of shareholders. See, e.g., DEL. CODE ANN. tit. 8, § 262(b)(1)(i); N.J. REV. STAT. ANN. § 14A:11-1(1)(a)(1)(A) (West 2006); TENN. CODE ANN. § 48-23-102(c) (West 2006).

Though the history<sup>100</sup> and operation<sup>101</sup> of the two remedies are quite different, the dissenters' right of appraisal can be viewed in one respect as akin to a subset of the more general remedy of oppression.<sup>102</sup> This is because it operates to protect minority investors

100. Interestingly, the appraisal remedy was originally developed to solve a very different problem that arose as corporation statutes began to move away from a requirement of unanimous shareholder approval for fundamental corporate changes. *See, e.g.,* *Salomon Bros., Inc. v. Interstate Bakeries Corp.*, 576 A.2d 650, 652 (Del. Ch. 1989) (“[A]ppraisal rights were provided as a ‘quid pro quo for the minority’s loss of its veto power’”) (quoting *In re Shore*, 67 A.D.2d 526, 531-32 (N.Y. 1979)). Because such decisions were thenceforth to be made by a majority or supermajority vote rather than as a unanimous decision, it became possible—even likely—for some shareholders to become investors in a merged company against their will. CLARK, *supra* note 49, § 10.6, at 444; Barry M. Wertheimer, *The Purpose of the Shareholders’ Appraisal Remedy*, 65 TENN. L. REV. 661, 677 (1998). In order to avoid such a result, statutory provisions were drafted that permitted such a dissenting shareholder to seek to be cashed out by the corporation. Thus, the appraisal remedy was initially created to provide an exit for shareholders who did not agree with corporate policy with respect to fundamental decisions. *Id.* at 681.

As the years passed and the norm of majority shareholder rule became more fully internalized by investors, however, this concern has waned. *See* CLARK, *supra* note 49, § 10.6, at 444 (“[I]nvestors nowadays care only about the risks and expected return presented by their investments. They are not usually attached, out of sentiment or ideology, to a particular company or kind of company . . . [S]hareholders in today’s large publicly held companies do expect mergers and other major changes in the nature of their investments to occur with some frequency, and on the basis of majority vote.”). The statutory right of appraisal, however, found new relevance by evolving into a remedy for minority investors who have been squeezed out at an unfair price. *See* Wertheimer, *supra*, at 677-78 (describing the development of squeeze-out mergers in the mid-1970s that were used by controlling shareholders “for the sole purpose of eliminating the minority shareholders”); *see also* Elliott J. Weiss *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 647-48 (1981) (describing courts’ approaches in California, New York, and Delaware in protecting minority investors by using appraisal rights regardless of whether cash is considered a form of consideration in that state).

101. *See supra* notes 97-98 and accompanying text.

102. The procedures for accomplishing mergers and other fundamental changes provide numerous opportunities for minority investors to suffer oppression. In the case of a merger, for example, because they have final approval over the transaction documents, controlling shareholders can negotiate the structure and composition of the consideration in such a way as to appropriate for themselves some or all of the value of the minority’s investment. *See, e.g.,* *Landy v. Amsterdam*, 815 F.2d 925 (3d Cir. 1981) (merging a Pennsylvania real estate investment trust with a corporation in a share-for-share exchange that resulted in the corporation having eighty-seven percent of the voting power of the new company); *Carl Marks & Co. v. Universal City Studios, Inc.*, 233 A.2d 63, 64 (Del. Ch. 1967) (describing the terms of the merger of Universal Pictures Company, Inc. into Universal City Studios, Inc. where stockholders were given no choice but to accept \$75 cash per share, which the stockholders thought constituted a “confiscation of [their] property without due process of law”); *see also, e.g.,* *Heilbrunn v. Sun Chem. Corp.*, 150 A.2d 755, 758-59 (Del. 1959) (denying appraisal rights where a sale of assets was held not to constitute a de facto merger). The appraisal right, by limiting the ability of the controlling shareholders to structure the consideration, provides a remedy for a specific subset of oppression techniques—those culminating in an attempt to squeeze out the minority at an unfair price. *See* 2 O’NEAL & THOMPSON, *supra* note 24, § 9:5, at 9-22 (“Appraisal rights ostensibly protect minority shareholders against the majority’s use of its voting power to force the minority out of an enterprise at an unfair price.”).

from a particular subset of opportunistic behavior: the squeezing-out of minorities at an unfair price by means of a merger, consolidation or other fundamental transaction.<sup>103</sup>

The linchpin of the appraisal right is its “fair value” standard.<sup>104</sup> Rather than ordering an appraisal of the shares’ fair market value, a standard that might be interpreted as taking into account the different values placed on blocks of controlling and minority shares,<sup>105</sup> most statutes require that minorities be paid an amount based on their pro rata interest in the corporation.<sup>106</sup> Thus, in a typical appraisal of the fair value of a block of shares, the court first estimates a value for the enterprise as a whole.<sup>107</sup> Once this is done, the court simply divides the whole by the number of shares

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103. For examples of cases involving the interplay between squeeze-outs and appraisal rights, see, e.g., *Morley Bros. v. Clark*, 361 N.W.2d 763, 765 (Mich. 1984) (allowing the aggrieved shareholder to enforce her appraisal rights after the corporation consummated an unfavorable acquisition); *Pratt v. Ballman-Cummings Furniture Co.*, 549 S.W.2d 270, 274 (Ark. 1977) (finding a de facto merger and granting shareholders’ appraisal rights); *Flarsheim v. Twenty Five Thirty Two Broadway Corp.*, 432 S.W.2d 245, 255 (Mo. 1968) (holding that a sale of substantially all of the corporate assets triggered the appraisal rights). *But see Hariton v. Arco Elecs., Inc.*, 188 A.2d 123, 125 (Del. 1963) (refusing to grant appraisal rights where the corporation undertook a plan to sell all of its assets in exchange for stock in a separate corporation, distribute the new stock to the shareholders, and then dissolve the old corporation). See generally I O’NEAL & THOMPSON, *supra* note 24, § 5:6, at 5-19 to -31 (discussing instances where shareholders’ agreements were deemed to be invalid because of their violations of specific statutory norms that protect minority shareholders); *id.* § 9:27, at 9-184 to -189 (noting that these shareholders can petition for relief based on oppression, which is broader than the traditional relief of involuntary dissolution).

104. See Wertheimer, *supra* note 55, at 626 (“The statutory command in an appraisal proceeding is to find the ‘fair value’ of the dissenting shares.”). The Delaware Code and the Model Business Corporation Act provide examples of statutory language describing appraisal rights. DEL. CODE ANN. tit. 8, § 262(a) (stating that qualified dissenting shareholders “shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder’s shares of stock”); MODEL BUS. CORP. ACT § 13.02(a) (mandating that “[a] shareholder is entitled . . . to obtain payment of the fair value of that shareholder’s shares”).

105. See, e.g., DEL. CODE ANN. tit. 8, § 262(h) (stating that, in an appraisal proceeding, “the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation”); MODEL BUS. CORP. ACT § 13.01(4) (defining fair value as “the value of the corporation’s shares determined . . . without discounting for lack of marketability or minority status”). For a definition of “fair market value,” see *infra* note 251.

106. See *Kahn v. Tremont Corp.*, 1996 Del. Ch. LEXIS 40, 32 & n.17 (Del. Ch. 1996) (defining fair value as “the pro rata value of the entire firm as a going enterprise”), *rev’d on other grounds*, 694 A.2d 422 (Del. 1997); MODEL BUS. CORP. ACT § 13.01(4) (defining fair value as “the value of the corporation’s shares determined: immediately before the effectuation of the corporate action to which the shareholder objects” excluding any appreciation or depreciation in anticipation of the corporate action”).

107. See Wertheimer, *supra* note 55, at 628-29 (describing various common methods of finding the value of the company and thus the value of a particular block of shares).



outstanding, thereby establishing a per share value that can be used to calculate the price to be paid to the dissenting shareholder.<sup>108</sup> Under this standard, minority investors are entitled to the same consideration per share as are controlling shareholders.

Similar to the tests used to judge instances of oppression, the fair value standard is objective because it evidences an underlying conviction that each share is equivalent.<sup>109</sup> No discount is calculated for the lack of control over the corporation's policies and strategies, nor for the illiquidity that normally accompanies a minority position that lacks control.<sup>110</sup> Rather, courts look at each share of stock individually as representing a fragmented and separable—and uniform—interest in the enterprise as a whole. In other words, the fair value standard ignores the impact of the parties' private allocation of the risks associated with a lack of control.<sup>111</sup> The dissenters' right of appraisal thereby elevates the minority shares to the status of controlling shares. The fair value of each share is made equivalent, even if the particulars of the parties' bargain would suggest that some shares were intended to bear more of the risks than others. The appraisal right, like the remedy of oppression, again fixes a mandatory allocation of control and removes from the parties the discretion to negotiate their own unique deal.

### C. *The Sources for the Response*

The law has responded to the vulnerability of minority investors by retreating to objective, uniform standards. It treats all minority investors as members of a similarly situated, and equally vulnerable, category, thereby ignoring the possibility that some investors might prefer a different deal. As described in the preceding sections, the standards that have been adopted to ameliorate minority vulnerability are mandatory and objective, rather than default and subjective.<sup>112</sup> Each therefore ignores the deal actually negotiated by the parties and in doing so mandates a level of acceptable commercial behavior established by statute or caselaw.

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108. *See id.*

109. *But see infra* Part I.D.3.

110. For an explanation of the factors impacting the analysis of a share's value, see *infra* Part II.B.

111. *See* Butler & Ribstein, *supra* note 4, at 10 ("Despite shedding their state-creation origins, modern corporate statutes do include many mandatory terms.").

112. *See supra* Parts I.B.1 and I.B.2 (discussing the problems with an objective standard in evaluating a minority shareholder's cause of action for oppression and a court's calculation of the fair value of the shareholder's shares).

In developing the remedies for oppression as objective standards, courts and legislatures appear largely to have been following the approaches taken by the scholarly literature. Hodge O'Neal and Allen Afterman, for example, both advocated early on for the adoption of a blanket set of protections available equally to all minority investors.<sup>113</sup> Rather than make any distinctions among minority investors, they assumed in all cases that silence in an investment contract indicated investor ignorance as to the risks of minority status.<sup>114</sup> When minority investors failed to protect themselves, they believed it self-evident that the law should do so on their behalf.<sup>115</sup> Hetherington and Dooley similarly argued that all minority investors, regardless of their individual circumstances, should be granted certain legal protections—in their case, partnership-like dissolution rights.<sup>116</sup>

More recently, prolific close corporation scholars such as Robert Thompson and Douglas Moll have probed the proper boundaries of the legal protections, as well as their application.<sup>117</sup> Others have

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113. See Thompson, *Corporate Dissolution*, *supra* note 4, at 193 (“Professor O’Neal’s 1975 treatise, *Oppression of Minority Shareholders*, urged the reasonable expectations of shareholders as the most reliable guide to a just resolution of disputes among shareholders.”); O’NEAL, *supra* note 77, at § 9.08, 609-10 (advocating the adoption of dissenters’ rights statutes covering all types of combinations of mergers and sales of assets); Afterman, *supra* note 4, at 1043-46 (discussing the usefulness of section 210 of the English Companies Act in granting redress to “any member of a company who complains that the affairs of the company are being conducted in a manner oppressive to some part of its members”); see also Hetherington, *supra* note 4, at 946 (“Each shareholder is entitled to assume that the other shareholders will not intentionally exercise their rights as owners for the purpose of damaging or destroying the common venture.”).

114. See, e.g., O’NEAL, *supra* note 77, § 9.03, at 582 (“A person taking a minority position in a close corporation often leaves himself vulnerable to squeeze-out or oppression by failing to insist upon a shareholders’ agreement.”).

115. See *id.* §§ 9.02, 9.08, at 579, 609-10 (suggesting that restrictive statutes should be amended to enforce bylaw provisions and shareholders’ agreements, while at the same time minimizing the disadvantages and complexities facing minority shareholders in asserting dissenters’ rights).

116. See Hetherington & Dooley, *supra* note 4, at 6 (“Accordingly, we offer a model statutory provision requiring the majority to repurchase the minority’s interest at the request of the latter.”).

117. See, e.g., Thompson, *Corporate Dissolution*, *supra* note 4, at 200-05, 210-16, 228-36 (discussing alternative remedies to court-ordered involuntary dissolution such as voluntary dissolution, dissolution due to deadlock, dissolution based on misconduct, shareholders’ reasonable expectations, buyouts and custodial arrangements); Thompson, *Shareholder’s Cause of Action*, *supra* note 4, at 699 (discussing the response of legislatures in broadening the grounds for judicial dissolution of a corporation and providing additional remedies in addition to the courts expanding the ability of shareholders to bring a direct and individual cause of action against the corporation); Moll, *supra* note 4, at 989 (comparing contract law and the remedy of oppression); Moll, *supra* note 7, at 765-78 (discussing the availability of remedies based on the perspective of the trier of fact); Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation*

followed suit.<sup>118</sup> The goal of their research has been to explore and outline a legal structure that would ameliorate the vulnerability inherent in minority ownership, thereby minimizing the associated agency costs.<sup>119</sup> In doing so, however, each has made objective arguments based not on the parties' individually chosen allocation of power, but on public policy concerns equally applicable to all minority investors (or at least all unsophisticated minority investors).

Interestingly, even opponents of a broad remedy have approached the problem as one impacting all minority investors in a uniform manner. Easterbrook and Fischel, for example, cautioned against assuming that close corporation investors really desire an allocation of control other than the statutory norm.<sup>120</sup> In doing so, they appeared to open the door to a more subjective analysis that would seek to uncover the boundaries of proper conduct actually elected by the parties.<sup>121</sup> They failed to seize this opportunity, however. Instead, their recommendations were not to replace a mandatory standard with a case-by-case approach, but to change the default assumption

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*Disputes*, 86 MINN. L. REV. 717 (2001-2002) (examining the "time of investment" focus of most published oppression decisions); Douglas K. Moll, *Shareholder Oppression & Dividend Policy in the Close Corporation*, 60 WASH. & LEE L. REV. 841 (2003) (considering whether judicial intervention is warranted in close corporation dividend policy).

118. See, e.g., Ragazzo, *supra* note 68, at 1101, 1136 (discussing the extent to which Delaware corporation law prevents oppression of minority investors given the ruling in *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993), where the court declined to create any special rules for close corporations but applied the "entire fairness" test which requires the majority "to proceed in a manner that is both procedurally and substantively fair"); Rock & Wachter, *supra* note 4, at 947-48 (taking the approach that the close corporation structure should first be limited in its use, then that the law should take a passive approach to avoid undermining the self-enforcing structure already in place).

119. See Moll, *supra* note 7, at 775, 826 (advocating the use of a "modified minority perspective" where the court will consider the minority shareholder's reasonable expectations in light of the particular circumstances before the court at the time); Thompson, *Corporate Dissolution*, *supra* note 4, at 237 ("The change in law of involuntary dissolution . . . is a necessary complement to the broad flexibility now provided to participants structuring their relationship in a corporation."). For a further discussion of the interplay between oppression and agency costs, see *infra* Part II.D.

120. See EASTERBROOK & FISCHEL, *supra* note 8, at 250 (arguing that "the assumption that participants in closely held corporations want to be governed by partnership law is questionable. The participants incorporated for a reason."); Easterbrook & Fischel, *supra* note 4, at 285 ("In light of the potential cost of these protections [right of dissolution at will and imposition of strict fiduciary duties], it is conceivable, indeed certain, that there will be situations where all parties decide that they are better off without them.").

121. See Easterbrook & Fischel, *supra* note 4, at 301 ("There is no basis for treating one form or one group of investors as favorites of the law, and there is every reason to treat both groups of investors as intelligent adults who's contracts should be enforced.").

from one that is protective of minority investors to one that is not.<sup>122</sup> In this way, like the Delaware courts,<sup>123</sup> they continued to treat all minority investors as similarly situated and advocated a fixed, uniform scheme.<sup>124</sup> Rather than seek to uncover the parties' true bargain, they simply argued for a different underlying assumption regarding the implications of the minority's inherent vulnerability.

There appears to be broad agreement among scholars, then, that the range of permissible conduct in a close corporation should be determined in a uniform manner, treating all minority investors as similarly situated equally vulnerable. The choices and intentions of the parties, as reflected in their particular bargain, are generally ignored by scholars as well as by courts and legislatures.

#### *D. The Defects in the Response*

Wherever possible, the parties to a business corporation should be granted the freedom to bargain among themselves over the proper range of discretion to be allocated to the controlling shareholders.<sup>125</sup> In this way, they can select the balance between discretion and accountability that is optimal given the particular circumstances of their unique transaction.<sup>126</sup> Only when it is not possible to give deference to the parties' intentions should the legal system impose an objective standard for what constitutes proper commercial behavior.

The reluctance of scholars and other policymakers to permit investors to bargain privately for their own preferred standard of acceptable commercial behavior appears to be rooted in some combination of four assumptions. The following sections describe these assumptions and challenge their application to close corporations.

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122. See *id.* at 273 ("No *a priori* case can be made for greater legal intervention in closely or publicly held corporations."). O'Kelley also advocated an approach that would tend to enforce "the level of majority discretion normally afforded by the corporate form." O'Kelly, *supra* note 6, at 246. However, he based his recommendation on the assumption that "the parties are presumed to have chosen corporate form rationally and for governance reasons." *Id.*

123. See *supra* notes 7 and 68.

124. In this respect, interestingly, Easterbrook and Fischel's hypothetical bargain approach differs from a strict contractarian analysis, which would seek to provide a default rule applicable when the parties are silent, rather than imposing a mandatory rule. See Butler & Ribstein, *supra* note 4, at 17 ("It is, therefore, a mistake to identify the hypothetical bargain approach with the contract theory of the corporation.").

125. See *id.* at 32 (arguing that "the fundamentally contractual nature of fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts").

126. See BRUNER, *supra* note 3, at 636 (characterizing risk management as a commodity that can, and should, be priced by the parties to a business transaction).

*1. A false analogy*

As Americans, we profess to value equality and to abhor injustice. On both a philosophical and emotional level, we reject the disparate treatment of others, even if we sometimes disagree in practice over what conduct constitutes improper discrimination.<sup>127</sup> The reluctance of policymakers to permit minority investors to waive protections therefore appears to be predicated in part on a belief in the similarity between their vulnerable status and that of other aggrieved minorities, such as racial and ethnic minorities.<sup>128</sup> In fact, the law's very language and use of metaphor—the term “oppression,” for example—appears to be borrowed from the realm of equal protection law.<sup>129</sup> As with a “protected class,” to borrow a term directly from constitutional law, it is the mere fact of the minority's vulnerable status that triggers the application of special protections.<sup>130</sup> The remedies for oppression therefore seem based as much on an intuitive sense of equity arising out of concern for vulnerable minorities as on traditional notions of contract law.<sup>131</sup>

Being a minority investor is quite different from being a racial or ethnic minority, however. Presumably, one is born with certain largely immutable physical characteristics that determine one's race or ethnicity. Whether or not the concepts of race and ethnicity are in part constructed, minority status is for the most part beyond the control of the typical citizen, at least insofar as she cannot easily take action to permanently alter her race or ethnicity. Accordingly, the

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127. For a general discussion of the status of, and the challenges facing, racial and ethnic minorities in the United States, see generally DERRICK BELL, *AND WE ARE NOT SAVED: THE ELUSIVE QUEST FOR RACIAL JUSTICE* 26-50 (1987).

128. See Chander, *supra* note 1, at 153-58 (comparing the history and motivation of corporation law's treatment of minority investors to constitutional law and critical race theory in terms of power of the majority and fairness to the minority).

129. The Supreme Court's early view of the Fourteenth Amendment was that its “one pervading purpose” was “the freedom of the slave race, the security and firm establishment of that freedom, and the protection of the newly-made freeman and citizen from the oppressions of those who had formerly exercised unlimited dominion over him.” *Slaughter-House Cases*, 83 U.S. 36, 71 (1872) (emphasis added).

130. Under modern constitutional jurisprudence, individuals are deemed members of a protected class if they constitute “discrete and insular minorities.” *United States v. Carolene Prods. Co.*, 304 U.S. 144, 152-53 n.4 (1938). The designation as a protected class means that the courts will apply “strict scrutiny” when reviewing the constitutionality of legislation that disparately impacts such individuals. See generally JOHN E. NOWAK & RONALD D. ROTUNDA, *CONSTITUTIONAL LAW* 687 (7th ed. 2004).

131. Traditional notions of contract law are based on the concept of a free exchange of consideration. FARNSWORTH, *supra* note 15, § 2.2, at 47-48. The remedies for oppression, on the other hand, provide minority investors with protections for which they neither bargained nor paid. But see Moll, *supra* note 4, at 989 (distinguishing the remedy of oppression from the contract law doctrine of an implied-in-fact contract).

laws of a multi-ethnic nation are often crafted with a view toward ameliorating the vulnerabilities that are associated with inherent minority status.<sup>132</sup>

Conversely, minority investors freely elect their vulnerable status. Their decisions to purchase shares in a close corporation are made deliberately and without coercion.<sup>133</sup> Unlike racial and ethnic minorities, they are free to participate (or not) in a given enterprise depending upon the investment's perceived merits and risk. To the extent a particular term or set of terms in a deal offends them, they can refrain from investing. In fact, not only do minority investors freely submit to the fact of their vulnerability, but they are complicit in shaping its bounds. Often, they can use the threat of withholding their investment dollars as leverage to negotiate *ex ante* for a more favorable allocation of risk. Thus, unlike race or ethnicity, minority vulnerability is both highly mutable and largely determined by the minority itself. The decision as to whether to become a minority is therefore wholly and entirely within their control.<sup>134</sup> Though there is no costless means of exit, a minority investor has control over the choice of entry.

What is or is not fair and equitable with respect to racial and ethnic minorities, therefore, is not the same as what is or is not fair and equitable with respect to minority investors. It is also not the same for all minority investors. In other words, although the comparison to other aggrieved minorities has a certain emotional appeal, the metaphor misleads, and the assumption that minority investors represent a homogeneous and victimized category does violence to their individually negotiated investment contracts.<sup>135</sup> Treating all minority investors the same—as if they all negotiated, or tried to negotiate, the identical deal and thus are all equally vulnerable—robs them of the ability to select an allocation of control that is best suited

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132. See Chander, *supra* note 1, at 167 ("The ideology of governmental colorblindness does not deny the persistence of difference within the polity. Rather it proposes that law must ignore such difference, lest it become complicit in its perpetuation.").

133. In the event an investment decision is made under the influence of coercion or subject to some other defect in the bargaining process, such as if the investor were a minor or the victim of fraud or duress, the law of oppression would not be implicated as the parties' initial investment contract would be a nullity under traditional principles of contract law (or at least voidable at the election of the investor). FARNSWORTH, *supra* note 15, § 4.16, at 255-57.

134. *Id.*

135. For examples of circumstances that might lead a minority investor to agree to cede a greater degree of control than might seem reasonably prudent, thereby subjecting herself to a high level of risk of oppression, see *supra* notes 28-34 and accompanying text.

for their own specific needs and those of their particular corporate enterprise.

## 2. *A false resemblance*

The law's concern for the vulnerable position of minority investors may also arise partly from the resemblance between close corporations and partnerships. This point was made most forcefully by Hetherington and Dooley, who believed that the parallels were significant enough to warrant the extension of partnership-like protections to minority shareholders.<sup>136</sup> As is the case with a partnership, they argued, investors in a close corporation serve simultaneously as owners and managers and also are involved in a close relationship of mutual trust and confidence.<sup>137</sup> Unlike partners, however, minority shareholders have no costless means of exit, and so are therefore uniquely vulnerable to abuse.<sup>138</sup> For Hetherington and Dooley, a close corporation is simply a partnership with limited liability.<sup>139</sup> They therefore advocated extending partnership-like dissolution rights to close corporations, thereby providing minority investors with an exit right at the expense of their co-investors.<sup>140</sup>

136. Hetherington & Dooley, *supra* note 4, at 6 (offering "a model statutory provision requiring the majority to repurchase the minority's interest at the request of the latter and subject to appropriate safeguards").

137. *Id.* at 2-3 ("Typically, such firms are founded by individuals who have a virtually complete identity of interests and strong feelings of trust and confidence for one another.")

138. *Id.* at 3 ("The consequences of a breakdown in consensus are quite different depending on whether the parties have been operating in the partnership or corporate form, and the difference lies in the ease with which the participants' interests can be liquidated."). See also Thompson, *Shareholder's Cause of Action*, *supra* note 4, at 701 ("Free transferability, if there is a public market for the corporation's shares, provides liquidity that can provide the minority shareholder with an escape from the majority's possible misuse of centralized power.").

139. Their assumption seems to have been that investors in close corporations actually desire the attributes of a partnership but elect to incorporate instead in order to obtain the benefits of limited liability. See *infra* Part II.D; see also Donahue v. Rodd Electrotype Co. of New England, Inc., 328 N.E.2d 505, 515 (Mass. 1975) (noting the "fundamental resemblance" that a close corporation bears to a partnership). But see Easterbrook & Fischel, *supra* note 4, at 286 (providing reasons investors might prefer restrictive rules regarding involuntary dissolution, including the possibility that a rule of easy exit would increase the number of deadlocks and other conflicts and concern that the loss of a key entrepreneur-manager could reduce the value of the corporation).

140. Hetherington & Dooley, *supra* note 4, at 6. Under traditional norms of partnership law, a partner generally has the right to dissolve the partnership and retain her proportional value of the firm's assets upon liquidation. U.P.A. § 38(1) (1914); R.U.P.A. § 807 (1997). Alternatively, the remaining partners can elect to continue the partnership and pay the departing partner the amount she would have received had the firm been liquidated. U.P.A. § 41; R.U.P.A. § 701. Under either scenario, the amount to be paid to the departing partner depletes the firm's value and so comes at the expense of the remaining partners. If partnership-like exit rights were to be extended to close corporation shareholders, as Hetherington and

The shortcomings of this approach are several, and some have been described before. First, as Easterbrook and Fischel responded, it is not clear that investors are as ignorant or passive as the foregoing analysis would suggest.<sup>141</sup> There is a danger, in fact, in assuming that investors who are savvy enough to choose the corporate form for its limited liability—and perhaps even to elect partnership tax treatment through a subchapter S election<sup>142</sup>—are nonetheless unaware of the other attributes of a corporation.<sup>143</sup> Easterbrook and Fischel posited, for example, that some investors cognizant of their inability to foresee all contingencies may have selected the corporate form in order to lock one another into the investment.<sup>144</sup> It is at least plausible, then, that the investors may have chosen the corporate form not solely or even primarily for its limited liability, but in order to make exit more difficult. Any assumptions that investors

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Dooley advocated, then the ability to exit would likewise either cause the dissolution of the corporation or require the corporation to pay the departing shareholder a liquidation value, thereby reducing the corporation's value in the hands of the remaining shareholders. Hetherington & Dooley, *supra* note 4, at 27-28. Where the corporation retained value as an ongoing enterprise, the ability of the parties' to bargain makes it likely that they would in most cases negotiate a buyout of the departing shareholder rather than acquiesce passively in a dissolution procedure. *Id.*

141. Easterbrook & Fischel, *supra* note 4, at 298 (arguing that "the assumption that participants in closely held corporations want to be governed by partnership law is questionable. The participants incorporated for a reason. . . . Corporate law is different from partnership law in many ways, and the venturers may desire to preserve these differences.").

142. A common planning technique for close corporations is to elect to be taxed under Subchapter S of the Internal Revenue Code. See I.R.C. § 1361 (2006) (outlining the procedures for making such an election). So-called "S corporations" are taxed much like partnerships and so avoid the impact of a double tax. However, they may not have more than 100 shareholders (or any corporate or non-resident alien shareholders) or more than a single class of stock, making them unsuitable for many close corporations. See DWIGHT DRAKE, BUSINESS PLANNING: CLOSELY HELD ENTERPRISES 30-32 (2006). For a more thorough discussion of other tax planning techniques available to close corporation shareholders, see *supra* note 48.

143. Easterbrook & Fischel, *supra* note 4, at 299 ("Even if the parties did not consciously decide to opt out of the partnership rule, all this means is that they were asleep. What reason have we to think that if they were awake they would have selected the partnership rule?").

144. *Id.* at 287; see also Rock & Wachter, *supra* note 4, at 918-20 (arguing that investors may prefer to limit exit in order to avoid the loss of match-specific assets that "have great value to insiders and little value to outsiders"). This inability to anticipate the long-term consequences of their agreement is referred to as "bounded rationality." See O'Kelley, *supra* note 6, at 221 ("While individuals may intend to act rationally, there are cognitive limits, or bounds, on their ability to do so."); BAINBRIDGE, *supra* note 39, at 25 ("Decisionmakers inherently have limited memories, computational skills, and other mental tools, which in turn limit their ability to gather and process information."). Agreeing to be locked into an investment—thereby increasing the incentives toward good behavior—is one method for dealing contractually with the problem of bounded rationality. See Easterbrook & Fischel, *supra* note 4, at 287.



ignorantly select the corporate form are therefore suspect and likely to result in at least occasional injustice.<sup>145</sup>

A second drawback to the Hetherington and Dooley approach results from the subsequent development of the limited liability company. Though not available as a planning tool at the time they were writing, limited liability companies combine partnership-like management structures (and, potentially, exit opportunities) with the benefits of corporation-style limited liability.<sup>146</sup> As a result, it is now far more difficult to assume that an investor group views the decision to incorporate as a straight-forward compromise between the benefits provided by a corporation and those provided by a partnership. Rather, if those were their concerns, such a group would presumably opt to form an LLC instead.<sup>147</sup> At least to the extent they incorporated after 1996, then, it would seem more likely that the investors actually desired what the corporate form has to offer, including perhaps a prohibition against easy exit.<sup>148</sup>

A third reason for questioning an approach that is based on an analogy between close corporations and partnerships is that they are dissimilar in important ways. Most significantly, partners are generally liable for the debts of the partnership to the fullest extent

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145. Certainly, investor expectations will in many cases overlap with such assumptions. The overlap will not, however, be complete. *See id.*

146. For an overview of the basic features and early history of the limited liability company, see generally Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 2-6 (1995). Interestingly, in order to ensure that LLCs were taxed as flow-through entities under applicable IRS rules, early state LLC statutes generally applied the partnership law norm of easy exit as the default rule. Douglas K. Moll, *Minority Oppression & The Limited Liability Company: Learning (Or Not) From Close Corporation History*, 40 WAKE FOREST L. REV. 883, 926-31 (2005). After the IRS promulgated its "check-the-box" regulations in 1996, however, many states amended their LLC statutes to adopt the corporation law norm of limited exit as the default rule. *Id.* at 932-35. This appears to have been done in part to reduce the value of close corporation stock for estate and gift tax purposes by making it subject to a discount for lack of marketability. *Id.* at 936-40.

147. If, as Hetherington and Dooley appear to believe, most close corporation investors would have formed a partnership but for the unlimited liability they would incur, then the presence of a new form of entity that combines the attributes of a partnership with the limited liability of a corporation should attract such investors in the future. *See* Hetherington & Dooley, *supra* note 4, at 6. Thus, investors who nonetheless choose to incorporate might appear to prefer the attributes of a close corporation, as predicted by Easterbrook and Fischel, rather than the attributes of a partnership. *See* Easterbrook & Fischel, *supra* note 4, at 299.

148. Prior to the adoption of new Treasury Department regulations in 1996, the federal income tax treatment of limited liability companies was both complex and uncertain, making LLCs initially less attractive than they otherwise might have been. *See generally* Steven A. Dean, *Attractive Complexity: Tax Deregulation, The Check-the-Box Election, and the Future of Tax Simplification*, 34 HOFSTRA L. REV. 405, 422-50 (2005) (comparing the federal income tax treatment of entities before and after the "check-the-box" regulations).

of their individual wealth.<sup>149</sup> Thus, because each partner can bind the partnership,<sup>150</sup> and hence effectively pledge the assets of the other partners, it is critical that they be able to exit where there is disagreement over fundamental policy matters.<sup>151</sup> The same is not true of corporations, however, where the doctrine of limited liability generally shields investors from losing more than the value of their investment.<sup>152</sup> A rule that protects the capital of a business enterprise from withdrawal by restricting easy exit is therefore much more consistent with the lesser risks associated with a corporate investment as well as with the concept that a corporation constitutes a distinct (if artificial) person.<sup>153</sup>

A final reason for doubting the notion that close corporation investors would actually prefer the attributes of a partnership (other than with respect to liability) is that many partnerships actually contract for corporate-style limitations on exit. In sophisticated partnership agreements, for example, it is often the norm to contractually prohibit the withdrawal of a partner's capital.<sup>154</sup> The same is true, in fact, of sophisticated limited liability companies.<sup>155</sup> Thus, at least some evidence suggests that the proper conclusion to draw from the parallels between close corporations and partnerships is not that exit rights should be expanded in the corporate context,

149. U.P.A. § 15 (1914); R.U.P.A. § 306(a) (1997). *See generally* GEVURTZ, *supra* note 57, § 1.1.1, at 3 ("Individual partners have unlimited personal liability for debts incurred in the business.").

150. U.P.A. § 303 (1914); R.U.P.A. § 301 (1997) ("Acts of a partner in the ordinary course of business bind the partnership"). *See generally* GEVURTZ, *supra* note 57, § 1.1.2, at 14.

151. *See* Hetherington & Dooley, *supra* note 4, at 6 (arguing that the "problem of exploitation" of minority investors in close corporations can be traced primarily to the illiquidity of their shares).

152. DEL. CODE ANN. tit. 8, § 162 (2006); MODEL BUS. CORP. ACT § 6.22(b) (2005) ("[A] shareholder of a corporation is not personally liable for the acts or debts of the corporation except that he may become personally liable by reason of his own acts or conduct"). *See generally* GEVURTZ, *supra* note 57, § 1.1, at 7 (explaining that "stockholders have no liability for the corporation's debts simply by virtue of being stockholders").

153. Chief Justice Marshall famously described a corporation as "an artificial being, invisible, intangible, and existing only in contemplation of law," thus confirming and solidifying the principle that a corporation exists at law separate and apart from its shareholders. *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518, 636 (1819).

154. *See, e.g.*, JAMES M. SCHELL, PRIVATE EQUITY FUNDS: BUSINESS STRUCTURE AND OPERATIONS, § 9.03, 9-17 (2004).

155. *See* LARRY E. RIBSTEIN & ROBERT R. KEATINGE, 1 RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES § 11.01, at 11-2 (2002) (arguing against a dissolution-at-will doctrine for limited liability companies). Although early LLC statutes generally provided for partnership-style dissolution-at-will, the modern trend is to eliminate such rights. *Id.* One of the reasons for this is that the limitation on transfer can be used by investors to argue that their holdings are relatively illiquid and so less valuable for estate and gift tax purposes. Moll, *supra* note 146, at 936-40.

but that they should be eliminated as the default position in the partnership context.

For a variety of reasons, then, the superficial resemblance between close corporations and partnerships does not support an expansion of the rights of minority shareholders. Such an unjustified shift in the allocation of control would come at the expense of controlling shareholders, and hence would constitute an injustice without furthering any significant policy goal or theoretical concern.

### 3. *A false equivalency*

The law's focus on the relative power and status of controlling and minority shareholders is also partly the result of a third assumption—that each share of a corporation's stock represents the same bargain. The assumption appears to be that, because the specific rights set forth in the corporation's charter documents and in the applicable statute are the same for all shares of a particular class, the individual shares somehow serve to symbolize the same bargain as to risk and reward.<sup>156</sup> Each such share, for example, has the same right to participate in dividends. Accordingly, it is assumed that the only distinction represented by different blocks of shares is that a controlling shareholder owns more, thus providing her with a larger aggregate portion of any dividends declared by the board. The controlling shareholder is not, however, entitled to a greater portion of the per share profits as a result of her status. According to this logic, the risks associated with minority vulnerability must be allocated evenly among the shares in order to maintain the equivalency of the shares' rights and privileges.

Focusing on the shares themselves, however, misses the point. The shares merely represent the language in which corporation law speaks. They do not provide their holder with a direct claim on any of the corporation's assets, nor do they guarantee any specific

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156. Corporation statutes generally permit companies to issue multiple classes and series of stock with different rights and privileges. CLARK, *supra* note 49, §§ 18.3.3, 18.3.4, at 779-80. See, e.g., DEL. CODE ANN. tit. 8, § 151(a) ("Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof."); MODEL BUS. CORP. ACT § 6.01(a) ("If more than one class of shares is authorized, the articles of incorporation must prescribe a distinguishing designation for each class or series."). However, all of the shares of a particular class or series must, on their face, have identical rights and privileges. See, e.g., DEL. CODE ANN. tit. 8, § 151(f); MODEL BUS. CORP. ACT § 6.01(a) ("Except to the extent varied as permitted by this section, all shares of a class or series must have terms, including preferences, rights and limitations, that are identical with those of other shares of the same class or series."). Therefore, for convenience, references throughout the text to "all shares" or similar terms are intended to refer only to shares of the same class and series of stock and not to all shares issued by the corporation.

management or employment rights.<sup>157</sup> Rather than representing some fixed, unalterable and equivalent bundle of rights, they simply serve as a proxy for the parties' business deal, which may or may not contemplate an equal or proportionate division of power.<sup>158</sup> In other words, different shares of stock, though in all respects equivalent on their face, can represent different bargains and hence different value propositions.

Shares of stock in fact represent both more and less than the bundle of rights and privileges expressly granted by the applicable statute.<sup>159</sup> Thus, depending on the risks and benefits associated with its ownership, a particular share may be significantly more or less valuable than the others of its class. If that share provides its owner with control over the corporation's future conduct, for example, it would represent more than a mere pro rata claim against the corporation's assets.<sup>160</sup> The bundle of rights of such a share would include the discretion to guide corporate policy—a valuable right indeed.<sup>161</sup> If the share is part of a minority block, on the other hand, the holder's inability to influence or control the actions of the company could mean that she might never actually enjoy the rights that are technically granted her by the statute.<sup>162</sup> In fact, when viewed

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157. See PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 8-10 (explaining that although a person may hold stock in a brewery, that person cannot go to the brewery and trade the value, or even a discounted value, for an amount of beer).

158. See BRUNER, *supra* note 3, at 466-67 (noting that the value of control over a corporation's affairs derives from the relative, as opposed to absolute, degree of power exerted).

159. In fact, the rights granted by statute to shareholders are surprisingly narrow in scope. Typically, they include the right to receive a pro rata share of any dividends or other distributions—but only to the extent they are declared by the board—the right to vote on fundamental corporate changes and in the election directors, and the right to sue on behalf of the corporation in a derivative action. See, e.g., DEL. CODE ANN. tit. 8, §§ 170, 212, 327 (2006) (declaring shareholder dividend, voting, and derivative action rights under Delaware corporation law). They also include the right to receive a pro rata share of the corporate assets in the event of dissolution. See *id.* § 281 (mandating the priority and procedure for payment to claimants and stockholders of a dissolved corporation).

160. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 18 (noting that "control owners have rights that minority owners do not"). See also BRUNER, *supra* note 3, at 465 (characterizing control as an option that can be valued, purchased and sold separately from the underlying stock).

161. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 18.

162. Although the corporation statutes put the power to elect directors in the hands of shareholders, for example, this power is severely limited by a variety of factors. See Cox & HAZEN, *supra* note 57, §§ 13.12, 13.19, at 739, 759 (noting that before a shareholder can vote, the corporation must call a meeting at which a quorum must be present, and determine through the corporate books who has legal ownership of the voting shares and thus who is entitled to vote, "mere possession" of the share certificate being insufficient). Moreover, in large public corporations, nominations are typically controlled by the existing board, meaning that there is generally only one candidate per open seat. See *id.* § 13.33, at 803 (noting that one of

in this light, control can be understood as an economic right that is distinguishable from the underlying shares.<sup>163</sup> It can be valued, purchased and sold separate and apart from the block of shares to which it adheres.<sup>164</sup> In financial terms, then, control might be considered to be a call option that gives its holder the ability to choose between alternative corporate strategies and policies.<sup>165</sup>

The bundle of rights that is associated with minority shares therefore differs from that associated with controlling shares, much like shares of different classes or series differ in the extent of their rights and privileges.<sup>166</sup> Certainly, no court would find conduct oppressive where the right to engage in such conduct was tied to a particular class of shares and denied to another class, even if such disparate rights made the secondary class of shares less valuable. Such is almost uniformly the case with preferred stock, which often has superior dividend and dissolution rights but inferior voting and control rights. Why not, then, acknowledge that this division of control is often achieved through the simple process of divvying up the shares? Indeed, for unsophisticated investors who are less likely to engage in careful planning (and who are therefore less likely to use a dual-class capital structure), many of the rights and risks the parties intended to affix to the shares may not be set forth in the legal documents that purport to govern them. Rather, it is frequently the context in which the shares are held that determines the actual extent of the holders' rights.

Because the shares held by close corporation investors vary in their rights, the law should not attempt to impose a false equivalency. Rather, the law regarding close corporations should seek to determine which rights the parties themselves believe that they purchased. An investor who paid full consideration for shares she believed would enjoy equal status with all other shareholders deserves to reap the benefits of her bargain. On the other hand, an investor who paid a discounted price for a lesser set of rights should not then

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many control devices can be the classification of directors, with staggered elections of only some of the directors each year). The shareholders vote, but their vote does not matter. *Id.* Likewise, in close corporations, the result of a norm of majority rule is to give the power to the controlling shareholders to elect, not merely a proportional number of directors, but all of the directors. *See supra* notes 36-38 and accompanying text. Thus, the allocation of power resulting from the relative size of the parties' share holdings may determine the extent to which the legal rights afforded a share of stock in the statute is meaningful.

163. BRUNER, *supra* note 3, at 465-66.

164. *See infra* Parts II.B.2 (discussing how control is valued) and II.C (discussing techniques for privately allocating control).

165. BRUNER, *supra* note 3, at 465-66.

166. *See supra* note 156.

be granted them by law. Such an outcome would be at the expense of the controlling shareholders and would constitute an uncompensated transfer of wealth. In the first instance, then, the law should look past the apparent equivalency of the shares themselves and instead attempt to interpret the bargain that the shares symbolize.

4. *An ambiguous silence*

The most important basis for the reluctance of policymakers to consider a larger role for private ordering in the context of close corporations appears to arise from the ambiguity inherent in the decision to opt out. In fact, minority investor vulnerability poses an especially acute problem in that it confronts policymakers with the limits of the law's power.

In the first place, no legal scheme, whether based on statute or operating through the more flexible means of fiduciary duties, is capable of protecting minority investors from the full panoply of risks they face at the hands of their fellow shareholders.<sup>167</sup> In fact, most of the indignities likely to be suffered by minority investors will be isolated or transient enough that they fail to rise to the level of oppression.<sup>168</sup> Thus, it is highly unlikely that minority investors will seek redress from the judicial system except under the most egregious of circumstances.

Shareholders in close corporations are also involved in an intimate, ongoing relationship, which in many cases overlaps with significant familial and other bonds.<sup>169</sup> Certainly, all lawsuits are expensive, time-consuming, and uncertain—burdens that are likely to weigh especially heavily on unsophisticated or resource-poor investors. In the context of a close corporation, however, bringing a lawsuit has the added disadvantage of destroying the parties' other

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167. Butler and Ribstein refer to the assumption that legal rules will in all cases of market failure operate to provide a perfect (or even preferable) remedy as the "nirvana fallacy." Butler & Ribstein, *supra* note 4, at 53.

168. See Easterbrook & Fischel, *supra* note 4, at 288-89 ("The restrictive rule of involuntary dissolution based on fault does not leave the minority shareholder without any remedy but rather limits its use to egregious cases.").

169. See generally Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 Nw. U. L. REV. 749, 749-52 (2000) (building on Ian Macneil's theory that long-term contracts are relational because events in the long term cannot be accurately predicted so as to include all events within the contract). Posner argues that courts must find a way to resolve such relational disputes by drawing on social norms or the norms of the relationship, by filling in gaps with terms that maximize the value of the contract, or by reading the long-term contract literally. *Id.*

relationships.<sup>170</sup> Thus, for example, if a minority investor also is involved with the controlling shareholders in one or more non-business relationships, such as if they are relatives or close friends, the prospect of a lawsuit can seem even more unpleasant than the norm and could even rise to the level of seeming shameful.

Resort to the legal system, then, at least in the context of close corporations, is likely to be infrequent. Instead, other influences—including market forces, societal norms of good behavior, and, most importantly, private ordering by means of agreements among the parties—appear to play a much larger role than legal rules in policing opportunistic behavior in close corporations.<sup>171</sup> Because the law of oppression plays a relatively small role in the enforcement of good behavior in most close corporations, it is of critical importance that minority investors negotiate for private contractual protections.<sup>172</sup> If

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170. See Easterbrook & Fischel, *supra* note 4, at 274 (noting that “[p]articipants in closely held corporations frequently have familial or other personal relations” that make it less comfortable to engage in conflict).

171. It is also possible to argue, from an economic standpoint, that in many cases legal rules result in less efficient outcomes than markets. See, e.g., Butler & Ribstein, *supra* note 4, at 7 (arguing that “serious questions remain concerning the efficiency of the alternative to private ordering—mandatory terms”). Unfortunately, however, market forces are unlikely in most cases to play a significant role in protecting minority investors in close corporations. Laws of supply and demand only work where there is an active market for the good, such as with respect to the markets for managerial talent or the markets for investment dollars. See, e.g., *id.* In a typical close corporation, where the shareholders also double as managers, the parties are not likely to be frequent repeat players. The controlling shareholders’ opportunistic behavior is therefore unlikely to significantly damage their chances to enlist future business partners or bring in future investment dollars, as there it is unlikely that there will be a future. Moreover, if there is a future, it will most likely arise based on some type of personal interaction rather than a market-style competition with others for the same resources. Thus, market forces are unlikely to serve as a significant check on the controlling shareholders’ conduct. As a result, societal norms of behavior and other systems of private ordering are likely to factor more heavily in protecting minority investors. See *id.* at 34 n.139 (arguing that, although there is no active trading market for close corporation shares, “the participants in closely held firms contract with each other directly, and so do not need the protection of the securities markets as a constraint on the development of efficient arrangements”).

172. See, e.g., 1 JOSEPH W. BARTLETT, *EQUITY FINANCE: VENTURE CAPITAL, BUYOUTS, RESTRUCTURINGS AND REORGANIZATIONS* 230 (2d ed. 1995) (noting that “the Stock Purchase Agreement is usually accompanied by a Stockholders Agreement, an agreement by and among the founder in his capacity as a stockholder and the investors.”); MARVIN HYMAN, *CORPORATION FORMS* 42-7 (1994) (explaining that shareholders’ agreements can provide for the rules governing the management and control of a close corporation, including specific situations such as the death, disablement or retirement of one or more of the shareholders). Even publications aimed at popular audiences—who are less likely to hire legal counsel—acknowledge the ubiquity and importance of shareholders’ agreements. See, e.g., ANTHONY MANCUSO, *INCORPORATE YOUR BUSINESS: A 50-STATE LEGAL GUIDE TO FORMING A CORPORATION* 5/5 to /8 (2d ed. 2004) (recommending that entrepreneurs who are otherwise “tired of incorporation paperwork” nonetheless consider adopting a shareholders’ agreement).

the parties fail to do so, the corporation law norms of centralized control and majority rule will allocate wide discretion over corporate policy to the controlling shareholders.<sup>173</sup> In fact, the need for expressly negotiated guarantees is so obvious and fundamental that many commentators seem to assume that the mere fact of their absence justifies legal intervention in an otherwise private relationship.<sup>174</sup> This concept is often expressed by means of a generalization along the lines of “only a fool would purchase a minority interest in a close corporation.”<sup>175</sup> Although such statements are generally used to highlight the minority’s inability to exit, they also evidence a fundamental belief that the existence of a minority interest unprotected by appropriate contractual guarantees is indicative of the sort of unjust surprise that the law should remediate.<sup>176</sup>

Ideally, in a realm where private agreements dominate, the law’s highest priority should be the interpretation and enforcement of those agreements.<sup>177</sup> Only where it is not possible to interpret those agreements should the law consider substituting its judgment for that

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Although one might argue that many small investors are too unsophisticated or lack the resources to protect themselves, a detailed understanding of the operation of corporation law is not necessary. Rather, an investor need only recognize the threat of opportunistic behavior to negotiate an adjustment to the price. See Easterbrook & Fischel, *supra* note 4, at 272-73 (cautioning against assuming that shareholders are unable to make their own choices). But see O’Neal, *supra* note 4, at 884 (noting that even a minority investor’s lawyer, “if he has one, may not have the knowledge, experience and skill necessary to draft effective protective arrangements”); Thompson, *Corporate Dissolution*, *supra* note 4, at 199 (“Investors often fail to anticipate the failure of their enterprise, or they demonstrate an overly optimistic trust in those with whom they are undertaking the venture.”); Bebchuk, *supra* note 4, at 1836 (“The main problem with the shareholder voting mechanism is the lack of information.”); Brudney, *supra* note 4, at 1420 (noting that “investors’ knowledge and volition are a quantum jump from the kind of knowledge and volition that are the premises for operation and enforcement of the classic law of contract and its claimed attendant economic efficiency”).

173. See *supra* notes 36-38 and accompanying text.

174. See, e.g., Moll, *supra* note 4, at 989 (“The law of shareholder oppression protects the close corporation minority investor from the improper exercise of majority control.”); Thompson, *Corporate Dissolution*, *supra* note 4, at 199-201, 231 (supporting judicial remedies such as voluntary dissolution, dissolution for misconduct, dissolution on deadlock and court-ordered buyout arrangements).

175. See, e.g., *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 328 N.E.2d 505, 515 (Mass. 1975) (“No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties.”).

176. See *id.*

177. See, e.g., Butler & Ribstein, *supra* note 4, at 64 (arguing that “the approach throughout the law of contract is to presume in favor of private ordering until some type of market failure can be shown”).



of the parties.<sup>178</sup> In other words, efficiency in contracting should be the goal, not efficiency of outcome.

The problem posed by close corporations, however, is that the structure of corporation law and the content of the deal documents often make it difficult for observers to uncover the parties' true bargain.<sup>179</sup> This interpretive problem arises because of the effect that silence has on statutory default rules. When investors acquire shares in a close corporation, they typically execute several documents, including in most cases some type of purchase agreement, a set of charter documents governing the corporation and, especially when the parties are more sophisticated, a shareholders' agreement.<sup>180</sup> The documents that the parties negotiate and sign do not encapsulate their entire bargain, however, because the applicable corporation statute is deemed to be incorporated into the company's charter.<sup>181</sup>

178. In particular, currently available remedies for minority oppression require the court to substitute its own business judgment for that of the parties. *See supra* notes 83-88 and accompanying text. This requires the judge to determine whether to insert into the parties' agreement a set of contractual provisions that the parties omitted. The judge, in other words, in ruling for the minority, is expressing her judgment that the parties should have—but did not—negotiate for minority protections. *See id.* This aspect of the remedy runs counter to the general thrust of corporation law as evidenced by the business judgment rule, which holds that courts are not generally deemed competent to challenge or overturn the decisions of the corporation. *See supra* note 93. Under normal circumstances, the law provides parties to a business deal, or managers of a corporation, with a degree of latitude in arranging their affairs. *See Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000) (explaining that "directors' decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available"). It is only when there is a breakdown in the normal functioning of the bargaining process that the judge is deemed competent to impose her own judgment. *See Easterbrook & Fischel, supra* note 4, at 280-81 (giving examples of where courts today enforce various types of voluntary agreements among investors in close corporations unless there is injury to a third party).

179. *See, e.g., id.* at 284 (noting that the rule of law plays an important role in close corporations because it is difficult to tell whether the parties did not include a term in the shareholders' agreement because they were ignorant of a statutory rule or because they purposefully chose to leave it out); *see also* HYMAN, *supra* note 172, at 42-1 to -17 (illustrating a typical form of shareholders' agreement).

180. *See, e.g.,* 1 BARTLETT, *supra* note 172, at 54, 211-35 (describing the types of information that should be included in the corporation's charter documents, stock purchase agreement, stockholders' agreement, and employment agreements); HYMAN, *supra* note 172, at 42-8 to -17 (providing a detailed template of a shareholders' agreement to organize a close corporation); MANCUSO, *supra* note 172, at 2/10 to /12, 2/28 to /34, 5/5 to /8 (introducing the reader to the primary corporate documents of Articles of Incorporation, Bylaws, Stock Certificates, and Minutes of the First Directors Meeting, suggesting ways to raise capital through sales of stock, and instructing the reader to create a shareholders' agreement with suggestions on information to include).

181. *See, e.g.,* DEL. CODE ANN. tit. 8, § 121(b) (2006) ("Every corporation shall be governed by the provisions and be subject to the restrictions and liabilities contained in this chapter."); MODEL BUS. CORP. ACT § 1.02 (2005) (stating that all corporations

Where documents are silent regarding an issue, therefore, the parties' bargain will include all of the default rules contained in the statute, as well as an often extensive and detailed body of caselaw.<sup>182</sup>

The presence of silence can therefore indicate one of two possibilities: either (1) the parties were aware of the default rules and deliberately left the investment documents silent so as to select them, or (2) one or both of the parties were unaware of the default rules and left the investment documents silent out of ignorance.<sup>183</sup> Silence in the investment documents, in other words, could be consistent with either agreement or lack of agreement. In both cases, the documents would appear the same but the parties' intentions would be different.<sup>184</sup> Observers who look for express contractual language protecting the minority will therefore be unsure of how to interpret the omission of such language. In fact, most of the governing provisions that serve to allocate power among the investors will appear in a document that they are unlikely even to have read—namely, the corporation statute.<sup>185</sup>

In the absence of clear information regarding the parties' intentions, corporation statutes and legal decisions have erred on the side of protecting all minority investors by equating omission with oversight.<sup>186</sup> As a result, current protections for minority investors impose a mandatory rule rather than a default one that the parties can waive or renegotiate.<sup>187</sup> Indeed, a rule that protects those investors who are most likely to lack the legal sophistication or resources to protect themselves seems like a sensible notion. A single standard that applies to all close corporations also offers the benefit of providing a bright-line rule, although the inherently uneven

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organized pursuant to the Model Act "are governed by the amendment or repeal" of any provision thereof); *see also* Easterbrook & Fischel, *supra* note 4, at 283 ("Corporate law, both statutory and judicial, is best understood as a set of standard [contract] terms that lowers the costs of contracting.").

182. *See, e.g.,* Butler & Ribstein, *supra* note 4, at 7 ("The terms of the agency contract include the provisions of state law."); O'Kelley, *supra* note 6, at 216.

183. *See* O'Kelley, *supra* note 6, at 216 (explaining that "the close corporation contract—the standard form rules provided by state corporation law as supplemented by a particular corporation's articles, by-laws, and shareholders' agreements—usually does not specify how an incorporated, closely held firm and its investors will substantively adapt to most future contingencies").

184. *See* O'Neal, *supra* note 4, at 886 ("In a close corporation, the corporation's charter and bylaws almost never reflect the full business bargain of the participants.").

185. Brudney, *supra* note 4, at 1414-20 (arguing that most investors are unaware of the constantly shifting statutory and case law regarding fiduciary duties).

186. *See* O'Neal, *supra* note 4, at 883-84 (arguing that statutory protections are needed for minority investors because minority investors often do not put all of the necessary terms in their shareholders' agreements).

187. *See supra* Part I.B.

application of fiduciary rules is likely to undercut this advantage somewhat.<sup>188</sup>

A flaw in the existing objective approaches to minority vulnerability, however, arises because policymakers focus unduly on express contractual provisions. When interpreting the parties' initial investment agreement, a natural tendency is to look for express guarantees and interpret their absence as oversight.<sup>189</sup> What is overlooked by such an approach, however, is a concept familiar to dealmakers—that price adjustments can substitute for express protections in a contract.<sup>190</sup> When the parties to a business transaction identify a particular risk, they can choose to allocate it either by bargaining for specific language to that effect or by adjusting the price to be paid.<sup>191</sup> If goods are to be shipped overseas, for example, a purchaser can either negotiate for an express contract provision requiring the seller to assume the risk of delivery, or merely pay a lower purchase price and use the money saved to acquire insurance.<sup>192</sup> In this way, adjustments to the purchase price and the negotiating and drafting of contract language are effectively interchangeable and serve the same purpose.<sup>193</sup> Just as a future

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188. See Moll, *supra* note 7, at 749 (arguing that courts apply legal protections for minority investors unevenly, with the result in any given case being determined largely on the basis of the judge's preconceptions regarding the causes of the minority's vulnerability). But see Mitchell, *Death of Fiduciary Duty*, *supra* note 4, at 1675 (arguing against a rigid application of fiduciary rules).

189. See Easterbrook & Fischel, *supra* note 4, at 285 (acknowledging that "the failure of the parties to include a particular contracting term is ambiguous. It may mean that the parties did not want the term, but it *could* mean that they were ignorant.").

190. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 21 (arguing that all issues in a negotiation, regardless of how sacred, can be reduced to dollars). See also BRUNER, *supra* note 3, at 779, 781 (describing business negotiations as a "system" that involves monetizing or otherwise quantifying different possible trade-offs in order to assess their relative value).

191. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 21.

192. The purchaser could also self-insure. In either case, the purchaser would assume the risk because she believes that her cost of bearing the risk would be lower than the seller's cost. As a result, this would allow her to create value in the deal. See DAVID A. LAX & JAMES K. SEBENIUS, THE MANAGER AS NEGOTIATOR: BARGAINING FOR COOPERATION AND COMPETITIVE GAIN 99-100 (1986) (explaining that parties with different levels of risk aversion can use the differences to negotiate mutually beneficial trade-offs).

193. In order for parties to a multi-issue negotiation to make concessions and trade-offs, they must have at least a rough sense of the value they place on each issue. See RAIFFA, *supra* note 31, at 148-65 (describing a multi-issue negotiation as a process whereby each party attempts to "sort out its own preferences, by approximating a monetary or other value for each issue, and then engages in appropriate trade-offs and concessions with the other party based on their differing evaluations); LAX & SEBENIUS, *supra* note 192, at 74-84 (describing methods that negotiating parties can use to assess the economic value they place on intangible interests in order to make trade-offs). To the extent issues can be monetized or otherwise valued, a party making a particular concession should find it irrelevant whether she is "paid" in the

stream of income can be reduced to its present value, a particular business risk can be reduced to a dollar amount that represents a party's best estimate of its potential cost.<sup>194</sup> Therefore, a contract that appears silent because of its omission of express language might not be silent at all. Rather, the observer might simply be looking in the wrong place and the key element of oversight may in fact be absent.

An observer who interprets the lack of express contractual guarantees as evidence that the parties did not consider the risks associated with minority status may therefore be overlooking evidence that the parties did in fact consider, and allocate, such risks. Without analyzing the purchase price, it is not possible to know whether the parties intended a specific allocation of power. Thus, the law's retreat to uniform standards in the face of a perceived lack of subjective information about a particular deal may be premature. The information may in fact exist and may be waiting to be uncovered on a case-by-case basis.

#### *E. Investor Protections as Default Norms*

Mandatory legal protections for minority investors in close corporations appear both overly rigid and likely to misconstrue the relative equities of many cases. They appear overly rigid to the extent they impose on the parties a fixed, uniform allocation of control, and limit the parties' ability to freely determine among themselves the

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form of a concession on another issue or by means of a purchase price adjustment. The two, in other words, are interchangeable. *See, e.g., id.* at 86 ("To assess tradeoffs among intangible interests, it is sometimes helpful to imagine services one could buy otherwise to satisfy the same interests."). Freund, in fact, counsels that "it is often prudent to counsel your client not to agree on the purchase price, even if the negotiations have reached that point, until the other material terms of the deal have been settled." FREUND, *ANATOMY OF A MERGER*, *supra* note 12, at 59.

Indeed, adjusting the purchase price is in many instances superior to negotiating specific contractual language in that it does not require as careful a parsing of the risks. *See id.* at 74 ("Thinking about tradeoffs is often excruciatingly difficult and done badly."). In the shipping hypothetical described in the text, for example, a purchaser who elects to pay a lower purchase price need not identify with precision, and then spend the time and money to negotiate, each of the many causes for losing cargo at sea. Rather, for unsophisticated investors who lack the knowledge, time or resources to carefully analyze and negotiate every possible risk—a universe that is limited only by the imagination, including anything from adverse weather conditions to piracy—adjustments to the purchase price may be preferable to lengthy contract negotiations. Where transaction costs cannot easily be engineered, in other words, price adjustments may often be utilized by less sophisticated investors almost as a form of poor man's corporate attorney. *See generally* Gilson, *supra* note 11, at 253-55 (discussing the value that business lawyers bring to a transaction).

194. *See* FREUND, *ANATOMY OF A MERGER*, *supra* note 12, at 21 ("I am a firm believer in the ultimate solubility of most issues negotiated in an acquisition—by reducing down to dollars what appear to be sacred principles. When an adversary states that an issue is non-negotiable, I take that to mean that the price is very high, or at least that he would like it to be.").

distribution of power that is optimal for their own unique circumstances.<sup>195</sup> Moreover, by focusing exclusively on the fact of the parties' unequal status and ignoring the question of whether they chose—and were compensated for—their vulnerability, current doctrine may in some cases find injustice where there is none. The result in such cases is an uncompensated wealth transfer from one of the parties to the other.<sup>196</sup> A minority investor who was already compensated for the risks associated with her vulnerable status through a reduced purchase price should not be able to claim redress to the legal system upon the later occurrence of those risks.<sup>197</sup> Whether or not the minority fully understood the precise risks, such a result would require controlling shareholders to pay twice.

In fact, given that minority investors are in a position to influence the corporation's particular allocation of control, it seems that injustice will occur in the close corporation context only when a minority investor is both justifiably unaware of the risks associated with her vulnerable status and, more importantly, uncompensated for bearing those risks. Thus, if a minority investor foresaw a particular risk and agreed to bear it in exchange for some other benefit, such as a lower purchase price, there is no injury in the event the risk becomes reality. The law has never intervened in private contracts by reallocating risk merely because of differences in bargaining power or business acumen.<sup>198</sup> Likewise, even if she does not fully comprehend the nature of the risks she assumed, a minority investor is not injured in a legal sense upon the occurrence of a negative outcome for which she was previously compensated. Where a risk is identified and allocated, as in an investment contract, injustice occurs

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195. See Butler & Ribstein, *supra* note 4, at 71 (arguing that “corporate rules, ultimately are and, from an efficiency perspective, should be the product of private ordering”).

196. For an example of such a case, see *infra* Part III.B. Note also that the uncompensated transfer could occur in either direction. For example, if a minority investor had previously been compensated for bearing the risks associated with a lack of control, then a rule that protects her from such risks would be the legal equivalent of permitting the minority to “have her cake and eat it too.” On the other hand, if such consideration were not present, then the absence of a protective rule would allow the controlling shareholders to pay less while still reaping the rewards of control.

197. See FARNSWORTH, *supra* note 15, § 12.3, at 735-38 (discussing what happens when one party to a contract “err[s] in calculating the net benefit to be anticipated from performance of the agreement”).

198. See, e.g., *Protech Indus., Inc. v. URS Corp.*, 377 F.3d 868, 873 (2004) (“The purpose of the unconscionability doctrine is not to disturb the allocation of risks because of superior bargaining power, but to prevent oppression and unfair surprise.”).

only in the presence of unfair and uncompensated surprise.<sup>199</sup> The legal protection of minority investors, then, should be focused on providing a remedy for specific instances of surprise, not on eliminating the vulnerability of minority investors as a class.

Current doctrine ultimately fails because it ignores the subjective particulars of the parties' deal, particulars that are often hidden in plain sight. In fact, the general confusion present in current law,<sup>200</sup> as well as its reliance on mandatory standards,<sup>201</sup> may in part be the result of an underlying dissatisfaction with the tools currently available for uncovering the subjective equities of a particular case.

A better, more nuanced approach to the problem of minority investor vulnerability would in the first instance compare the controlling shareholders' alleged misconduct with the parties' initial bargain, paying particular attention to matters of price. To the extent the parties purposefully elected an allocation of power within the corporate enterprise, and to the extent that allocation was reflected in an appropriate adjustment to the purchase price, their private allocation should be preferred over the law's. However, where there is a mismatch between the parties' deal and their subsequent conduct, or when an analysis of price does not yield additional information as to the nature of their bargain, an objective analysis based on the reasonable expectations standard would appear to be appropriate.<sup>202</sup> In other words, the cause of action for oppression should be treated as a default gap-filler that the parties may opt out of, and the law's objective approach to minority vulnerability should continue to be applied, but only after a thorough investigation of the parties' intentions has been concluded.

This approach is superior to prevailing standards in several respects. First, it is more firmly rooted in norms of contract law than are current standards, and thus does justice to the parties' deal by

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199. In this respect, the remedy of oppression mirrors the contract law doctrine of unconscionability, which is often described in a short-hand manner as involving the presence of an "unfair surprise." See, e.g., *Faber v. Menard, Inc.*, 367 F.3d 1048, 1053 (2004) ("The Iowa Supreme Court has established that we should analyze the following factors of unconscionability: (1) assent; (2) unfair surprise. . ."); *W.L. May Co., Inc. v. Philco-Ford Corp.*, 543 P.2d 283, 286 (Or. 1975) (holding that, in order to determine the unconscionability of a particular contract provision, the court must consider whether invalidation of the provision would prevent "oppression and unfair surprise"). The presence of unconscionability makes the contract voidable at the option of the injured party. FARNSWORTH, *supra* note 15, § 4.28, at 301.

200. See *supra* notes 7-9 and accompanying text.

201. See *supra* Part I.B.

202. See, e.g., Thompson, *Corporate Dissolution*, *supra* note 4, at 237-38 (advocating the use of the reasonable expectations standard as "an effective response to the problems of minority shareholders").

seeking to give them the benefit of their respective bargains.<sup>203</sup> In this way, it would serve to bolster and support, rather than undercut, the primary mechanism for protecting minority investors in close corporations—privately negotiated contractual guarantees.<sup>204</sup>

Second, treating minority protections as default norms would make it less likely for courts to mistake the equities of a given case. An examination of the price brings into the analysis the important question of the minority's complicity in their vulnerability. Courts that consider not only express contractual guarantees but also the ways in which price can serve to allocate risk are less likely to overcompensate minority investors who already received adequate consideration for assuming the risk of their vulnerability.<sup>205</sup> At the same time, because it utilizes an objective standard as a second step in the event an investigation of the price does not illuminate the underlying bargain, a price-based approach to contract interpretation continues to err on the side of protecting unsophisticated minority investors.

Third, by providing a limited space for parties to privately negotiate their preferred allocation of control, a price-based approach offers a compromise between those who believe that fiduciary duties constitute mandatory rules and those for whom they are subordinate to private ordering.<sup>206</sup> One of the most important critiques of the contractarian view that fiduciary duties should be waivable, at least in the context of public corporations where market forces are deemed powerful,<sup>207</sup> has been that investors are often ignorant of the true nature and content of their investment

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203. See Moll, *supra* note 4, at 989 (discussing the relationship between contract law and the remedy of oppression). In fact, for contractarians, fiduciary duties are deemed to be part of the parties' investment contract and are therefore subject to waiver or negotiation the same as any other provision. Butler & Ribstein, *supra* note 4, at 19. See *Trustees of Dartmouth College v. Woodward*, 17 U.S. 518, 592 (1819) ("A grant of corporate powers and privileges is as much a contract as a grant of land."). But see Coffee, *supra* note 4, at 939 ("Historically, American corporate law has never regarded the corporation as simply a private contract.").

204. See Butler & Ribstein, *supra* note 4, at 34 n.139 (arguing that a court's refusal to enforce the parties' waiver of fiduciary duties makes planning more difficult). See also *infra* Part II.C.

205. For examples of investors who might have been paid to bear such risks, see *supra* notes 28-34 and accompanying text.

206. See Butler & Ribstein, *supra* note 4, at 4 ("An important recent battleground of the debate over freedom of contract in the corporation is the question of whether the fiduciary duties of corporate managers should be subject to private ordering through contract or should be to some extent law-imposed and non-waivable.").

207. *Id.* at 6.

bargain.<sup>208</sup> The approach advocated in this Article, however, solves that problem by recognizing a waiver as legitimate only where there is clear evidence that the investor was previously compensated for the additional risk. The test, in other words, is not whether the investor was aware of the risk of controlling shareholder opportunism, but whether she was paid for bearing it. Even if the investor were in fact ignorant, the waiver could cause no legally cognizable injury. By focusing on compensation rather than knowledge, this approach causes the concern regarding investor knowledge and sophistication to recede. Thus, conceiving of minority protections as default norms makes it possible to permit investors the freedom of waiver, as is generally advocated by the contractarians,<sup>209</sup> while retaining a concern for the adequacy of the status and sophistication of the investor.

Finally, by encouraging a case-by-case analysis of each deal, default norms suggest a middle ground between the extensive legal protections provided by states such as Massachusetts and the near complete lack of protections afforded investors in states such as Delaware.<sup>210</sup> Thus, it appears to satisfy the concerns of both jurisdictions, neither over- nor under-compensating the parties. Under this approach, only investors who are not otherwise compensated for bearing the risks associated with their minority status—rather than all or none—would receive compensation.

## II. A SOLUTION: USING PRICE AS A DIAGNOSTIC TOOL

The existing scholarship regarding close corporations has focused its attention on creating a mandatory standard in large part because of the difficulties associated with interpreting silence in an investment contract.<sup>211</sup> Because silence as to the allocation of power can indicate either agreement or lack of agreement, policymakers have largely given up on efforts to interpret each individual contract

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208. See *id.* at 42 (“Some anti-contractarian writers argue that corporate contracts should not necessarily be enforced because individual investors are ignorant concerning the corporate governance arrangements they vote on or invest in.”).

209. See *id.* at 71.

210. See *supra* note 7 (comparing the refusal of the Supreme Court of Delaware to extend special relief for minority investors in *Nixon v. Blackwell*, 626 A.2d 1366, 1380-81 (Del. 1993), with the holding of the Supreme Judicial Court of Massachusetts in *Donahue v. Rodd Electrotape Co. of New England*, 328 N.E.2d 505, 515 (Mass. 1975), and subsequently in *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 661 (Mass. 1976), which held that shareholders owe a duty to each other of “utmost good faith and loyalty”).

211. See *supra* Part I.D.4 (discussing the default rule of protecting all minority investors by equating omission with oversight).



to determine the bounds of fair conduct as negotiated by the parties.<sup>212</sup> They have instead substituted an objective standard for measuring in all cases what constitutes appropriate behavior by controlling shareholders.<sup>213</sup> In so doing they have substituted a blunt instrument—a uniform rule—for a precise one—a case-by-case analysis. Under this standardized approach, however, courts are likely to misperceive the equities of many situations.<sup>214</sup> In the first instance, then, courts should instead attempt to engage in a subjective analysis, applying the objective “reasonable expectations” standard only when efforts to interpret the parties’ chosen allocation fail.

In order to engage in a subjective analysis, however, a different set of analytical tools is needed. It is the claim of this Article that a careful examination of the price initially paid by shareholders for their interests can serve as just such an analytical tool. Price offers a window into the structure of the parties’ deal because it reflects their allocation of risk.<sup>215</sup> Because a party who bears a greater portion of the risks associated with a venture would expect to be compensated accordingly, changes in risk are typically associated with changes in price.<sup>216</sup> When the allocation of risk is express, one obviously does not need to examine the price in order to observe the allocation. Both will point in the same direction. But when a default allocation is imposed as a result of contractual silence, an assessment of the price may uncover whether the parties intended the default term or whether its presence was the result of oversight.<sup>217</sup> If all investors paid the same price, for example, it might suggest that the omission was

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212. *But see* Butler & Ribstein, *supra* note 4, at 32 (arguing that “the fundamentally contractual nature of fiduciary duties means that they should be subject to the same presumption in favor of private ordering that applies to other contracts”).

213. *See supra* Part I.B.

214. For example, if an entrepreneur were to purposefully and consciously cede control of her corporation to a venture capital fund in order to attract seed capital that was not otherwise available, it would seem unjust to limit the control rights of the venture fund simply because most other investors would not agree to such a lopsided allocation of control. *See* BARTLETT, *supra* note 29, at 96 (noting that venture capital investors wield significant power over a corporation’s affairs because they are often the only source of funds available to early-stage entrepreneurs); BAGLEY & DAUCHY, *supra* note 29, at 191 (explaining that one downside of raising money from venture capital investors is that they are likely to require the ability to take over control “if the entrepreneur stumbles”).

215. *See infra* Part II.A (discussing the risks associated with investment and how, if those risks are identifiable, investors can attempt to eliminate or minimize those risks through private ordering).

216. *See* BODIE, KANE & MARCUS, *supra* note 51, at 13 (“Naturally, if all else could be held equal, investors would prefer investments with the highest expected return.”); PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 2.

217. *See supra* Part I.E.

uninformed or unintentional. Alternatively, if the investors paid different prices, with some contributing more to the corporate enterprise than others, then it might be reasonable to assume that the parties did not intend to bear the risks of the enterprise proportionately.<sup>218</sup> In such a case, the allocation may have been deliberate.

The following sections explore the nature of share prices in close corporations to determine whether pricing can shed light on the problem of minority investor vulnerability.

#### A. *Price as a Proxy for Risk*

As a general principle, investors expect to be compensated for the level of risk they incur in any given investment.<sup>219</sup> The more risky the investment, the higher the return that is required to offset the possibility that their investment dollars will be lost or that a positive return will prove elusive.<sup>220</sup> This represents the fundamental relationship between risk and return: to entice investors to make a more risky investment, there must be the promise of a commensurately large return.<sup>221</sup> Moreover, as a corollary to this equation, where there is a risk that is not to be borne equally by all investors, those who will bear the risk most heavily must receive appropriate compensation for their extra burden.<sup>222</sup> In other words, an investor would expect to pay less for shares that have a higher level of risk associated with them, whether or not those risks are shared proportionately by other investors.

Certainly, where a particular risk can be identified, the parties to a contract can attempt to eliminate or minimize the risk, so that it does

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218. See BRUNER, *supra* note 3, at 462-67 (characterizing liquidity and control as options for purposes of corporation finance).

219. RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 181 (1996) ("Wise investors don't take risks just for fun. They are playing with real money. Therefore, they require a . . . risk premium"); SLEE, *supra* note 18, at xxi, 19. See also Butler & Ribstein, *supra* note 4, at 40-41 (explaining that increased risks of opportunistic behavior by managers can be expected to result in lower returns, thereby leading to lower share prices).

220. See PRATT, *DISCOUNTS AND PREMIUMS*, *supra* note 18, at 2; BODIE, KANE & MARCUS, *supra* note 51, at 133 ("The degree to which investors are willing to commit funds to stocks depends on risk aversion.").

221. SLEE, *supra* note 18, at xxi, 19; BODIE, KANE & MARCUS, *supra* note 51, at 7. See generally BREALEY & MYERS, *supra* note 219, at 173-203 (discussing the relationship between risk and return).

222. See BRUNER, *supra* note 3, at 457-58 ("Whenever liquidity and/or control change, value changes. . . as you move from the base case of no control asymmetries to the world where control asymmetries exist, two things happen: The control group gains a premium value to their shares, while the minority shareholders experience a discount.").

not need to be allocated.<sup>223</sup> For example, if there were uncertainty in the historical records as to whether an underground storage tank containing hazardous substances remained buried beneath a factory, a potential buyer of the factory would run the risk that she would unwittingly acquire a significant environmental clean-up cost.<sup>224</sup> The parties could eliminate this risk by hiring an environmental scientist to dig a hole under the factory and, if necessary, remove the tank. All that would remain would be to bargain over which party should bear the costs of hiring the scientist.<sup>225</sup>

If, on the other hand, a risk cannot be eliminated, the parties must bargain over who will bear it.<sup>226</sup> Thus, to continue the example above, if the location of the factory made digging an exploratory hole impractical, the buyer and seller could simply agree on which of them will bear the costs in the event they discover some years later that remediation was indeed necessary. In fact, one of the basic functions of a contract is to allocate the risks associated with cooperative activities.<sup>227</sup> In most cases, this will be the party who can most cheaply bear the risk.<sup>228</sup>

Allocations of risk can be made either explicitly through express contractual language or implicitly through silently acquiescing to the status quo ante.<sup>229</sup> Thus, to complete the factory example, the purchase contract could be drafted to expressly state that the seller will bear the cost of investigating and, if necessary, remedying the

223. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 112 (discussing ways that parties to a negotiated transaction can seek to avoid the assumption of unwanted liabilities).

224. The Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. § 9601 *et seq.* (2006), requires polluters to shoulder the financial burden of cleaning up certain contaminated sites. "Potentially responsible parties," including owners and operators of contaminated sites, are brought into a lawsuit and have the opportunity to establish among them who and to what degree each party will be liable for the clean-up costs. Commonly known as "CERCLA," the statute was enacted by Congress to enable the federal government to have the tools necessary for a prompt and effective response to problems of national magnitude resulting from hazardous waste disposal, and to make those responsible for creating the harmful conditions bear the costs and responsibility for remedying them. See *United States v. Reilly Tar & Chem. Corp.*, 546 F. Supp. 1100 (D.C. Minn. 1982).

225. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 21.

226. See LAX & SEBENIUS, *supra* note 192, at 99-100 (explaining that parties with different levels of risk aversion can use the differences to negotiate mutually beneficial trade-offs).

227. See generally FREUND, ANATOMY OF A MERGER, *supra* note 12, at 18-21.

228. LAX & SEBENIUS, *supra* note 192, at 90-92 (noting that value is created most readily when negotiating parties are able to make trade-offs based on differences in, among other things, their preferences and capacity to bear risk).

229. See *supra* Part I.D.4.

environmental concern.<sup>230</sup> In this way, the risk may be expressly allocated by contract and a subsequent observer would have no difficulty recognizing who had agreed to bear it. This is, in fact, the more common understanding of how contracts allocate risks.<sup>231</sup> Alternatively, however, if the buyer chose to bear the environmental risk herself, the contract could indicate this by simply remaining silent, thereby engaging the status quo as a default norm.<sup>232</sup> This would not be the omission that it first appears to be, however, because the buyer would most likely require some type of price adjustment to compensate her for bearing the additional risk. The factory, as it were, would be less valuable. Instead of an environmentally safe investment, the buyer would be acquiring a property subject to a cloud.<sup>233</sup> Indeed, all risks that can be identified can at some level be quantified, with more or less certainty, thereby enabling the parties to bargain over their allocation, either by means of express language or through silence coupled with a change in the price.<sup>234</sup> An observer who overlooks the role that price often plays

230. See, e.g., COMMITTEE ON NEGOTIATED ACQUISITIONS, AMERICAN BAR ASSOCIATION, MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY xiii (2001) (explaining that a purchase agreement typically deals expressly with “the allocation of risk among the parties from such contingencies as environmental, pension and tort liability”); COMMITTEE ON NEGOTIATED ACQUISITIONS, AMERICAN BAR ASSOCIATION, MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY 111 (1995) (characterizing sample environmental language as “in part a risk-shifting mechanism”).

231. See, e.g., RAIFFA, *supra* note 31, at 148-65 (describing multi-issue negotiations as a series of trade-offs and concessions over different issues); LAX & SEBENIUS, *supra* note 192, at 75-76 (giving the example of a tort plaintiff who is willing to accept a decreased settlement award in exchange for less anxiety over the judgment).

232. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 112 (explaining how liabilities, both known and unknown, may in some cases be assumed to be undertaken unless specifically excluded in the agreement).

233. CERCLA liability attaches to any “owner or operator” of certain contaminated property. 42 U.S.C. § 9607(a)(1) (2006). Thus, a purchaser of a contaminated facility would inherit the liability associated with its clean-up costs. See *supra* note 224.

234. FREUND, MATING DANCE, *supra* note 12, at 130 (arguing that all “sacred principles” can be reduced to “mundane dollars”). Risks that investors cannot identify can also be allocated, through price adjustments and/or an express agreement as to which party will bear the cost of any unknown or contingent liabilities. They cannot, however, be quantified as their exact nature and extent remain unknown. For an excellent—albeit bizarre—explication of this concept as applied to national security issues, consider Secretary of Defense Donald Rumsfeld’s comments of February 12, 2002:

Reports that say that something hasn’t happened are always interesting to me, because as we know, there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns—the ones we don’t know we don’t know. And if one looks throughout the history of our country and other free countries, it is the latter category that tend to be the difficult ones.

may therefore believe she is witness to an omission when in fact she is in the presence of an express allocation.

In the close corporation setting, two of the most significant risks faced by an investor involve control over the corporation's affairs and the marketability of its shares.<sup>235</sup> By accepting a minority position, an investor subjects herself to the risk that the controlling shareholders will prove incompetent, lazy and/or untrustworthy.<sup>236</sup> Without the ability to influence the operations and affairs of the corporate enterprise, the minority investor must passively accept that the value of her investment will be determined by the behavior of others.<sup>237</sup> Similarly, because of the lack of a market for minority interests in close corporations, the inability to exit her position, either at the time she prefers or at all, could destroy the value of an otherwise successful investment.<sup>238</sup>

Both of these risks, like any other risk, can be expressly allocated among the parties. By giving the minority a seat on the board or a position in management, for example, the parties may give the minority some degree of influence over the corporation's affairs, thereby re-allocating the default rules as to the risks associated with a lack of control.<sup>239</sup> Likewise, by entering into a buy-sell arrangement, the risks associated with a lack of marketability may similarly be shifted.<sup>240</sup> In other words, the parties can adjust, contractually, the degree of risk each assumes with respect to their respective investments in the close corporation.

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Donald H. Rumsfeld, U.S. Sec'y of Defense, Department of Defense News Briefing (Feb. 12, 2002), [http://www.defenselink.mil/transcripts/2002/t02122002\\_t212sdv2.html](http://www.defenselink.mil/transcripts/2002/t02122002_t212sdv2.html).

235. See *infra* Part II.B (stating that the context in which non-public stock is held determines whether a discount should be applied to appropriately represent its value).

236. See *supra* notes 39-40; see also BRUNER, *supra* note 3, at 468 ("One reason that control might be valuable is that it presents the opportunity for the majority to expropriate wealth of the minority.").

237. See *supra* note 40 (explaining that the concept of reliance on the efforts of others is essential to being considered a security under federal law, citing as an example the definition of an investment contract found in *S.E.C. v. W.J. Howey Co.*, 328 U.S. 293, 298 (1946)).

238. See PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 78 ("Lack of marketability, more often than not, is the largest dollar discount factor in the valuation of a business interest, particularly a minority interest."); BRUNER, *supra* note 3, at 462 ("Illiquidity, or lack of marketability of an asset, commands a discount sufficient to induce investors to buy the nonmarketable asset rather than an identical marketable asset.").

239. See *infra* Part II.C; see also 1 BARTLETT, *supra* note 172, at 230 (discussing ways in which the shareholders can structure the board so as to allocate control in accordance with their understandings).

240. See HYMAN, *supra* note 172, at 42-13 to -23 (providing an example of a buy-sell agreement).

To the extent a party assumes a greater portion of these risks, however, she would expect to receive appropriate compensation.<sup>241</sup> A minority investor who is subject to the full panoply of risks associated with a lack of control, for example, would presumably pay a lower price for her shares than one whose investment is protected by one or more express contractual guarantees.<sup>242</sup> The price of the shares will fluctuate with the degree of risk assumed.<sup>243</sup> Price, in other words, serves as a proxy for risk.<sup>244</sup> By determining the relative value of the shares, an observer can therefore make certain inferences as to the manner in which the parties allocated the risks associated with their joint endeavor. Where the contract is silent regarding a particular risk, price can provide a window into whether such omission represents regrettable oversight or deliberate choice.

*B. The Valuation of Private Firms*

Attempts to use price as a window into the parties' intentions are complicated by the lack of an active market for shares of private companies.<sup>245</sup> The existence of a market for a commodity or financial instrument, for example, enables one to estimate with confidence the value investors place on the item in question.<sup>246</sup> So long as the market is sufficiently deep and transparent, the collective interactions of large numbers of willing buyers and sellers will shed light on how investors perceive the item and its particular components.<sup>247</sup> Where no such market exists, however, as is the case with respect to close corporations, no such consensus opinion is readily available. Thus, it is impossible to measure with precision the relative value investors

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241. See PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 2; BREALEY & MYERS, *supra* note 219, at 180; BODIE, KANE & MARCUS, *supra* note 51, at 149 (discussing the trade-off between risk and return in portfolio management).

242. See BREALEY & MYERS, *supra* note 219, at 180 (explaining that investors require a higher return for a given investment in order to compensate for greater risk).

243. See BRUNER, *supra* note 3, at 457 ("Whenever liquidity and/or control change, value changes.").

244. See FREUND, ANATOMY OF A MERGER, *supra* note 12, at 21 (stating that most issues negotiated during an acquisition can be solved by "reducing down to dollars what appears to be sacred principles").

245. See *supra* note 41.

246. According to proponents of the Efficient Capital Markets Hypothesis, for example, "[p]rices of actively traded securities quickly reflect at least all public information about a company." Butler & Ribstein, *supra* note 4, at 34 (citations omitted). For a fuller explanation of the hypothesis as it relates to securities issued by public corporations, see generally Eugene Fama, *Random Walks in Stock Market Prices*, 21 FIN. ANAL. J. 55 (1965).

247. See *supra* Part II.A (discussing the relationship between a share's price and the risks associated with owning it).

place on different allocations of power and risk in the context of close corporations.<sup>248</sup>

One way around this impasse may be to consider the growing body of literature produced by and for the business valuation industry. Beginning in the early 1980s, a previously disparate collection of business valuation practitioners generally began to coalesce into today's more unified body of experts.<sup>249</sup> As a result, the once haphazard practice of providing ad hoc valuation opinions has evolved into an organized profession with its own standards, metrics, and academic literature.<sup>250</sup> Presumably, then, one can consider the techniques developed by valuation professionals to gain insight into how investors perceive non-marketable securities. To the extent the procedures developed in the valuation marketplace constitute more or less accurate measures of the relative value of controlling and minority stakes in a close corporation—which is indeed their claim—the industry's views can be understood to be generally representative of the views of investors.

When calculating the value of a block of shares in a close corporation, professional appraisers generally begin by attempting to place a value on the enterprise as a whole.<sup>251</sup> Depending on such factors as the purpose of the valuation and its premise of value, the appraiser selects one or more techniques from a catalog of available

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248. See Butler & Ribstein, *supra* note 4, at 34 n.139 (noting that the price efficiency of securities markets does not extend to close corporations).

249. See SLEE, *supra* note 18, at 1 (explaining that “private business valuation has become a career path” with thousands of practicing appraisers in the United States). The professionalization of the industry was catalyzed in large part by the publication of Shannon Pratt’s seminal work, “Valuing a Business.” See PRATT, VALUING A BUSINESS, *supra* note 18 (presenting a comprehensive overview of the theory and practice of valuing a business or an interest in business).

250. See SLEE, *supra* note 18, at 1.

251. The value of a close corporation depends on the “value world” that the appraiser is applying. SLEE, *supra* note 18, at 23 (“Every private company, therefore, has a large number of different values at the same time, depending on the purpose and function of the valuation.”). Possible value worlds include fair market value, fair value, investment value, early equity value, collateral value, market value, intangible asset value, insurable value, impaired goodwill value, economic value, and owner value. *Id.* at 26. For purposes of this Article, fair market value is the most relevant value world as it is the closest approximation to the value investors place on corporate participation. *Id.* at 88-89. Fair market value is defined by the IRS to mean:

[T]he price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts. . . . [T]he hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property. Rev. Rul. 59-60, 1959-1 C.B. 237.

metrics and applies them to the corporation.<sup>252</sup> The selection of techniques is usually based on one of three broad approaches to value—income value, cost of capital, and comparative market value.<sup>253</sup>

In this way, the appraiser attempts to recreate the value an investor would place on the enterprise by estimating the present value of its future income stream, the investor's relative cost of capital, and/or the value the market places on a more or less similar public company.<sup>254</sup> Regardless of the method used, however, the goal initially is to approximate the value that a willing buyer would pay for the corporation as a whole.<sup>255</sup>

Once the appraiser places an estimate on the value of the entire enterprise, prorating that value so as to make it proportional to the size of the minority's share is a simple matter of arithmetic. If the enterprise is estimated to be worth \$10 million, for example, a thirty percent interest in the whole would presumably be worth \$3 million. This is not the end of the investigation, however, as there is a second step to the analysis: an analysis of the risks associated with owning the particular block of shares.

After estimating the proportional enterprise value of a block of non-public stock, an appraiser must consider whether to apply one or more discounts (or premiums) to the stock as a measure of the value imparted to the shares by the context in which they are held.<sup>256</sup> For a minority investor, the most important discounts arise from the risks associated with a lack of control and a lack of marketability, which are discussed below in Parts II.B.2 and II.B.3.<sup>257</sup> Before exploring the operation of these discounts, however, it is necessary to examine in the following section the extent to which such discounts apply to close corporations.

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252. A valuation's premise refers to whether the company is to be valued as a going concern or for liquidation. JAMES R. HITCHNER, FINANCIAL VALUATION: APPLICATIONS AND MODELS 6 (2003).

253. See *id.* at 7-8 (highlighting the three approaches, termed by Hitchner simply as the income, asset, and market approaches, and discussing examples of the numerous methods within each that can be considered when performing a valuation).

254. *Id.*

255. See *supra* notes 107-08 and accompanying text.

256. SLEE, *supra* note 18, at 91, 96.

257. Other common discounts include key person discounts, discounts for trapped-in capital gains taxes, portfolio discounts, and discounts for contingent liabilities. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at xxiii. These do not relate disproportionately to a minority's stake, however, and so are beyond the scope of this Article.



### 1. *Firm-specific risk*

Mainstream corporate finance theory generally assigns a zero value to firm-specific risks.<sup>258</sup> This is because it assumes that a rational investor will seek to diversify her portfolio in such a way as to negate the impact of any risks unique to individual firms.<sup>259</sup> Thus, when determining the level of return that is required to induce investors to purchase a given financial instrument, risks specific to the issuer of the instrument (such as the particular competitive pressures impacting the firm) are not generally included in the calculation.<sup>260</sup> In this respect, internal allocations of control would appear to be irrelevant to the stock's value to a well-diversified investor, and so the risks associated with a particular minority position would appear to be irrelevant to the shares' price.

Investors in close corporations, however, are generally unable to diversify away firm-specific risks.<sup>261</sup> Often, for example, their capital investment in the enterprise represents a substantial portion of their individual net worth, making it impossible for them to acquire other significant positions.<sup>262</sup> Moreover, in the typical close corporation, the investors often double as employees.<sup>263</sup> To the extent they work full-time, minority investors are therefore similarly unable to diversify

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258. STANLEY J. FELDMAN, *PRINCIPLES OF PRIVATE FIRM VALUATION* 80 (2005); Butler & Ribstein, *supra* note 4, at 40 ("The Capital Assets Pricing Model, the dominant theory of financial valuation, states that the market price of securities will reflect 'systematic,' or market-wide, risk . . . which cannot be eliminated by diversification, but not 'firm-specific' risk, which can be eliminated by holding diversified portfolios of assets") (citations omitted). The focus, instead, is on market risk, or beta. *See, e.g.,* BREALEY & MYERS, *supra* note 219, at 194-95.

259. BREALEY & MYERS, *supra* note 219, at 173 ("Investors can eliminate the unique risk [that is particular to a stock] by holding a well-diversified portfolio."); FELDMAN, *supra* note 258, at 80. For a small or retail investor, this may mean concentrating her investments in diversified mutual funds or index funds. For a large or institutional investor, this means spreading its investment dollars over a wide variety of financial instruments, each with varying levels of risk and time horizons.

260. In other words, the required return will typically ignore firm-specific attributes such as reliance on key personnel, customer concentration, and transparency. *Id.* at 80-81.

261. FELDMAN, *supra* note 258, at 80 ("In estimating the cost of capital for a private firm, it is generally assumed that the owners cannot diversify away from the unique risk that the firm represents, and thus anybody desiring to purchase the firm would incorporate a premium to reflect this fact.").

262. Easterbrook & Fischel, *supra* note 4, at 274 (explaining that "investors in closely held corporations have large percentages of their wealth tied up in one firm and lack access to capital markets").

263. *See id.* at 273-74 (noting that in a close corporation, the firm's principal investors are also its managers and that this is both a detriment, in that the firm loses specialization, but also an advantage, because each individual is more likely to work harder and realize that what is good for the firm is also good for the individual).

away their firm-specific investment of human capital.<sup>264</sup> For an investor in a close corporation, firm-specific risks, including the negotiated allocation of control, pose real challenges and comprise significant factors in their expected level of return. In fact, many principles of corporate finance theory, not only the principle that firm-specific risks are ignored, are inapplicable to smaller, non-public entities such as close corporations.<sup>265</sup> The value of close corporation stock, therefore, will vary depending upon the firm-specific risks associated with holding any particular block of shares.

## 2. *The discount for lack of control*

In the close corporation context, professional business appraisers generally apply a large discount to blocks of shares that do not provide the owner with the ability to influence the direction and activities of the corporate enterprise.<sup>266</sup> This is referred to as the discount for lack of control.<sup>267</sup> After estimating the value of the enterprise as a whole (and adjusting for the size of the interest in question), appraisers generally reduce the amount by as much as twenty-five to thirty percent or more, depending upon the degree of control represented by the interest.<sup>268</sup>

The opposite of a discount for lack of control, of course, is a control premium.<sup>269</sup> Investors will typically pay a premium price for a controlling block of shares because of the discretion over the corporation's direction and activities that such shares impart on their owners.<sup>270</sup> Assuming all else is equal, the discount and the premium should be mirror images of each other: a controlling shareholder's

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264. See *id.* at 273-74 (observing that in most instances a close corporation's "principal investors are also its managers").

265. SLEE, *supra* note 18, at xix, 6 (noting that, while corporate finance theories explain and organize public capital markets, they were never meant to explain nonpublic capital markets).

266. See HITCHNER, *supra* note 252, at 272 (explaining that discounts for lack of control, also referred to as minority interest discounts, "quantify the level of risk assumed by a non-controlling shareholder").

267. *Id.*

268. See SLEE, *supra* note 18, at 97 (noting that "the average control premium paid in the past 10 years has typically been in the 35% to 45% range") (citing studies published by *Mergerstat Review*). In fact, appraisers frequently apply the formula of  $1/(1 + \text{control premium})$  to the *Mergerstat* data to derive minority interest discounts. *Id.* For examples of ways in which control can be divided, see *supra* text accompanying note 46.

269. HITCHNER, *supra* note 252, at 272.

270. *Id.*; see also BRUNER, *supra* note 3, at 468 ("One reason control might be valuable is that it presents the opportunity for the majority to expropriate wealth of the minority.").

control premium should be proportional to the discounted price paid by a minority investor.<sup>271</sup>

The size of the appropriate discount (or premium) is dependent on the level of control to be exercised.<sup>272</sup> Obviously, a share position that provides its owner with complete control over the corporation is more valuable than one with rather limited influence, just as a share position with rather limited control is more valuable than one exercising no control.<sup>273</sup> Therefore, in determining the size of the appropriate discount for lack of control (or control premium), one must consider the corporation's capital structure and other factors impacting the internal allocation of risk.<sup>274</sup>

In the close corporation context, the prerogatives of control are many. Because the board of directors is directly responsible for managing the corporation's affairs, for example, a shareholder with a large enough stake to elect a majority of the board will be able to establish corporate strategy and to select, evaluate, and (if necessary) change management.<sup>275</sup> Perhaps more importantly, such a shareholder would also control the corporation's policy toward dividends and distributions and toward the payment of salaries and other employee compensation.<sup>276</sup> As these are the most significant tools a corporation has for dispensing its profits on an ongoing basis, the level of a shareholder's discretion over such policies may significantly impact the value of her investment in the company.<sup>277</sup>

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271. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 19 (demonstrating the math whereby a thirty-five percent control premium translates into a proportional twenty-six percent minority discount).

272. See *supra* text accompanying note 46; see also BRUNER, *supra* note 3, at 467-68 (noting that control is relative).

273. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 18; BRUNER, *supra* note 3, at 466-67 (demonstrating mathematically how the value of control derives from its relative power).

274. See *infra* Part II.C (describing the private allocation of risks associated with a lack of control, through methods such as determining the relative number of shares that each investor purchases, determining the presence or absence of the various attributes of the shares themselves, and using different tools to alter the degree of marketability of a given block of shares); see also FREUND, ANATOMY OF A MERGER, *supra* note 12, at 112; 1 O'NEAL & THOMPSON, *supra* note 24, § 5:2, at 5-5.

275. See BRUNER, *supra* note 3, at 465-66 (describing control as a "call option on alternative strategies and policies"); see also, e.g., DEL. CODE ANN. tit. 8, § 141(a) (2006) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation."); MODEL BUS. CORP. ACT § 8.01(b) (2005) ("All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed by or under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized under section 7.32.").

276. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 20.

277. See HITCHNER, *supra* note 252, at 277 (stating that from the viewpoint of the minority shareholder, the majority shareholder's control can reduce or eliminate the

Given the many opportunities a controlling shareholder has to influence the affairs of the corporation, it is not at all surprising that investors would pay a premium price in order to acquire the greatest degree of control possible. The success or failure of the corporate policies and strategies undertaken by the controlling shareholders will, to a significant degree, determine the value of each investor's stake.<sup>278</sup> Similarly, the degree to which the controlling shareholders use their control to restrict dividends or pay themselves preferential salaries will to a significant degree determine how much minority investors share in the corporation's profits.<sup>279</sup> Although the size of the discount will be affected by the corporation's particular capital structure and allocation of control, there can be no doubt that buyers would value minority shares less highly than they would a block of shares that exercises a greater degree of discretion.

### 3. *The discount for lack of marketability*

The ability to exit an investment is another key determinant of its value.<sup>280</sup> For this reason, investors will pay extra for shares that may be quickly and efficiently sold on an active market.<sup>281</sup> The value appraisers place on the lack of an efficient exit is known as the discount for lack of marketability.<sup>282</sup>

In the close corporation context, the discount for lack of marketability and the discount for lack of control are closely related.<sup>283</sup> Shares that lack control are obviously less marketable than

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return on the minority's investment, specifically in regards to paying excess compensation, which "reduces the earnings of the corporation by distributing those funds to the majority shareholder or his or her designee").

278. See *supra* notes 39-40.

279. For a general discussion of the causes of minority investor vulnerability to oppression, see *supra* Part I.A.

280. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 79.

281. *Id.*

282. *Id.* at 78-79. The term "discount for lack of marketability" appears to be preferred in the literature over the more traditional term "liquidity discount." See, e.g., *id.* at 79 (using the term consistently when explaining this type of minority discount); SLEE, *supra* note 18, at 97-98 ("The lack of marketability discount (LOMD) is the amount or percentage deducted from the value of a marketable ownership interest to reflect the relative absence of marketability for private company."). See also BRUNER, *supra* note 3, at 462 ("'Liquidity' and 'marketability' are often used interchangeably. However, the terms differ in subtle ways."). But see FELDMAN, *supra* note 258, at 170 n.1 ("We use the terms *liquidity discount* and *marketability discount* interchangeably in this paper, as is customary in this literature."). The marketability of shares is defined as "the ability to quickly convert property to cash at minimal cost." HITCHNER, *supra* note 252, at 285 (using the definition provided by the *International Glossary of Business Valuation Terms*).

283. BRUNER, *supra* note 3, at 471-72 (discussing the interaction between liquidity and control).

shares that comprise a controlling stake.<sup>284</sup> Where a buyer might be willing to purchase (thereby making a market for) a controlling interest, she would be less willing to purchase an interest that bears the risks associated with minority status.<sup>285</sup> In this respect, although the two discounts are distinct in theory, it is not clear that they can be differentiated in practice, at least with respect to minority interests in close corporations.

Marketability is important to investors for a variety of reasons. For one, the value of an investment invariably changes over time. Thus as the price of a stock increases and decreases, the ability to exit at exactly the right moment can mean the difference between a loss and a gain (or a small loss or gain and a large one).<sup>286</sup> Consider, for example, the plight of the Enron employees who were prohibited from selling their stock even as the corporation slid toward bankruptcy, and compare the value of their investments to those of the Enron executives who were able to bail out before the slide turned into a rout.<sup>287</sup>

A second reason investors value liquidity is that their own personal circumstances may evolve rapidly such that the flexibility to cash out of a particular investment may prove critical. Any number of factors—margin calls, for example, or the need to cover losses in other investments—could place an investor in a cash squeeze. Similarly, opportunities to invest ahead of the market in promising new technologies or business ideas may be lost if the investor cannot quickly liquidate her existing positions and move her investment

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284. See HITCHNER, *supra* note 252, at 78-79.

285. See *Donahue v. Rodd Electrotypes Co. of New England*, 328 N.E.2d 505, 515 (Mass. 1975) (“No outsider would knowingly assume the position of the disadvantaged minority. The outsider would have the same difficulties.”).

286. This is, in essence, the basis for the Black-Scholes model of option pricing. See generally Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J. POL. ECON. 637 (1973) (presenting a model of option pricing that can be applied to common stock, corporate bonds, and warrants). The longer an option remains exercisable, the more valuable it is because it is more likely that the price of the underlying stock will rise above the strike price at some point within the period. See *id.* at 641 (noting that, after making certain assumptions, “the value of the option will depend only on the price of the stock and time and on variables that are taken to be known constants”).

287. See generally Michael Ash, *Enron: Where to Start?*, in FIELD GUIDE TO THE U.S. ECONOMY: A COMPACT AND IRREVERENT GUIDE TO ECONOMIC LIFE IN AMERICA (Jonathan Teller-Elsberg, Nancy Folbre & James Heintz eds., 2000) (lambasting top Enron management for cajoling Enron employees to hold Enron stock to maintain its share price, while the chairman of Enron sold his shares after hearing reports that Enron was in trouble); Lorraine Schmall, *Defined Contribution Plans After Enron*, 41 BRANDEIS L.J. 891, 894 (2003) (“Management also had the legal right to sell their stock whenever they wanted, which their rank-and-file plan participants did not have.”).

dollars into a potentially more lucrative new venture. Liquidity, then, can be invaluable and is one of the most highly sought after of investment characteristics.<sup>288</sup>

A significant number of empirical studies have attempted to quantify the level of discount investors impose for a lack of marketability.<sup>289</sup> Such studies typically fall within two categories. In the first, researchers compared the price of securities pre- and post-IPO and attributed the bulk of any increase to a marketability premium.<sup>290</sup> Such studies suggested average discounts of around forty-five to fifty percent for lack of marketability.<sup>291</sup> In the second set of studies, researchers compared prices paid for publicly traded shares of a corporation's stock with identical shares of the same corporation that were subject to restrictions on trading.<sup>292</sup> Here, the discounts averaged around thirty-five percent.<sup>293</sup> Although both sets of studies suffer from a variety of well understood shortcomings,<sup>294</sup> they provide powerful evidence that investors differentiate investments—even investments in the same corporation—based on their relative marketability.

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288. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 79 ("Investors love liquidity and are willing to pay a high premium for it.").

289. *Id.*

290. *Id.* at 83.

291. *Id.*

292. *Id.* at 80-81. Shares of a public corporation can be restricted for any number of reasons, the most common of which may be the failure of the corporation to register the shares with the SEC at the time it registered its other shares. *See id.* at 80 (noting that "underwriters of initial public offerings often are not willing to have all of the outstanding stock registered for public trading at the time of the offering. They are concerned about the risk that insiders may bail out and depress the market.").

293. *Id.* at 81. In 1990, the SEC loosened the restrictions on resale of restricted securities by adopting Rule 144A. *Id.* The SEC further loosened the restrictions on resale in 1997 by reducing the required holding period for Rule 144 from two years to one. *Id.* Rules 144 and 144A establish a safe harbor for certain private resales of restricted securities by providing that the seller in a transaction qualified under either of the rules will be deemed not to be an underwriter pursuant to Section 2(11) of the Securities Act of 1933. 17 C.F.R. §§ 230.144, 230.144A. As a result, qualified participants can take advantage of Section 4(1) of the Securities Act of 1933, which exempts from registration "transactions by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1) (2005). As a result of the increased marketability of such shares, studies of restricted securities after 1990 have shown markedly lower discounts (generally in the "low 20s"). PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 81-82.

294. For a detailed description of the various studies, including their drawbacks, *see* HITCHNER, *supra* note 252, at 287-311 (discussing and critiquing various studies, including the Emory IPO studies, the Willamette Management Associates IPO studies, two IPO studies by James R. Hitchner, the author of the text, and multiple restricted stock studies). Despite any faults pertaining to particular studies, however, their sheer number and the consistency of the results suggests the accuracy of their basic insight.

Just as there are different levels of control, however, there are also different levels of marketability. Marketability discounts are affected by both the investor's opportunity to exit and her ability to withdraw profits on an ongoing basis.<sup>295</sup> Thus, where the amount of dividends or other distributions is fixed, the discount for lack of marketability is likely to be smaller than when the board maintains discretion over dividend policy.<sup>296</sup> Similarly, though dividends on common stock are generally discretionary, a history of generous or consistent dividends will also serve to reduce the impact of the discount.<sup>297</sup>

The prospect of future liquidity may also affect marketability. Where there is soon to be a liquidity event, such as an upcoming IPO or a lifting of transfer restrictions, for example, the discount for lack of marketability is generally smaller than when such future liquidity is more uncertain.<sup>298</sup> Similarly, the existence of registration rights may tend to make securities trade at prices closer to marketable securities.<sup>299</sup> Other factors may also tend to minimize the impact of the absence of an active market for the security.<sup>300</sup>

The discount for lack of marketability, then, represents a second major factor that distinguishes the value of different shares of the same securities. Where the market for such securities is limited or nonexistent, investors will demand a discounted price to compensate them for the additional risks associated with an illiquid investment. Alternatively, where there is a market, investors will pay a significant premium for shares that are liquid over otherwise identical shares that are subject to restrictions on transfer.

### C. *The Private Allocation of Risk*

Although corporation statutes and caselaw provide default rules, the allocation of the risks associated with minority ownership is not

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295. See PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 153 (noting that the "primary drivers" of the reduced marketability discounts include the size and frequency of historic distributions, prospects for future liquidity, and the pool of potential buyers).

296. *Id.* at 153-57.

297. *Id.*

298. *Id.* at 157.

299. See *id.* at 79, 157 (noting that registration of the interest in an IPO contributes to achieving liquidity, and the greater the prospect of the liquidity, the smaller the discount, therefore making the prices closer to those of marketable securities).

300. *Id.* at 153. For example, the size of the pool of potential buyers for the security may affect its marketability (and thus the discount). *Id.* at 153, 158. The size of the pool of potential buyers may in turn be affected by factors such as the strength of the ultimate trading market and the size of the block to be sold. *Id.* at 159-60.

outside the control of investors.<sup>301</sup> A company is not formed by happenstance. Rather, the investors themselves determine the degree of control to be exercised by each party and also influence the market for the corporation's shares.<sup>302</sup>

The primary way in which investors elect their particular allocation of control is by determining the relative number of shares they and the other shareholders purchase.<sup>303</sup> Venture capital funds, for example, commonly invest only in companies where they are permitted to purchase at least fifty-one percent of the shares.<sup>304</sup> Thus, when negotiating the corporation's capital structure, both the venture capital investor and the entrepreneurs are involved in an affirmative allocation of control. By agreeing to give up a controlling block of shares in exchange for an influx of risk capital, the entrepreneurs are electing their minority status and, hence, their vulnerability. Since there is no general duty to buy or sell securities, the choice to invest is made freely and either party can back out if they view the proffered terms, including the risk of oppression, as unreasonable.<sup>305</sup> Embedded in the corporation's capital structure, then, are the parties' choices.

Investors also allocate control by determining the nature of the shares to be issued.<sup>306</sup> For example, a corporation may issue multiple

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301. For a discussion of the default allocation of control, see *supra* Part I.A.

302. It should be noted, in fact, that controlling shareholders often have incentives to offer protections to minority investors even if they are not requested. To the extent the minority investors are aware of the risks associated with minority participation, offering protections will permit the corporation to demand a higher purchase price for the minority's investment. Likewise, to the extent the minority investors are unaware, the possibility that they will later discover the risks may incentivize the controlling shareholders to offer protections up front so as to ensure the long-term continuation and success of a relationship based primarily on mutual trust and respect. Indeed, to the extent the shares are offered as part of an employee-incentive scheme, it is critical that the shares be protected or they may over time lose their ability to incentivize the minority. See 1 O'NEAL & THOMPSON, *supra* note 24, § 5:2, at 5-5 ("Holders of the controlling interests in a corporation may be willing to share their control in order to bring into the enterprise persons who otherwise would not buy a minority interest."); Johnston, *supra* note 4, at 309 (noting that a well-informed controlling shareholder may find it in her interest to offer a minority investor/employee some protection against oppression so as to encourage the investor/employee to make a greater level of "relationship-specific investments").

303. See PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 18 ("The value of control depends not only on legal power and rights, but also on economic potential.").

304. See *supra* note 29.

305. FARNSWORTH, *supra* note 15, §§ 4.1-4.20, at 217-67; see also FREUND, ANATOMY OF A MERGER, *supra* note 12, 5-7.

306. See 1 O'NEAL & THOMPSON, *supra* note 2, § 1:2, at 1-3 ("As a general proposition, a corporation operates under the principle of majority rule: the holders of a majority of the shares with voting power control the corporation.").



classes or series of stock, each with different voting rights.<sup>307</sup> Preemptive rights, supermajority voting requirements, cumulative voting provisions and other rights are also options that can impact both the relative allocations of control and the ease with which a shareholder may exit her investment.<sup>308</sup> Shareholders can, for example, impose supermajority voting requirements either in the corporation's charter or in a separately negotiated shareholders' agreement to which they are all party.<sup>309</sup> A typical requirement might be that approval of eighty percent of the outstanding shares, rather than a simple majority, is necessary before the corporation may enter into a merger or other similar corporate reorganization.<sup>310</sup> Under such circumstances, the holder of a twenty-one percent block of shares could veto any such proposal.<sup>311</sup> The effect of adopting such a

307. See *supra* note 156.

308. See *supra* note 57 and accompanying text (explaining preemptive rights and cumulative voting provisions). With respect to supermajority voting requirements, investors are always free to negotiate for a higher vote requirement than is provided by the applicable statute. See, e.g., DEL. CODE ANN. tit. 8, § 102(b)(4) (2006) (permitting the certificate of incorporation to include "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power, or a larger number of the directors, than is required by this chapter"); MODEL BUS. CORP. ACT § 7.27(a) (2005) ("The articles of incorporation may provide for a greater quorum or voting requirement for shareholders (or voting groups of shareholders) than is provided for by this Act"). This may be put into effect either in the corporate charter itself or in a separate agreement among the shareholders.

309. Courts historically have frowned on shareholders' agreements that limited the parties' discretion. See *supra* note 59 and accompanying text (noting the judicial hostility toward private attempts to change the default allocation of control by contract. The modern view, however, is that shareholders' agreements should generally be respected to the extent they do not cause harm to third parties. 1 O'NEAL & THOMPSON, *supra* note 24, § 5:6, at 5-25 to -26 ("Since at least 1960 courts and legislators have shown an increased sensitivity to the need of close corporations to depart from the traditional statutory norms. Court decisions reflect a definite trend toward greater judicial readiness to uphold shareholder control agreements, at least in close corporation settings."). In fact, in modern legal practice, the adoption of a shareholders' agreement appears to be standard practice when organizing a new entity. See, e.g., 1 BARTLETT, *supra* note 172, at 230 ("the Stock Purchase Agreement is usually accompanied by a Stockholders Agreement, an agreement by and among the founder in his capacity as a stockholder and the investors"); 2 HYMAN, *supra* note 172, at 42-7 ("The shareholders of a close corporation, by agreement, may provide for the rules governing the management of the corporation."); MANCUSO, *supra* note 172, at 5/5 to /8 (recommending that entrepreneurs who are otherwise "tired of incorporation paperwork" nonetheless consider adopting a shareholders' agreement).

310. See, e.g., SLEE, *supra* note 18, at 348-49 (highlighting sample provisions for a shareholders' agreement, including one to the effect that for decisions on certain issues of corporate governance, such as selling the business, acquiring another business, or optional buyouts, supermajority approval of the shareholder interests is required).

311. Interestingly, it has been pointed out that minority shareholders can be guilty of oppression by using veto and other similar blocking rights in an opportunistic manner. See generally *supra* note 35; see also Easterbrook & Fischel, *supra* note 4, at

provision, then, is to adjust the degree of discretion afforded to a controlling shareholder and thus reduce (or increase) the risks associated with a lack of control.<sup>312</sup>

Investors can apply a similarly wide variety of tools to alter the degree of marketability applicable to a given block of shares. By entering into some form of buy-sell agreement, for example, the parties can ensure that they will have an exit if they ever decide to liquidate their investment.<sup>313</sup> Similarly, granting registration rights may increase the shares' marketability somewhat in that the grant may signal the anticipation of an active public market.<sup>314</sup>

By altering the default rules, then, investors can increase or decrease the levels of control and liquidity represented by their investments and so alter the level of risk associated with a minority position. A shareholder who wishes to exercise wide latitude over the corporation's affairs can therefore purchase such influence by receiving less consideration per share from the minority investors and structuring the corporation accordingly. Absent a breakdown in the bargaining process—a breakdown for which contract law would

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296 (explaining that certain minority conduct, such as refusing to attend meetings so that a quorum does not exist, can constitute tools that allow the minority to extract a disproportionate benefit). The arguments made in this Article therefore apply equally to oppressive minority conduct as to oppressive controlling shareholder conduct.

312. Another typical set of private agreements deals with the composition of the board of directors. Frequently, founding shareholders will enter into an agreement to nominate and vote for each other (or for each other's designee) at each election of directors. 2 HYMAN, *supra* note 172, at 42-7; 1 O'NEAL & THOMPSON, *supra* note 24, § 5:9, at 5-45. This would ensure that each shareholder has a seat on the board. Likewise, by adopting a cumulative voting scheme in the corporate charter, a corporation's investors can ensure that even minority investors have representation on the board. 2 HYMAN, *supra* note 172, at 42-7. Such a provision, much like a supermajority voting provision, would serve to limit somewhat the scope of the majority's discretion. It is unlikely, however, to be crafted so as to transfer real control to the minority. *See generally* 1 O'NEAL & THOMPSON, *supra* note 24, § 5:9, at 5-45 to -54 (discussing state statutes that limit the duration of certain shareholders' agreements).

313. Pursuant to such an agreement, the parties can outline a set of circumstances that would cause the corporation to be obligated or entitled to repurchase an investor's shares. *See* 2 HYMAN, *supra* note 172, at 42-13, 42-18 (providing draft buy-sell agreements). Generally, a formula for determining the price for such shares is set forth in the agreement, as well as a description of the event or events that would trigger the buyout right. *Id.* at 42-15, 42-20.

314. Registration rights agreements generally provide investors with the right to have their shares registered with the SEC, and hence qualified for immediate resale, in the event or soon after the corporation files an IPO. *See* Royce de R. Barondes, *An Alternative Paradigm for Valuing Breach of Registration Rights and Loss of Liquidity*, 39 U. RICH. L. REV. 627, 641-42 (2005). Thus, by increasing the likelihood that the shares will become tradable in an active public market, the presence of a registration rights agreement will tend to increase the marketability of the shares prior to their registration. PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 157.

presumably supply a remedy<sup>315</sup>—such minority investors will have been compensated for the additional level of risk in the form of a lower purchase price. In other words, if a corporation's internal allocation of control makes the minority's interest riskier than the interests of the other shareholders, she would expect to pay a lower purchase price, just as she would expect to pay a lower purchase price for shares in an unproven venture than for shares in an established one.<sup>316</sup> The investors themselves—not some passive circumstances into which they are born—often privately determine their level of control and, hence, their level of block-specific risk.<sup>317</sup> Risk and reward are united.

To the extent control is purchased for consideration (and the risks associated with a lack of control are sold), an injustice occurs only when that control is circumscribed by court action.<sup>318</sup> In such a circumstance, the controlling shareholder will have paid for some level of discretion over the direction of corporate policy but not received the benefit of her bargain. Likewise, if for some reason a minority investor were prohibited from exercising a veto right for which she had negotiated and paid, she would have been unjustly denied a level of influence for which she had paid. Risk and reward, in both cases, would have been separated.

Existing remedies for minority investors increase the likelihood of such injustices by approaching each investor as if she had negotiated

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315. It is a basic premise of contract law that each party entered into the agreement freely. Where there is evidence of fraud, duress, lack of capacity to form the intent to contract, or other defect in the bargaining process, the law generally holds such agreements null and void (or at least voidable at the option of the injured party). FARNSWORTH, *supra* note 15, §§ 4.1-4.20, at 217-67. Thus, where an investment contract—an agreement to purchase shares for a given consideration—is not entered into freely, contract law provides a remedy and the remedies for oppression are not needed. *See id.* (discussing grounds to nullify a contract and grounds for contractual remedies). *But see* Moll, *supra* note 4, at 989 (arguing that, despite the existence of contract law, the remedy of oppression “serves a critical protective function that justifies its independent existence”).

316. *See* PRATT, DISCOUNTS AND PREMIUMS, *supra* note 18, at 2-3.

317. *See supra* Part I.D.1.

318. To illustrate this point, imagine two corporations, each having one seventy-five percent owner and one twenty-five percent owner. Corporation A's charter requires an eighty percent vote to approve mergers, whereas Corporation B's charter is silent and so adopts the default norm of majority rule. All else being equal, the minority shareholder in Corporation B will pay less than the minority shareholder in Corporation A because the A minority is purchasing not only the shares but also the additional right of a veto over mergers. *See* BRUNER, *supra* note 3, at 465 (characterizing control as a financial commodity that can be isolated from the underlying stock). If, however, a court were to intervene and prohibit a merger involving Corporation B on the grounds that it is unfair that the minority be left out of the decision, the B minority will have obtained the benefit of a veto without paying for it. The B majority will thus have been the victim of an uncompensated wealth transfer.

the same allocation of control.<sup>319</sup> An objective standard is a blunt instrument that is likely to overcompensate those minority investors who forgo contractual guarantees.<sup>320</sup> Such investors, to use a colloquial phrase, are likely to “have their cake and eat it too.” An objective standard is also likely to undercompensate a minority investor who expends the resources necessary to negotiate—and pay—for express contractual guarantees. In other words, to the extent the law will provide such protections anyway, she may have overpaid for her shares.

An examination of negotiated prices, however, may allow subsequent observers to determine whether a minority investor was already compensated for bearing the risks associated with her lack of control. Because the parties may elect—and pay for—the degree of discretion they exercise, the legal system’s intervention in the allocation of corporate control risks doing injustice to both minority and controlling shareholders. If the court misinterprets the parties’ agreement, it can cause an uncompensated wealth transfer and alter their bargain in fundamentally unjust ways. Thus, only by inquiring into the parties’ actual bargain, through an examination of price, can one assure a just outcome in all cases.

#### *D. Pricing and Efficiency*

In some respects, the central claim of this Article, that price can sometimes be used to illuminate the parties’ intentions, may appear at odds with current theory. Price is generally assumed to be synonymous with cost, and one of the primary goals of corporation law is to minimize agency and other transaction costs.<sup>321</sup> Thus the premium price an investor might pay for control actually represents a form of agency cost.<sup>322</sup> If the parties could trust each other to always act in their mutual best interests, then there would be no need to allocate the risk of minority vulnerability because the risk would not be present, thus yielding a more efficient result.<sup>323</sup> Rather than using price to identify private allocations of risk, it would therefore seem

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319. See *supra* Part I.B.

320. See *supra* notes 28-34.

321. See, e.g., Easterbrook & Fischel, *supra* note 4, at 283 (“Corporate law, both statutory and judicial, is best understood as a set of standard terms that lowers the costs of contracting.”); Gilson, *supra* note 11, at 253-55 (arguing that business lawyers create value as “transaction cost engineers”).

322. See generally Easterbrook & Fischel, *supra* note 4, at 283 (discussing contractual ways to “minimize agency problems in close corporations,” as well as a cost benefit analysis of various legal rules “designed to assist minority shareholders”).

323. See *id.* at 272 (“[I]f family owned ventures reduce the agency costs of management, there will be gains for all to share.”).

more prudent for the law to attempt to eliminate the agency costs inherent in the risk of shareholder opportunism.<sup>324</sup>

This critique would probably be correct were the law a more formidable force in the context of close corporations. As was discussed previously, however, investors in a close corporation are generally involved in a series of overlapping relationships, often including bonds of family and friendship.<sup>325</sup> The reality is that close corporation shareholders are far more likely to be protected by extra-legal constraints on behavior, such as market forces and societal norms of good behavior, than they are to resort to the legal system as a dispute resolution mechanism.<sup>326</sup>

As a result, legal remedies in the close corporation context are unlikely to be capable of significantly reducing the agency costs associated with shareholder opportunism regardless of how they are crafted.<sup>327</sup> However, because of the law's general impotence vis-à-vis the protection of minority investors, expansive legal rules risk disrupting private ordering without providing any concomitant benefits. Thus, although it might be aspirational to attempt to craft a set of rules that minimize or even eliminate the agency costs associated with the management of close corporations, the effort is probably doomed. Thus it might instead be more productive to attempt to maximize the impact of existing non-legal constraints on behavior, in particular private contracting.<sup>328</sup> In other words, the goal with respect to close corporations should be, whenever possible, to enforce the actual agreement of the parties, thereby reinforcing their private arrangements and also minimizing the likelihood that a fixed legal standard will result in unexpected consequences. In other words, where the upside is illusory and the downside genuine, the law should take a back seat. The law of close corporations, then, should be crafted to prefer efficiency in contracting over efficiency in outcome. A uniform approach to the problem of minority

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324. See, e.g., Chander, *supra* note 1, at 121 ("Corporate law . . . routinely intrudes into the corporation to secure the protection of minority shareholders against controlling persons within corporations.").

325. Easterbrook & Fischel, *supra* note 4, at 274 ("Participants in closely held corporations frequently have familial or other personal relations in addition to their business dealings.").

326. See *id.* at 272 (noting that agency costs are generally lower in close corporations as a result of such relationships).

327. But see Mitchell, *Death of Fiduciary Duty*, *supra* note 4, at 1675 (arguing that "the law of corporations historically has attempted to provide a principled and coherent set of regulations to ensure that those who hold power are accountable to those who are dependent upon its fair exercise").

328. See Butler & Ribstein, *supra* note 4, at 32 (arguing in favor of a "presumption in favor of private ordering").

vulnerability should be used only when it appears that there truly was no private agreement as to the allocation of risk.<sup>329</sup>

### III. A TEST: REVISITING THE EARLY CASELAW

This Article has argued that the law regarding minority investor vulnerability is at odds with the reality of the typical minority investors' decision-making process. Rather than assuming that all shares are equivalent, such investors generally recognize, if only intuitively,<sup>330</sup> that minority stakes in close corporations suffer from the risks associated with a lack of control.<sup>331</sup> Recognizing such risks, they often negotiate for a different allocation of control or accept the risks and pay a lower purchase price.<sup>332</sup> Especially for the unsophisticated investor, price can serve a similar protective function as do contractual guarantees.<sup>333</sup>

To observe that current doctrine over-emphasizes the status of minority investors as minorities is not, however, to reject current doctrine. Rather, what is needed is a more nuanced, two-step approach. In the first instance, a court should investigate the particular equities of the case before it by measuring the controlling shareholders' conduct against the allocation of control actually contemplated by the parties.<sup>334</sup> In the event an examination of the parties' bargain fails to uncover their intentions or demonstrates that

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329. *But see* Moll, *supra* note 4, at 993-94 (arguing that the doctrine of minority oppression is more than a mere replacement for contract law).

330. An overriding concern of policymakers who are uncomfortable with converting minority investor protections into default norms appears to be an intuition that most investors are ignorant of the rules of corporation law. *See, e.g.*, Hetherington & Dooley, *supra* note 4, at 36 (arguing that the approach taken by this Article "credits close corporation shareholders with too much foresight and fails to give sufficient weight to the difficulties of contracting for adequate protection"). However, investors do not need to have a deep understanding of all of the various rules and norms of corporation law in order to negotiate to protect themselves. Rather, they need merely to understand that their business co-venturers might not be trusted, especially over the long-run, and that ceding them control exacerbates the risks associated with the investment. *See* Easterbrook & Fischel, *supra* note 4, at 284 ("The extent to which minority shareholders are ignorant of problems they might face and thus fail to protect themselves is impossible to tell. . . . Certainly participants in close corporations are better informed about their legal rights and obligations than participants in either partnerships or public corporations."); *id.* at 298 ("Proponents of the partnership analogy assume that participants in closely held corporations are knowledgeable enough to incorporate to obtain the benefits of favorable tax treatment or limited liability but ignorant of all other differences between corporate and partnership law. There is no support for this assumption once you realize that people have to jump through a lot of formal hoops (assisted by counsel) to incorporate but could become partners by accident.").

331. *Id.* at 274-75.

332. *See id.* at 285.

333. *See supra* Part I.D.4.

334. *See supra* Part I.E.

silence did in fact equate with oversight, the court should engage in a second-step reasonable expectations analysis.<sup>335</sup> The ultimate test would therefore remain one of the fairness of the controlling shareholders' particular course of action.<sup>336</sup>

The claim of this Article, then, is not that existing doctrine in all cases leads to the wrong result. Rather, it is that existing doctrine is a sometimes useful but unnecessarily blunt instrument given the clues that may be afforded by an examination of the price. Before resorting to such a blunt instrument, courts should first attempt to resolve disputes using a more precise interpretive tool. This Article suggests that price is such a tool.

This supposition can be tested by revisiting two of the leading judicial opinions that were influential in the early development of the protections afforded to minority investors. In some cases, one would expect an examination of price to uncover no new useful information. This would be the case if, for example, the parties' preferred allocation of control mirrors the default rule,<sup>337</sup> or if the presence of silence is in fact indicative of the kind of oversight that a reasonable expectations analysis would remedy. In both situations, the application of a blunt, category-based remedy would yield the same result as a more precise, subjective analysis—a victory for the minority plaintiff. A price-based approach and a reasonable expectations test, in other words, often yield overlapping results. In other situations, however, one would expect an examination of price to uncover instances where the court misperceived the equities and overcompensated one of the parties.<sup>338</sup> Using price as a diagnostic tool, then, should account for the existing, correct body of caselaw while also identifying errors in the caselaw. This is, in fact, exactly

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335. See Thompson, *Corporate Dissolution*, *supra* note 4, at 237-38 (advocating the use of the reasonable expectations standard as "an effective response to the problems of minority shareholders").

336. See Chander, *supra* note 1, at 124 (arguing that, "[a]s crafted over the centuries by judges and legislators, corporate law is . . . a device to ensure that minorities will be treated fairly").

337. In situations where omissions result in a dispute, courts typically supply rules through "gap-fillers" that attempt to approximate what the parties would have bargained for had they considered the issue themselves. FARNSWORTH, *supra* note 15, § 7.15, at 480-83; Easterbrook & Fischel, *supra* note 4, at 291 ("Properly interpreted, fiduciary duties should approximate the bargain the parties themselves would have reached had they been able to negotiate at low cost.").

338. For example, it would seem unjust for a court to award a remedy against a venture capital fund investor for exercising a control right that the corporation's founders ceded to it as a condition of receiving early stage risk capital. See, e.g., BARTLETT, *supra* note 29, at 124-26 (noting that venture capital investors frequently retain the ability to terminate the corporations' founders).

what one finds when one revisits the early precedents that led to the development of the modern doctrine of oppression.

The following sections apply a pricing analysis to two of the leading cases in the development of the doctrine of minority shareholder oppression as a test of the usefulness of such an approach.

#### A. Donahue v. Rodd Electrottype

Perhaps the most famous and broadest statement of the doctrine of minority investor oppression is contained in *Donahue v. Rodd Electrottype*.<sup>339</sup> A staple of casebooks, *Donahue's* influence has been wide—in one recent count, it had been cited by courts no less than 239 times.<sup>340</sup> Its facts are therefore well-known and perhaps not unusual, though they are somewhat complicated.

At the time of the events at issue, the plaintiff, Euphemia Donahue, found herself a minority investor and a widow.<sup>341</sup> Harry Rodd, the original controlling shareholder, had retired as a director and as the president and general manager of Rodd Electrottype, and been replaced by his two sons.<sup>342</sup> He had further limited his involvement in the company by embarking upon a systematic, eight-year program of gifting to his three children his majority interest in the company, presumably as part of an estate planning process.<sup>343</sup> At the completion of his gift program, each of Harry's three children owned fifty-one shares, while Euphemia Donahue controlled fifty shares.<sup>344</sup> This gave each of them approximately equal interests in the company.

At issue in the case was the disposition of forty-five of Harry Rodd's shares which, unlike the others, were never transferred to his

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339. 328 N.E.2d 505 (Mass. 1975).

340. A Westlaw "Citing References" search performed at the time of this Article's publication yielded 1,026 documents. Many of these citing documents were United States cases. Of these, 16 gave it negative treatment, 17 offered positive treatment, 48 discussed it, 134 cited it, and 24 mentioned it. Further, a staggering 556 secondary sources have cited to *Donahue*.

341. *Donahue*, 328 N.E.2d at 508-09.

342. *Id.* at 509-10.

343. *Id.* at 510 ("From 1959 to 1967, Harry Rodd pursued what may fairly be termed a gift program by which he distributed the majority of his shares equally among his two sons and his daughter."). Harry Rodd began with 200 shares, made gifts to his three children totaling forty-nine shares each, sold each of his children two additional shares, and returned two shares to the corporate treasury. *Id.* This left him with the 45 shares at issue in the case.

344. See *id.* (regarding the Rodd family holdings). Euphemia Donahue owned forty-five shares and her son, Robert, owned the other five. *Id.* at 510 & n.8. For simplicity of explanation, this Article treats the interests held by Euphemia and Robert as if they were held by a single person, as did the court. See *id.* at 520 (combining the forty-five shares held by Euphemia and the shares held by her son as a single block of fifty shares).



children as part of his estate plan.<sup>345</sup> Rather, in order that Harry should take some money out of the company upon the occasion of his retirement, the board authorized Rodd Electrotpe to redeem his remaining forty-five shares for cash in the amount of \$800 per share.<sup>346</sup> As a result, the Rodd family's combined interest was diluted from eighty percent to just over seventy-five percent.<sup>347</sup>

The gist of Euphemia's complaint was that the company and its controlling shareholders, the Rodds, had breached the fiduciary duties they owed to her because they "failed to accord her an equal opportunity to sell her shares."<sup>348</sup> Stated in financial terms, her complaint was really that the Rodd family, acting collectively as a block of controlling shareholders, had given up nothing of substance—no real voting power—in exchange for \$36,000 of the company's cash.<sup>349</sup>

In holding for the Donahues, Chief Justice Tauro famously noted the "fundamental resemblance" that a close corporation bears to a partnership and established the rule in Massachusetts that shareholders in close corporations owe one another substantially the same fiduciary duty that partners owe to one another—namely, "the

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345. *Id.* at 510.

346. *Id.*

347. *See id.* (stating the Charles Rodd, Frederick Rodd and his daughter, Phyllis Mason, held a total of 153 shares to the Donahue's 50 shares—roughly seventy-five percent of the issued and outstanding shares of the corporation's stock). Euphemia's late husband, Joseph Donahue, had originally held 50 shares (or 20%) to Harry Rodd's 200 shares (80%). *Id.* at 509. Thus, the result of the transactions was to increase the Donahue family holdings from 20% to 24.6%.

To understand the extent of Euphemia's vulnerability, it is worth noting that, following the redemption of Harry's 45 shares, the three Rodd children's combined 153 shares represented 75.4% of the voting power. As a result, where the three children voted together, they controlled every corporate decision by a wide margin. Moreover, even if they split their votes, with one of the children siding with Euphemia, the remaining two children were nonetheless guaranteed to win—102 to 101. Thus, unless two of the three Rodd children sided with her, Euphemia's shares would never be counted with the majority. Furthermore, if two children did vote with her, Euphemia's 50 votes would still remain superfluous—the two children would win the contest over the third even if Euphemia abstained. Euphemia's 24.6% interest in the company, in other words, had exactly zero impact on the outcome of any vote where all the shares were voted.

348. *Id.* at 511.

349. Although the forty-five shares were returned to the corporate treasury, the Rodd family holdings only fell 4.6% (from 80% to 75.4%), thereby enabling them to retain complete control over the future and direction of the company. *See infra* note 347. It is also worth noting as well that each of Harry Rodd's two sons, as well as his daughter's husband, were employed by the company. *Donahue*, 328 N.E.2d at 519. Thus, each was presumably taking money out of Rodd Electrotpe in a form not available to Euphemia—salary and benefits. For a discussion of the use of compensation as a device to misappropriate the value of minority investments, see *supra* note 2. For a discussion of the use of employee compensation as a tax-planning device, see *supra* note 48.

utmost good faith and loyalty.”<sup>350</sup> The ruling stressed the need for “trust, confidence and absolute loyalty” among close corporation shareholders, implying that such relational values could somehow be inculcated, or at least enforced, by the legal system.<sup>351</sup>

What seemed to offend the court the most, however, was not so much a lack of cooperative spirit as the mere fact of disproportionate treatment. In stating its specific rule as to redemptions—that, in order to show good faith, a corporation that redeems shares from a controlling shareholder must also offer an equal opportunity to any interested minority investors<sup>352</sup>—the court seemed to find injustice in the fact that the Rodd family enjoyed the benefits of their control. For example, the court placed particular emphasis on the fact that the offer of redemption transformed Harry Rodd’s previously illiquid investment into a liquid one, while leaving Euphemia’s minority interest to remain forever illiquid.<sup>353</sup>

It is not clear, however, how creating increased liquidity for some shareholders injures others, given that liquidity is not a zero-sum game. In fact, corporation statutes do not generally require that redemptions be offered to all shareholders or none,<sup>354</sup> and Euphemia’s late husband, when making his original investment, must have known that he might never have the opportunity for an exit. Thus, it was not in the subjective injury per se that the court found affront. Rather, the court believed that apples should be compared to apples—that one share of the company’s stock should be treated, and valued, exactly the same as any other.<sup>355</sup> Contrary to the court’s assumption, however, each share of stock is not the same; shares that comprise a controlling interest are more valuable.<sup>356</sup>

The question that should have been asked was not whether the redemption at issue in *Donahue* was somehow inherently unfair because it treated the shares held by the minority and the majority differently, but whether such shares were indeed different. It was a leap to assume that the parties bargained for equal conduct without

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350. *Donahue*, 328 N.E.2d at 515. The court’s language is itself reminiscent of Judge Cardozo’s famous opinion in *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (“Not honesty alone, but the punctilio of an honor the most sensitive”).

351. *Donahue*, 328 N.E.2d at 512. See also Hetherington & Dooley, *supra* note 4, at 2 (emphasizing that the adoption of “special contractual arrangements is much less important than [the] ability to sustain a close, harmonious relationship”).

352. *Donahue*, 328 N.E.2d at 518.

353. *Id.* at 512.

354. See CLARK, *supra* note 49, § 14.4, at 625-31 (describing the operation and function of redemptions and repurchases).

355. For a critique of such an approach, see *supra* Part I.D.3 (discussing the equivalency of rights associated with shares of stock).

356. See *supra* Part II.B.2.

examining the price. The court's objective approach therefore ignored the particular intentions of the parties and so undermined their deal. It should have begun with an analysis of the parties' intentions in order to reinforce their private bargain.

In order to uncover the subjective particulars of the parties' deal, a court would typically begin with a close reading of the express provisions of the contract.<sup>357</sup> Rodd Electrottype's corporate charter, however, omitted any mention of supermajority voting procedures or other provisions that would have served to allocate a degree of influence to the Donahues.<sup>358</sup> Their agreement, therefore, presented front and center the interpretive problem of how to construe silence: did the omission of express guarantees signify regrettable oversight or a deliberate choice to adopt the default norm of majority rule? Certainly, the investment agreement itself could not shed any light on the parties' intentions.

Faced with this uncertainty, a traditional analysis of the equities would probably look next at the particular facts and circumstances of the case for evidence of the parties' intentions.<sup>359</sup> Rodd Electrottype, it turns out, existed as a corporation before any involvement by either the Rodds or the Donahues. Originally known as Royal Electrottype Company of New England, Inc., it had been a wholly owned subsidiary of Royal Electrottype Company before Harry Rodd and Euphemia Donahue's late husband, Joseph, purchased it for \$20 per share in 1955.<sup>360</sup> Presumably, if Harry and Joseph were sophisticated enough to structure a fairly complicated buyout of Royal of New England, they were also aware of the rather simple fact that the end result would be eighty percent control by Harry.<sup>361</sup>

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357. It is widely accepted that contract interpretation begins with the document's plain language. See, e.g., *Fort Vancouver Plywood Co. v. United States*, 860 F.2d 409, 413 (Fed. Cir. 1988) (stating that contract provisions are determined under a plain language analysis); *Arizona v. United States*, 575 F.2d 855, 863 (Cl. Ct. 1978) ("[P]rovisions of a contract must be so construed as to effectuate its spirit and purpose . . . and . . . an interpretation which gives a reasonable meaning to all of its parts will be preferred to one which leaves a portion of it useless . . . or achieves a weird and whimsical result.").

358. See *Donahue*, 328 N.E.2d at 519 (noting that while the Rodds owned stock separately, they voted as a block, essentially providing no protection to the Donahues).

359. See FARNSWORTH, *supra* note 15, § 7.10, at 453 (explaining that, in attempting to interpret the "plain and ordinary meaning" of a contract, "the court is free to look to all the relevant circumstances surrounding the transaction").

360. *Donahue*, 328 N.E.2d at 519.

361. See *Easterbrook & Fischel*, *supra* note 4, at 284 (noting that investors in close corporations are "better informed about their legal rights and obligations" than is often assumed).

Why, then, if Joseph knew he was acquiring unequal rights, would he have agreed to pay an equivalent (or, more properly, a proportional) consideration? One answer that suggests itself is that perhaps they did not believe they were contributing proportionately. Each, for example, had expertise to contribute. Perhaps they believed that the management expertise that Harry was contributing was more valuable than Joseph's operational expertise, thus suggesting that Harry did indeed pay a premium price for control.<sup>362</sup> On the other hand, given that Harry would be spreading his expertise over more shares, it is just as likely that they believed the eighty-twenty percent split accurately represented their contributions of both money and skill. Certainly, their actions were not so inconsistent with such an interpretation as to require a different result in the case.

A more rewarding factual inquiry might be to instead inquire why Harry included Joseph in the deal in the first place. The fact that Harry was liquid enough to finance the entire deal himself suggests that he did not need Joseph's money.<sup>363</sup> Rather, Harry more likely included Joseph so as to incentivize him to continue working as an employee after Harry took control and changed the company's name to Rodd Electrottype.<sup>364</sup> Giving Joseph a twenty percent stake may have amounted to a 1950s version of a modern stock incentive program, such as the grant of phantom stock or stock appreciation rights.<sup>365</sup> Although such shares would provide him neither a real say

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362. Harry Rodd and Joseph Donahue joined Royal of New England as employees in the mid-1930s, thereafter working their way up to being general manager and treasurer, and plant superintendent and corporate vice president, respectively. *Donahue*, 328 N.E.2d at 519. For an example of a partnership case where one party was allegedly compensated for his superior management expertise, see *Richert v. Handly*, 330 P.2d 1079, 1081 (Wash. 1958).

363. According to the facts, Harry loaned the company most of the \$75,000 that it paid at closing. *Donahue*, 328 N.E.2d at 509. Given that Joseph's investment amounted to only \$1,000, it is not a leap to imagine that Harry could have increased the loan to \$76,000 had he needed to.

364. See *id.* (noting that Joseph, at Harry's suggestion, decided to purchase shares in the corporation even though a majority of the financial backing would be coming from Harry).

365. See O'Kelley, *supra* note 6, at 220-21 (considering the possibility that "Rodd merely allowed Donahue to continue as a shareholder as an incentive-compensation device"). Stock appreciation rights, or SARs, grant the employee cash "equal to the excess of the fair market value of a share of the corporation's common stock on the date of exercise over the fair market value of a share on the date the right is granted." Rev. Rul. 80-300, 1980-2 C.B. 166. SARs are granted without cost to the employee and an employee does not have to own the corporation's stock to obtain a SAR. *Id.* "Phantom stock is '[a] right . . . to receive . . . an award with a value equal to the appreciation of a share of stock from the date the Phantom Stock is cashed out.'" *Whitt v. Sherman Int'l Corp.*, 147 F.3d 1325, 1327 (11th Cir. 1998) (quoting Coopers & Lybrand, *Executive Summary of Nonqualified Long-term Incentive Plans*, CV01

in management nor the guaranty of continued employment,<sup>366</sup> they would serve as an important symbol. Joseph would gain the important emotional feeling of having a stake in the enterprise. The shares also would provide an easy way to compensate Joseph for his efforts toward the success of the business—a direct share of any corporate dividends.

The problem with such a scheme, and perhaps one reason for the modern preference for stock incentive programs, is that in a private corporation the value of a minority stake is based almost entirely on the goodwill of the controlling shareholders.<sup>367</sup> Unless the board of directors, acting at the direction of the controlling shareholders, agreed to redeem the shares or declare a dividend, there would be no way for the employee to realize any value from her shares.<sup>368</sup> In this sense, such shares are more akin to a promise to be considered for a discretionary cash bonus plan. Under either structure, the minority holder would receive a payout only to the extent the controlling shareholders caused the company to declare a payment.<sup>369</sup> Because a company is always free to pay a bonus to any employee in any reasonable amount, minority share ownership, such as that held by Joseph Donahue, is generally redundant and, hence, largely ineffective as an employee incentive (other than as a morale booster).<sup>370</sup>

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ALI-ABA 619, 632 (1996)). Like SARs, phantom stock constitutes a form of employee compensation awarded to incentivize executives. *Chamison v. HealthTrust, Inc.*, 735 A.2d 912, 915 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000). The purpose of equity incentive plans like phantom stock and SARs is to align the interests of management and stockholders. *See Emmenegger v. Bull Moose Tube Co.*, 197 F.3d 929, 931 (8th Cir. 1999) (stating that the purpose of a phantom stock plan is to “promote the interests of the [c]orporation . . . by aligning the interests of senior management . . . with those of the stockholder”). For income tax purposes, both phantom stock and SARs are characterized as rights to receive future compensation and not as stock of the issuing corporation. Rev. Rul. 80-300, 1980-2 C.B. 166.

366. For a discussion of the relationship between minority oppression and employment law, see Douglas K. Moll, *Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution*, 1999 U. ILL. L. REV. 517 (1999) (describing the deficiencies in contesting termination of employment under the at-will doctrine in contrast with the advantages of making the claim under the oppression doctrine where the employee is also a shareholder).

367. *See Donahue*, 328 N.E.2d at 513 (noting that minority stockholders are at the mercy of majority stockholders in close corporations in terms of both monetary benefits and a role in corporate management).

368. *See Thompson, Shareholder's Cause of Action*, *supra* note 4, at 732 (noting that even if the minority shareholder is able to bring a derivative action “any recovery . . . remains under the control of the . . . defendants in the litigation”).

369. *See id.* at 702-03 (describing the use of dividend withholding as a form of squeeze-out technique).

370. They may, however, appear to have tax advantages by providing a means for distributing cash at lower rates. On the other hand, given that the payment of

If Joseph's investment represented little other than the privilege of participating in a discretionary cash bonus plan,<sup>371</sup> he could have had little expectation that his investment would be valuable beyond the life of Harry's goodwill toward him.<sup>372</sup> Thus, when the Rodd family finally did cut off the payments, there would seem to be little about their conduct that would constitute an unfair surprise. Joseph apparently took the job with the new company, and invested \$1,000, on the gamble that he would be repaid. Like any other business or investment risk, there is nothing inherently unjust about entering into a losing deal.<sup>373</sup> On the other hand, it is equally possible that Joseph expected to be able to sell his shares back to the company upon his retirement (or death) and that they represented not only participation in a discretionary cash bonus plan but also a sort of informal pension arrangement. In fact, the further one delves into the facts in search of evidence of the parties' intentions, the more complicated the analysis becomes and the more supposition that is necessary.

It is at this point, then, that a focus on the price offers a potential path out of the confusion. Where the facts and circumstances surrounding a dispute, as well as the express language of the agreement in question, fail to illuminate the parties' deal, an exploration of the price may provide the clues necessary to interpret their intent. In this way, the use of price may make possible a subjective analysis where traditional tools yield only confusion. If Joseph had paid a discounted price, for example, it might serve as evidence that he had already been compensated for bearing the risks

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dividends is not deductible to the company, their tax treatment may actually be less favorable than the payment of salary because of the resulting double tax. Moreover, because any dividends paid on such shares must also be paid to the majority in a proportionate amount, they are significantly less flexible than a discretionary cash bonus plan. See *supra* note 365 (discussing how the value paid on shares is determined).

371. The \$1,000 invested by Donahue may also represent bonding costs. At the time of the transition of the company from corporate subsidiary to Rodd-controlled private entity, Joseph may have believed it necessary to pledge his fidelity to Harry Rodd in order that Harry continue to partner with, and invest in, Donahue as a valued and trusted employee. See *Donahue*, 328 N.E.2d at 509 (noting that Joseph had served as an employee and had never served in management and at Harry's request, Joseph purchased fifty shares in the corporation knowing that Harry would have the majority of the shares).

372. See Hetherington & Dooley, *supra* note 4, at 2 (discussing the risks associated with a falling out among shareholders and a loss of a mutually trusting relationship).

373. See, e.g., *Protech Indus., Inc. v. URS Corp.*, 377 F.3d 868, 873 (2004) ("The purpose of the unconscionability doctrine is not to disturb the allocation of risks because of superior bargaining power, but to prevent oppression and unfair surprise.").

associated with his minority status.<sup>374</sup> A more productive line of inquiry would therefore be to ask how Euphemia (through Joseph) came to become a shareholder of Rodd Electrotpe in the first place. It is the initial investment transaction, then, that must be explored to determine the price that Joseph paid for the shares.

The acquisition of Royal of New England was structured as a two-step process. In the first step, Harry Rodd purchased 200 shares and Joseph Donahue 50 shares.<sup>375</sup> Each paid twenty dollars per share and acquired their shares directly from the parent company, leaving the parent with 725 of the 1000 outstanding shares.<sup>376</sup> In the second step, Royal of New England redeemed the parent corporation's 725 shares for \$135,000.<sup>377</sup> Of this amount, \$75,000 was paid in cash at closing, most of which appears to have been financed by a loan from Harry.<sup>378</sup> The remainder was payable in installments over five years.<sup>379</sup>

Thus, Harry and Joseph each paid identical amounts per share for their interests in the company. Moreover, the consideration for the 725 shares to be retired was paid out of the company's future revenues—revenues that otherwise would have benefited Harry and Joseph proportionately, in accordance with their relative share ownership.<sup>380</sup> The proportional structure of their initial investment transaction therefore seems to suggest that Harry and Joseph intended their interests to represent equal claims. Omission, in this case, appears to have resulted from oversight, and the later redemption of Harry Rodd's shares appears to have constituted an unfair surprise.

An analysis of the price, then, suggests an alternative basis for the court to have found in favor of the Donahues. Joseph paid full and

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374. See *supra* Part II.C.

375. *Donahue*, 328 N.E.2d at 509.

376. *Id.* The remaining twenty-five shares appear to have been owned by an individual identified only as Lawrence W. Kelley. *Id.* As they were redeemed by Royal of New England for \$1,000 as part of step two—for a tidy profit of \$500—their exact disposition is unimportant, as is the identity of Kelley. *Id.*

377. *Id.*

378. *Id.* Although Harry Rodd appears to have contributed most of the \$75,000 that was used to redeem the parent corporation's shares, he was acting as a lender, not an equity investor. *Id.* This amount was presumably repaid with interest and so does not represent a disproportionate investment in the company and so does not impact an analysis of price. *Id.* at 509-10.

379. *Id.*

380. *Id.* at 509. Interestingly, the acquisition of Royal of New England by Harry and Joseph appears to have been structured as a sort of crude management-led LBO. *Id.* at 509. The two financed their acquisition of the company with \$5,000 of their own cash as equity, together with two loans against the corporation's assets—one payable to the parent corporation and one to the bank of Harry Rodd—for the remaining \$135,000. *Id.* Over 96% of the purchase price, in other words, would be paid from the future revenues of the company. *Id.*

equal value for his shares, without minority discount. Their subsequent treatment as minority shares by the Rodd family was therefore inequitable and represented a misappropriation of the value of Joseph's investment. Joseph was never compensated for the additional risks he bore by agreeing to be a vulnerable minority investor, and so the Rodd family exceeded their discretion by treating their shares as superior in right. The blunt instrument of the court's objective approach thus yielded the same result in this case as would a subjective analysis of the parties' bargain through the lens of price.

Though the result was the same, a focus on the price yielded a more nuanced and more solid understanding of the parties' intentions than did a traditional exploration of the facts and circumstances. Price, then, served its purpose as a diagnostic tool, and would have allowed the court to uncover the true extent of the parties' bargain with a higher degree of certainty. Joseph Donahue paid the same price per share as did Harry Rodd. One can therefore deduce that he either was ignorant of the risks he was assuming or believed that his investment had equal (or, more accurately, proportional) value. To the extent he was ignorant, the omission from their bargain of language protecting him from abuse was an oversight that led to an unfair surprise. Alternatively, to the extent he believed his shares and those purchased by Harry were equivalent in right, the Rodd family's redemption unfairly subordinated his investment to that of Harry and constituted oppression. Either way, the similar pricing of the shares suggests that the parties intended equal treatment. Joseph, however, was denied the benefit of his bargain.

#### B. Ebrahimi v. Westbourne Galleries

Though an English case, *Ebrahimi v. Westbourne Galleries*<sup>381</sup> served as an important influence on the early development of the American response to minority vulnerability.<sup>382</sup> Preceding *Donahue* by about two years, it was hailed at the time as "the most significant decision on minority shareholder remedies delivered during the past two

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381. [1972] 2 All E.R. 492.

382. See Thompson, *Corporate Dissolution*, *supra* note 4, at 212 (tracing the impetus for the development of the reasonable expectations standard in the United States to the scholarly work of Afterman and O'Neal and to the House of Lords' decision in *Ebrahimi*); O'Neal, *supra* note 4, at 885 ("Perhaps the decision that has propounded [the concept that the law should protect the reasonable expectations of minority investors] most forcefully is a 1972 decision of the House of Lords, *Ebrahimi v. Westbourne Galleries Ltd.*").



decades.”<sup>383</sup> It addressed another common expression of opportunistic behavior—the dismissal of an employee who was also a minority shareholder—and serves as a useful contrast to *Donahue*.<sup>384</sup>

Plaintiff Ebrahimi and the defendant, Nazar, had organized a private company in 1958 as equal shareholders.<sup>385</sup> Each paid £500 and received 500 shares.<sup>386</sup> “Soon after the company’s formation,” however, Ebrahimi and Nazar each sold an equal portion of their shares to Nazar’s son, making the ownership structure forty percent for each of Ebrahimi and Nazar, and twenty percent for the son.<sup>387</sup> Assuming that Nazar and his son would pool their votes, and because the contract omitted any special protections for Ebrahimi, the Nazars therefore exercised near complete discretion over the corporation’s affairs.<sup>388</sup>

The court found in favor of the employee Ebrahimi, holding that his dismissal did not satisfy the English “just and equitable” standard.<sup>389</sup> As in *Donahue*, the court seemed offended not so much by the particular conduct at issue but rather by the inherent inequality present in the arrangement.<sup>390</sup> The court emphasized in its opinion that the Nazars treated—and indeed seemed to regard—Ebrahimi as a subservient employee rather than as a co-equal partner.<sup>391</sup> He was, as the court noted, “at the mercy” of the controlling shareholders.<sup>392</sup> The Nazars, for example, had the power to pay out the profits to themselves in the form of salaries, thereby depriving Ebrahimi of the value of his investment.<sup>393</sup>

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383. F. Hodge O’Neal, *Introduction*, 22 WAKE FOREST L. REV. 1 (1987) (quoting L. H. Leigh, *Just and Equitable Winding Up*, 88 LAW Q. REV. 468 (1972)).

384. *Id.*

385. *Ebrahimi*, 2 All E.R. at 492. Although the form of entity at issue in *Ebrahimi*—a private company governed by the English Companies Act—is not the same as an American close corporation, the two forms are close enough as to make the English precedent relevant for US legal decision-making. See Lutter, *supra* note 24, at 7-8 (describing a private company as one “whose shares were held by a few members, were not offered for public subscription, were not traded on the stock exchange, and whose transferability was restricted by the articles of association”).

386. *Ebrahimi*, 2 All E.R. at 492.

387. *Id.*

388. See *id.* (stating that Nazar and his son abused their power by excluding Ebrahimi from exercising any control and from participating in the management of the business).

389. *Id.* at 500-01.

390. See *id.* (stating that removing directors from the board is a normal course of business for companies but that does not mean the removal is always justified, especially where one partner is excluded from the management of the company).

391. *Id.* at 501 (“Mr. Nazar made it perfectly clear that he did not regard the appellant as a partner; but did regard him as an employee.”).

392. *Id.*

393. Running counter to this concern, however, was the fact that Nazar had apparently made assurances to the court that the company’s prior policy of not

*Ebrahimi*, then, would appear quite similar to the decision in *Donahue*, and in fact both served to further the protection of minority investors in their own jurisdictions.<sup>394</sup> In both cases, the courts took an objective approach to the problem by ignoring the possibility that the controlling shareholders had bargained for the discretion to engage in the conduct at issue. The Nazars, for example, made assurances to the court that they would pay dividends to Ebrahimi.<sup>395</sup> In other words, their conduct was not intended to make his investment unprofitable, but merely to remove him as an officer and director.<sup>396</sup> Is it not possible, however, that the Nazars had paid ex ante for the right to control management? Share ownership is not usually co-extensive with guaranteed employment, so this does not appear to be an unreasonable assumption.<sup>397</sup> The court, however, ignored the question of the parties' unique bargain and instead imposed its own view of proper commercial behavior. The English "just and equitable" standard, according to the court's approach, was to be interpreted by the judge, not bargained over by the parties.<sup>398</sup>

Using price to approach the case from a subjective viewpoint, however, one quickly uncovers evidence regarding the parties' intentions as to how much discretion would be allocated to the Nazars. As was the case in *Donahue*, the parties appear to have paid equal consideration for their shares, thus suggesting that they believed they were purchasing equivalent rights.<sup>399</sup> Had Ebrahimi paid less than Nazar for his shares, it might have been possible to infer that the parties deemed his shares less valuable, presumably because of a mutual understanding that Nazar's shares possessed the additional attributes of control and discretion.<sup>400</sup> This, however,

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paying dividends would be reversed, such that Ebrahimi would receive distributions of corporate profit. *Id.*

394. See Thompson, *Corporate Dissolution*, *supra* note 4, at 212 (discussing the importance of the decision of the House of Lords in *Ebrahimi* to extend the English "just and equitable" standard to the realm of minority oppression).

395. *Ebrahimi*, 2 All E.R. at 501.

396. See *id.* (explaining that while Ebrahimi would not have retained his position as a director, he would have retained dividends from his shares).

397. But see Moll, *supra* note 366, at 523 ("In the traditional public corporation, the typical shareholder is an investor who neither contributes labor to the corporation takes part in the responsibilities of management. In contrast. . . . Close corporation shareholders usually expect employment.") (citations omitted).

398. See *Ebrahimi*, 2 All E.R. at 500-01 (stating that it was unjust for the Nazars to exclude Ebrahimi from the management of the business even though it was evident that Nazar thought of Ebrahimi as an employee rather than a business partner).

399. *Id.* at 492.

400. See *supra* Part I.D.3.

appears not to have been the case. Rather, they each invested an identical one pound per share.<sup>401</sup>

Taking a closer look at the structure of the consideration, however, one uncovers a more nuanced, and perhaps unexpected, story—certainly one overlooked by the court. Though the facts are somewhat vague on this point, it appears from the opinion that Nazar had been engaged in the business of dealing in carpets before forming a new company with Ebrahimi.<sup>402</sup> In other words, the business was not commenced at the time Nazar and Ebrahimi joined forces; the business was a continuation of the prior one. Thus, Ebrahimi did indeed pay a discounted price for his shares in that he contributed only £500 cash, whereas Nazar apparently contributed £500 cash plus the assets and goodwill of the prior business.<sup>403</sup> Depending on the value of the prior business, it is even possible that the two £500 payments represented only a small portion of the business's actual value. In this way, the money itself could even have been essentially symbolic, much like the clods of dirt once exchanged to signify the sale of real property.<sup>404</sup> In fact, although the case does not provide the facts necessary to be sure, Nazar's insistence that he regarded Ebrahimi as his employee rather than his partner suggests that Ebrahimi's investment—unlike Joseph Donahue's—may indeed have represented an employee incentive scheme rather than a true partnership stake.<sup>405</sup> Why else would Ebrahimi have been willing to sell twenty percent of his shares back to Nazar and his son for little or

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401. *Ebrahimi*, 2 All E.R. at 492.

402. *Id.* at 492-93.

403. *Id.* at 492. Ebrahimi and Nazar had run the business for many years as a partnership, with each taking an equal share of the profits. *Id.* It was only after incorporating the business that they reconfigured the ownership to reflect the forty-four percent split that existed at the time of the trial. *Id.* While this additional wrinkle seems to suggest that the two both contributed equally to the private company, in that both contributed the assets and goodwill of the partnership, it does not so much change the story as move it back in time. Rather than contribute unequally to the private company, the two seem to have contributed unequally to the partnership. Given that the case is based in equity, however, it seems appropriate to carry this inequality forward through the different structures in order to discover whether the parties' investments were intended to be treated as equally valuable, or whether the parties' actions implied that they believed a fundamental inequality existed—one for which a price adjustment was made.

404. The ancient English custom of exchanging "a twig, a clod of dirt, or a piece of turf" to symbolize the sale of real property was known as the "livery of seisin." BLACK'S LAW DICTIONARY 953 (8th ed. 2004). See also *Tennant v. John Tennant Mem'l Home*, 140 P. 242, 244 (Cal. 1914) (explaining that a transfer accomplished by means of the manual delivery, in front of witnesses, of a clod or piece of turf served to make such transfer irrevocable).

405. See *supra* notes 369-70 and accompanying text (discussing SARs, phantom stock, other employee incentive plans generally).

no gain, thereby entrenching his minority status in the company's capital structure?

Unlike in *Donahue*, then, an analysis of price in *Ebrahimi* suggests a different outcome than does an objective approach. If Nazar did indeed contribute valuable assets and goodwill from a prior business in addition to the £500 cash amount, then he paid a premium price for his interest, presumably because the parties never contemplated equal treatment. Rather, they allocated to the Nazars a large degree of discretion over the company's operation.

To the extent the Nazars made oral or implicit promises to induce Ebrahimi to remain employed with the business, such an injustice could have been remedied by principles of either contract law or employment law.<sup>406</sup> With respect to corporation law, however, it would appear that Ebrahimi was previously compensated for assuming the risk that his employment could be terminated. He was admittedly at the mercy of the Nazars, but the fact of his lowly status was not itself an injustice but rather the nature of their bargain.<sup>407</sup> Certainly, there would have been no sense of injustice had Ebrahimi received shares of a non-voting class of stock. The court's decision in favor of Ebrahimi therefore gave him a dual benefit at the expense of the Nazars. Having contributed a disproportionately small amount of the consideration, Ebrahimi was erroneously treated by the court as if his interest was equivalent to that of the Nazars.

Again, as was the case in *Donahue*, the court in *Ebrahimi* failed to measure the controlling shareholders' conduct against the allocation of power adopted by the parties. Rather than seek to apply the allocation of power elected by the parties, the court applied its own opinion as to the proper scope of permissible commercial behavior. The court's mistake was in reading the omission of special protections as oversight, when in fact there was no omission.<sup>408</sup> The parties' preferred allocation of the risk of control was embedded in the structure of the consideration.<sup>409</sup>

To judge the equity of Ebrahimi's termination, it is necessary to consider whether the parties' bargain gave the Nazars discretion over

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406. See Moll, *supra* note 4, at 989 (discussing the relationship between the governance of close corporations and the principles of contract law); Moll, *supra* note 366, at 517 (discussing the relationship between the governance of close corporations and the principles of employment law).

407. See *supra* notes 28-34.

408. See *Ebrahimi*, 2 All E.R. at 500-01 (discussing the relationship between Nazar and Ebrahimi). Although Nazar believed the relationship to be one of employer and employee, the court believed the relationship to be one of equal partners. *Id.*

409. See *id.* at 492 (describing the beginning of the corporation and what assets each partner brought to the corporation).

such matters. Here, then, in contrast to *Donahue*, the blunt instrument of an objective approach to the problem of minority vulnerability resulted in a different outcome than would have a more precise, price-based analysis. By focusing on the deal's negotiation of price, then, it is possible in some cases to avoid injustice by granting the parties the benefits of their bargain. Rather than comparing allegedly opportunistic behavior to an idealized norm, an analysis of price frequently provides a mechanism for enforcing the parties' actual deal.

### CONCLUSION

A flexible norm is generally superior to a uniform and mandatory rule.<sup>410</sup> By giving the parties the benefits of their bargain, rather than imposing an allocation of risk that the court prefers, the legal system encourages and reinforces private contracting.<sup>411</sup> This enables parties to negotiate the allocation of risk that is optimal for their own circumstances and for the circumstances of their particular corporate enterprise.<sup>412</sup> Moreover, by attempting to recreate and enforce the parties' preferences, a subjective approach also serves a broad liberty interest. All else being equal, there is a good to be achieved by allowing investors the freedom to bargain over and structure their own affairs.

When a default approach is not possible, however, it may admittedly be necessary to apply a mandatory one. Many minority investors are certainly the victims of oppression, although its precise frequency cannot be known.<sup>413</sup> When it is unclear whether the omission of contractual protections represents oversight or intention, legal intervention may be necessary to avoid an injustice.<sup>414</sup> By erring on the side of protecting minority investors, the use of an objective standard is likely to provide a just result in most cases, as it did in *Donahue*.<sup>415</sup> The lack of sophistication of many small investors makes

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410. See Butler & Ribstein, *supra* note 4, at 32 (arguing for the establishment of a presumption in favor of private ordering). Skepticism regarding the competence of policymakers to second-guess the judgment of investors and businesspeople lies at the heart of the business judgment rule. See *supra* notes 93 and 178.

411. See Butler & Ribstein, *supra* note 4, at 64 (arguing that "the dominant trend in corporate law over the last 200 years has been to free corporate law from its state concession origins and treat it as a contractual relationship").

412. See *id.* at 46 (arguing that "legal regulation of the right of contract should be based on particularized circumstances").

413. See Easterbrook & Fischel, *supra* note 4, at 284 ("The extent to which minority shareholders are ignorant of problems they might face and thus fail to protect themselves is impossible to tell.").

414. See Chander, *supra* note 1, at 121, 124.

415. See *supra* Part III.A.

it likely that omission is often indicative of oversight rather than of intention.<sup>416</sup> An objective standard of permissible commercial conduct also serves an important educational role.<sup>417</sup> Its use should therefore not be casually discarded. Rather, an objective standard should be used to evaluate potentially opportunistic behavior when a subjective approach proves impossible.

Price, because it serves as a proxy for risk, can illuminate the parties' deal. In this manner, it can be used as a tool for uncovering and interpreting the range of behavior that the parties themselves had contemplated.<sup>418</sup> Where traditional methods of interpreting contracts fail to shed light on the meaning of contractual silence, exploring the relative prices the parties paid may often yield an insight. A price-based approach to contract interpretation—at least in the context of close corporations—makes it possible to protect deserving minority investors while still treating the courts' objective standards as default norms that the parties may waive.<sup>419</sup>

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416. See O'Neal, *supra* note 4, at 883 ("A person taking a minority position in a close corporation often leaves himself vulnerable to squeeze-out or oppression by failing to insist upon a shareholders' agreement or appropriate charter or bylaw provisions.").

417. See Lawrence E. Mitchell, *Cooperation and Constraint in the Modern Corporation: An Inquiry into the Causes of Corporate Immorality*, 73 TEX. L. REV. 477, 527 (1995) (arguing that within traditional moral discourse there is room for law to create moral accountability by reinvigorating the autonomy of corporate actors).

418. See *supra* Part II.C.

419. For a discussion of the advantages of a price-based approach to minority oppression over traditional oppression doctrines, see *supra* text accompanying notes 203-10.