PROTECTING MINORITY OWNERS OF SMALL AND FAMILY-OWNED FIRMS

by

Robert Sprague* and Roland E. Kidwell**

INTRODUCTION

According to a U.S. Census Bureau survey, approximately sixty percent of businesses in the United States have only one owner.¹ The remaining forty percent represent approximately 10.8 million businesses with potential ownership structures leaving one or more individuals with a minority ownership share of the business.² And some twenty-eight percent of these enterprises, perhaps 3 million businesses, are family owned—meaning that two or more members of the same family own a majority of the business.³ Small firms have two relatively unique governance environments: first, ownership interests are fairly illiquid, meaning owners may have difficulty selling their interest in the firm; and second, these firms are usually actively managed by the majority owners. With family owned firms, an additional familial dynamic is added to this environment which may place the interests of family members over nonfamily-member owners.

This paper explores strategies for protecting the interests of minority owners in small and family-owned firms, from both legal and managerial perspectives. From the legal perspective, courts generally impose fiduciary duties on majority owners to prevent oppression of minority owners. However, the origins of this fiduciary duty may arise from general corporate law or from partnership law.⁴ They are similar, but not, as discussed in this paper, the same. In addition, which fiduciary duty will be applied is not always entirely clear. Even if the small or family-owned business in question is a corporation, or an LLC, courts sometimes apply a partnership derived fiduciary duty under the theory that small—also known as “close”—corporations are for all practical purposes, from a managerial perspective, partnerships. The principal drawback of applying the corporate-derived fiduciary duty is that it is based on the law as it is applied to large publicly traded firms which operate in a vastly different managerial environment.

This paper also examines family dynamics within firms from a managerial perspective, highlighting various ways in which family-member majorities can abuse nonfamily, minority owners. This paper explores a theoretical construct illustrating the dynamics between board dysfunction within small and family-owned firms and associated legal protections. This paper concludes by identifying further research opportunities from empirical, managerial, and legal perspectives.

ORIGINS AND NATURE OF CORPORATE FIDUCIARY DUTIES

Corporations are not the dominant form of business in the United States, at least in terms of numbers. They comprise less than eighteen percent of all nonfarm proprietorships, partnerships and corporations.⁵ When it comes to revenues, however, corporations dominate with over eighty percent of reported business receipts.⁶ And it is a relatively few corporations, predominantly publicly traded, that generate the most receipts.⁷ A fundamental characteristic of the corporate form of business is that it is owned by shareholders and governed by directors, who are themselves elected by the shareholders. In large corporations shareholders outnumber directors. As a result, shareholders place their trust in directors to manage the business in the best interest of the shareholders.

Adam Smith recognized in the eighteenth century the potential conflicts of interest between owners and managers when managers had access to firm resources but a minimal stake in the efficient allocation of those resources.⁸ As publicly traded corporations grew in size in the latter part of the nineteenth and early twentieth centuries, Berle and Means showed that corporate shareholdings were becoming more dispersed, and control of the corporation was shifting from the shareholder-owners to the manager-directors—to the extent that shareholders were simply suppliers of capital with no power to participate in management.⁹ They noted that the extensive separation of ownership and control gave rise the question of whether legal and social pressure should be applied to ensure corporations were operated primarily in the interests of shareholders, or whether other and wider interests should be considered.¹⁰ Berle and Means argued that “[a]ll the powers granted to management and control are powers in trust[!]” for the benefit of the shareholders.¹¹

Jensen and Meckling retuned to this issue in the 1970s from the perspective of principal-agent, noting once again that managers—the agent—may not always act in the best interests of the shareholders—the principal.¹² Jensen and Meckling argued that asking what the role of the firm was or whether it had any social responsibility was misleading, viewing the firm as nothing more than a series of contracts which brought conflicting interest into equilibrium.¹³ Those conflicting interests can be measured in equity—the lower the manager’s equity the more likely he will appropriate larger amounts of corporate resources in the form of perquisites.¹⁴ In response to Jensen’s and Meckling’s principal-agent theory, greater proportions of

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equity have been granted to management in the theory that their conduct will be more closely aligned with the interests of the remaining shareholders. Again, this approach focuses on managing the firm to maximize shareholder wealth.

This evolution of shareholder primacy is reflected in statements on corporate responsibility published by the Business Roundtable, an association of CEOs of leading U.S. companies. In its 1981 Statement on Corporate Responsibility, the Business Roundtable stated that decision making requires an understanding of the corporation’s many constituencies, including customers, employees, communities, society at large, suppliers, and, lastly, shareholders. As for shareholders, the Statement’s emphasis was that “the corporation must be profitable enough to provide shareholders a return that will encourage continuation of investment.” Contrast the Roundtable’s 1981 Statement with the change in emphasis in the Roundtable’s 2010 Principles of Corporate Governance, which focuses on conduct for the benefit of shareholders and other interested parties.

But there remains the risk that managers, as shareholders, will act in their own short-term equity-related interests to the detriment of the long-term interests of investor-shareholders. From this concern, a formal business judgment rule has developed: “a presumption 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.” The presumption underlying the business judgment rule will apply when there is no evidence of fraud, bad faith, or self-dealing on the part of the directors. Fundamentally, in order to rebut the presumption, disgruntled shareholders must present evidence that the directors breached their fiduciary duties of due care, good faith, and loyalty.

In reality, an examination of directors’ fiduciary duties under the business judgment rule hinges on whether they acted in good faith, based primarily on either self-dealing or gross negligence. For example, an allegation that a director breached her fiduciary duty of care is the same as an allegation of gross negligence. However, the burden of a plaintiff to rebut the presumption of the business judgment rule by showing gross negligence is a “difficult one.” In order to establish a breach of the duty of care, a plaintiff must show that the directors were grossly negligent through a “reckless indifference to or a deliberate disregard of” their duties to protect shareholders’ interests. As such, duty of care violations are rarely found.

Corporate officers and directors are also not permitted to use their position of trust and confidence to further their private interests, meaning that directors must exhibit an undivided and unselfish loyalty to the corporation. “Deliberate indifference and inaction in the face of a duty to act is . . . conduct that is clearly disloyal to the corporation.” A plaintiff must show that the directors had actual or constructive knowledge that their conduct was legally improper and that they “knowingly violated a fiduciary duty or failed to act in violation of a known duty to act, demonstrating a conscious disregard for [their] duties.”

Finally, courts will not substitute their judgment for that of the board if the board’s decision is based on any rational business purpose. This doctrine focuses on the decision making process rather than on a substantive evaluation of the merits of the decision, which assumes that, in hindsight, courts are not qualified to evaluate whether directors made a “right” or “wrong” decision. It does not matter how “stupid,” “egregious,” or “irrational” a board decision may be in hindsight; as long as the process employed was either rational or employed in a good faith effort to advance corporate interests, the courts will not impose liability.

Second-guessing the substantive merits of a business decision is prohibited by the business judgment rule.

As this brief analysis demonstrates, the burden for a shareholder-plaintiff to establish that members of the board of directors have breached the business judgment rule is quite high. First, courts will presume that directors acted properly without evidence to the contrary. Second, the shareholder-plaintiff will have to establish that the directors were either grossly negligent, involved in self-dealing, or consciously disregarded a known duty to act. Unless one or more of these substantial burdens is met, courts will not question a board’s decisions, regardless of how stupid, egregious, or irrational they may be. It is this doctrinal foundation that underlies judicial review of board actions—in most cases regardless of the size or composition of the firm.

MINORITY OPPRESSION IN CLOSE CORPORATIONS

Most courts recognize that close corporations bear a striking resemblance to partnerships, to the extent that they are sometimes viewed as little more than an “incorporated partnership.” Unlike the typical shareholder described by Berle and Means that does little more than contribute capital, close corporation shareholders often contribute skills, experience, and labor beyond just capital. Because most shareholders in a close corporation are actively involved in managing the firm, they are more dependent upon each other for the success of the firm. One commentator has even described a close corporation as one in which “the identity of ownership and management is so complete that the independent judgment of directors is a fiction.”

Minority shareholders are vulnerable to abuse by controlling shareholders who manage the corporation, often in the form of controlling shareholders: refusing to declare a dividend; paying themselves exorbitant salaries and bonuses; paying exorbitant prices for property purchased or rented by the corporation from themselves; selling corporate property to themselves at highly discounted prices; or refusing to provide employment to minority shareholders. The high burdens to
establish a breach of the business judgment rule often leave minority shareholders with the unenviable choice of either suffering their losses or selling their shares.50 But unlike a shareholder in a publicly traded corporation, there is no ready market for shares in a close corporation.41 This is why some courts have held that shareholders in close corporations owe one another substantially the same fiduciary duty as do partners in a partnership.42 These duties are stricter than the duties directors owe to shareholders in publicly traded corporations.43

Courts early on demonstrated a reluctance to apply the business judgment rule to close corporations. For example, when the father and son who owned majority shares and had control of a scrap metal business were accused of diverting funds to which the corporation was entitled for their own personal use, the Seventh Circuit Court of Appeals concluded that if a shareholder is being unjustly deprived of dividends, then the court “will not permit management to cloak itself in the immunity of the business judgment rule.”54 In addition, the court placed the burden upon the father and son to establish the reasonableness of the compensation they paid themselves, presuming they acted in their own self-interest.55

While these views have been adopted by a number of states, they are not unanimously applied.46 In addition, Benjamin Means has argued that the partnership-based standard provides little useful guidance to courts:

If the majority must sometimes put the minority’s interests ahead of its own, or those of the corporation, the standard is unhelpfully vague, risks empowering minority shareholders to demand disproportionate benefits from the corporation, and treats the decision to incorporate a business . . . as inconsequential. Indeed, taken to its logical conclusion, the approach thwarts the majority’s ability to manage the business at all.47

Delaware courts continue to apply the same fundamental director fiduciary duties for publicly traded and close corporations.58 The Delaware courts will closely examine a corporate decision when directors are on both sides of the transaction.49 This “entire fairness test” requires directors in such a situation to show that the transaction was conducted in good faith and contained a fair price.50 However, the Delaware courts adhere to business judgment rule standards if the minority shareholders are alleging some form of oppression on the part of the controlling shareholders-managers.51

Restricting or withholding dividends exemplifies how the application of the business judgment rule for a close corporation can be especially troublesome.52 In the absence of dividends, the minority shareholder may face an indefinite future with no return on invested capital; meanwhile, the majority shareholders may even be able to deny the minority shareholder any return in the long run by siphoning off corporate assets in the form of high salaries or rents.53 Because whether to declare a dividend is generally at the discretion of the directors, this behavior can be insulated from judicial review by the business judgment rule.54 In all likelihood, the complaining minority shareholders might have to prove the board’s decision was in bad faith or irrational.55

Though decided sixty-five years ago, Gottfried v. Gottfried represents not only a family owned, close-corporation compensation scenario, but also represents the courts’ general attitudes towards such disputes.56 In Gottfried, the plaintiffs, minority shareholders who were not directors nor on the corporate payroll, claimed they were subject to bitter animosity on the part of the defendant-directors, who owned a controlling block of stock, and who had no interest in paying dividends because of their excessive salaries, bonuses, and corporate loans to themselves.57 The plaintiffs claimed this “starvation dividend policy” was being used to compel them to sell their stock to the majority interests at a grossly inadequate price.58 While acknowledging that intense hostility of the controlling faction against the minority, exclusion of the minority from employment by the corporation, high salaries, or bonuses or corporate loans made to the officers in control, and a desire by the controlling directors to acquire the minority stock interests as cheaply as possible are all factors in determining bad faith, as well as conceding that closely held corporations are easily subject to abuse on the part of dominant stockholders,59 the court nevertheless concluded that the directors’ policy regarding common stock dividends was not unduly conservative and not inspired by bad faith.60

By way of comparison, the bad faith standard applies in other contexts. In Stuparich v. Harbor Furniture Manufacturing, Inc.,61 two sisters, minority shareholders who disagreed with the manner in which the corporation was being run by the sisters’ brother and his wife and son, sought to dissolve the corporation, alleging the brother and his wife and son kept the business operating only so they could continue paying themselves over $200,000 per year in salaries and that the corporation had continued to pay dividends while incurring substantial losses.62 The sisters also argued that dissolution was necessary because the relationship between the sisters and their brother had deteriorated to the point of violence and the “rancor and animosity” between the sisters and their brother had made it impossible for them to work together in any fashion, either as a family or as a corporate entity.63 The court concluded that as minority shareholders, the sisters were not entitled to substitute their business judgment for their brother’s with respect to the viability of the firm’s operations, particularly where, despite acting out of fear for their own safety, they had removed themselves from participation in management.64

An additional approach to protecting minority shareholders in close corporations is to evaluate those shareholders’ reasonable expectations. For example, as exemplified in Wilkes v. Springside Nursing Home, Inc., minority shareholders might expect continued employment by or management involvement in the firm as a component of ownership.65 These expectations beyond simply having a right to vote for directors and to participate in dividend distributions.66 The reasonable expectations approach can even trump the business judgment rule. For example, in In re Topper, the court concluded that where two of the controlling shareholders discharged the third shareholder, that action severely damaged the third shareholder’s reasonable expectations and constituted a freeze-out of his interest.67 The court stated that whether the controlling shareholders discharged the third shareholder for cause or in their good business judgment was irrelevant.68
Reasonable expectations will not necessarily vary from shareholder to shareholder but can from corporation to corporation. For example, one could also argue that expectations underlying shareholder relationships in a family owned corporation may be quite different than those in a venture capital-funded start-up. The reasonable expectations approach is therefore much more flexible, as conduct which is oppressive in one corporation might be unobjectionable in another. But, as Peeples points out, these generalizations suggest the difficulty of identifying a shareholder’s reasonable expectations and problems of proof will be inevitable. And while reasonable expectations may not vary from shareholder to shareholder, it is possible that among shareholders they can vary over time. A final significant drawback to the reasonable expectations approach is that it turns on a hypothetical expectation and becomes a fictional device for courts to adjust the parties’ relationship after the fact. Means concludes that the reasonable expectations approach therefore “seems to invite protracted and expensive litigation over contested issues of fact that may be very difficult to prove or disprove.”

Final alternatives for alleviating minority shareholder oppression involve judicial dissolution of the corporation or a court-ordered buyout of minority shareholders’ shares. Since there is no ready market for close-corporation shares, providing an incentive for majority shareholders to mistreat minority shareholders in order to try to force a buyout of their shares at a low cost, many states have enacted statutes that allow courts to dissolve a corporation if those in control of the corporation have acted in a manner that is illegal, oppressive, or fraudulent. Two cases exemplify grounds for dissolution. In In re Kemp & Beasley, Inc., two long-time minority shareholder-employees ended their employment with the corporation. While they had been employed, the corporation had a policy of awarding de facto dividends, based on stock ownership, in the form of “extra compensation bonuses.” After the two minority shareholders left, the corporation changed its policy to award extra compensation solely on the basis of services rendered to the corporation. In affirming the corporation’s dissolution, the court agreed this policy change was oppressive. In Giannotti v. Hamway the Supreme Court of Virginia affirmed a court-ordered corporate dissolution in which the controlling shareholders had paid themselves nearly $2.8 million over a ten year period while only distributing $132,000 in dividends, of which $50,000 was paid to the complaining minority shareholder-plaintiffs. The court concluded there was “abundant, credible evidence to support the trial court’s conclusions that [the] defendants engaged in oppressive conduct.”

But dissolving a corporation is a drastic step. One alternative to dissolution is a court ordered buyout of the complaining minority’s shares by the corporation. A range of courts have held that although statutes provide for the dissolution of the corporation upon a finding of oppression of minority shareholders, they have the equitable power to order a buyback when dissolution is too harsh of a remedy. The challenging issue for the buyback alternative remedy, however, is setting a fair value for the shares. In most cases, courts will look to statutory formulas used to value dissenting shareholders’ ownership in the corporation. There are a number of factors that must be considered when attempting to value a close corporation’s stock, considering there is no ready market for the shares: the nature of the enterprise; leverage; discount; net asset value; market value; management; earnings and dividends; expenses of operation; and the firm’s tax situation. Determining the fair value of a shareholder’s interest in a close corporation has been characterized as frustrating and daunting, riddled with subjective components of value and numerous complexities and unique circumstances surrounding each case.

Ultimately, regardless of how the court views the close corporation—as just another corporation subject to the same standards as a publicly traded firm or an “incorporated partnership”—the business judgment rule clouds the analysis. As noted above, courts may exercise equity powers to fashion alternative remedies. As Peeples argues however, while courts claim that equity will intervene in cases of true oppression, the business judgment rule often inhibits proper analysis.

Minority Oppression in Limited Liability Companies

Limited liability companies (LLCs) have become a popular alternative to the close corporation, in that they provide pass through taxation advantages similar to a partnership while promising the corporate advantages of continuity and limited liability. What is the standard of care that the LLC managers—in lieu of directors—owe to one another, and particularly to minority owners? State LLC statutes are almost evenly divided between requiring a duty to exercise standard care or prudence and requiring managers to refrain from grossly negligent or intentional misconduct. And then there is Delaware, which allows fiduciary duties in LLCs to be expanded, restricted, or eliminated by contract, except for the implied contractual covenant of good faith and fair dealing. To date, only two cases have directly addressed fiduciary duties under Delaware’s statutory provision. In Wood v. Baum, an LLC member—in lieu of shareholder—brought a derivative action against other members of the LLC alleging breach of fiduciary duty regarding accounting and reporting controls. In affirming dismissal of the plaintiff’s complaint, the Delaware Supreme Court held that where directors are exculpated from liability except for claims based on fraudulent, illegal, or bad faith conduct, a plaintiff must also plead particularized facts that demonstrate that the directors acted with scienter—in other words, that they had actual or constructive knowledge that their conduct was legally improper. And in Fisk Ventures, LLC v. Segal, the Chancery Court of Delaware ruled that where an LLC agreement expressly eliminated all fiduciary duties except those expressly articulated in the agreement, then no fiduciary duties were owed, beyond those statutorily imposed, because none were articulated in the agreement. Miller suggests that a conscious disregard for one’s duties amounting to recklessness would be the functional equivalent of bad faith for which an LLC
manager could not contractually eliminate, but, as indicated by Wood v. Baum, the pleading standards may be quite high to establish the bad faith conduct. Miller also concludes that courts are central to the development of the LLC model, attempting to balance contractual freedom of the LLC members with the need to constrain opportunistic and deceptive conduct by developing a minimum mandatory core of acceptable business conduct.

**Unique Governance Issues in Family Firms**

The heart of a family firm is the founding family’s involvement in governing the business. The family establishes mechanisms encouraging family members to occupy executive positions and to decide the business’s direction and operation. Family members are trusted to make decisions enhancing the firm’s welfare, and the sense of shared identity among family members is reinforced by family ownership. To maintain identity as a family business, family members may form strong coalitions, allowing them to control the firm and keep it free from outside influence. Thus, the traditional corporate governance model again falls short in attempting to explain mechanisms relevant to relationships that exist in family firms.

Several aspects of the family business—major goals, altruism, entitlement perceptions, familiness, family social capital, and family bonds—distinguish it from the nonfamily business. First, a family firm’s most important goal is said to be value maximization rather than wealth or utility maximization. The family business therefore should be viewed as an interactive system involving the individual founder, his or her family, and a firm that contains internal mechanisms to determine value and the means for achieving it. As family firms in the first generation are generally small private concerns, the founder and family members make up managers, directors and shareholders in the formal business organization, thus fusing ownership and control. However, as the firm grows, this control diffuses as outsiders join the business. The degree to which the goals of owners and managers in the firm remain aligned relates to a smaller-sized board of directors, a lower percentage of outside directors, and a higher percentage of directors affiliated with the firm.

Second, altruistic behavior in family firms has been viewed as both positive and negative in its effects on agency and governance issues within the firm. Altruistic behavior, in the form of stewardship, can positively affect strategic decisions. However, altruism can be negative in that it may cause owner-managers to encourage free riding and other forms of deviant behavior among their children and other employees of the firm. These conditions create agency problems not easily rectified through the use of economic incentives or board design.

Third, as employment relationships develop, family firm members may come to believe they deserve certain benefits due to the employment relationship, illustrating the concept of organizational entitlement. An entitlement crisis can occur when some members of the family feel entitled to certain benefits from the firm and its members due to a perception that they have made important contributions to the company, their status as family, or their personal needs. The family member’s entitlement beliefs can become entangled with business practices, violating resource distribution based on merit and equity and violating fiduciary duty and replacing it with distribution of resources based on need. Entitlement can fuel family members’ beliefs that they should control the company or receive certain benefits due to past work and sacrifice—even defying their fiduciary responsibilities in extreme cases.

Finally, a strong family bond is a distinguishing factor that potentially affects directors’ conduct within the firm. Common bonds, rooted in commitment and mutual trust, provide an operating atmosphere featuring strong levels of devotion to other family members and high levels of concern for family well-being. Whereas individuals may bond with the firm and each other, encouraging them to act as stewards of the firm, strong bonds placing family members in most key governance positions provide them with chances to override, abolish, or ignore controls put in place to prevent shareholder abuse. Strong bonds may also encourage an attitude that the family and firm are one, allowing questionable family behavior because it is for the firm’s good.

These distinguishing characteristics of the family business form the basis for whether family dynamics in a given firm are effective or dysfunctional. When considered in the context of legal protections that are afforded to minority shareholders, they provide the foundation for four conditions suggested in a recent global typology of family firm governance: (1) Good family dynamics/strong legal protections; (2) Good family dynamics/weak legal protections; (3) Dysfunctional family/strong legal protections; and (4) Dysfunctional family/weak legal protections. In condition (1), the law reinforces the family, and productive minority shareholder relationships are maintained; in condition (2), the family replaces the law, with some risk to stability; in condition (3), the law replaces the family, providing some protection for minority shareholders; and in condition (4), minority shareholders are abused.

The conditions brought on by family business goals, altruism, entitlement, and strong bonds led to a recent case of dysfunctional family dynamics experienced by the Rigas family, primary owners of Adelphia Communications, a family business that grew into a major cable industry player. The Rigases, whose family members dominated publicly-traded Adelphia’s board, perceived that value maximization would be achieved through rapid expansion of Adelphia through acquisition of other cable firms, financed by massive amounts of debt. Meanwhile, family members set up loan agreements backed by the corporation to ensure that their ownership share in Adelphia would not be diluted by selling shares of additional stock to outsiders. These activities—and others that led to fraud convictions of two family members—were fueled...
by a sense of entitlement that the family deserved benefits based on status rather than merit, high levels of altruism in the family, and strong family bonds. Even though their actions led outsiders to lose their investments in the corporation, members of the Rigas family rationalized their behavior, believing they did nothing wrong, in part due to a strong sense of entitlement, the altruism factor, and strong family bonds in the company.\textsuperscript{115}

Extending de Holan’s and Sanz’s identified conditions surrounding family dynamics and legal protections to small and family firms generally, as shown in Figure 1, we see that when directors honor their fiduciary duties and place the best interests of the firm above their personal interests—conditions (1) and (2), minority shareholders are protected. Regarding family firms, in these conditions at least two variables merit further study. The degree to which the levels of family social capital—family relationships that can lead to action and create value—and of familiness—the resources and capabilities unique to a family’s involvement and interactions in the firm—impact structural protections of nonfamily shareholders is a ripe topic for empirical examination.

**Insert Figure 1 Here**

In condition (3), when directors do not act in the best interests of all the shareholders, strong legal protections do protect shareholders, but often only in extreme circumstances—for example, fraud or gross mismanagement.\textsuperscript{118} But, as discussed earlier, fraud, gross negligence, and breach of loyalty are coupled with high pleading and proof standards. Again, the role of family social capital and its potentially negative effects deserves scrutiny. Whereas a family’s social capital is generally expected to have a positive impact on the business, a high level of family social capital may have negative effects. These can include the transfer of dysfunctional family interactions to the workplace, which could have a detrimental outcome on minority shareholder relations.

But it is in condition (4), when the board is not protecting the interests of all the shareholders and there is weak legal protection, that raises the most significant concern for minority shareholders. This combination of factors can be expressed in two particular ways: first, the board is not fully protecting the interests of some or all of the shareholders, but the board’s conduct falls short of financial self-dealing or a conscious disregard of its responsibilities; or second, the jurisdiction in which the firm is located does not recognize special protections for minority shareholders in close corporations or LLCs. In either of these circumstances, there is little to no legal protection and the nonlegal assumption underlying traditional notions of corporate governance fails—there is no ready market in which the disgruntled or abused minority shareholder may exit the firm by selling his or her shares.\textsuperscript{119}

When the controlling members of a small or family firm are not acting in the best interests of all of the owners, strong legal protection is the only means to protect the interests of minority shareholders. But as demonstrated in this paper, the laws protecting minority shareholders are often weak, inconsistently applied, or difficult to implement without a strong evidentiary basis. The growth of LLCs can only strengthen the argument that close corporations are de facto incorporated partnerships. The business judgment rule simply does not afford adequate and consistent remedies when there is minimal separation between ownership and management. This paper’s analysis argues strongly in favor of courts adopting partnership-level fiduciary duties in closely held corporations and LLCs, particularly when family owned.

**CONCLUSION**

This interdisciplinary paper has used research in corporate governance law and family firm literature to set forth a theoretical framework for future research that will focus on what sort of legal protections combined with family member interactions will best protect minority shareholders of small or family firms. Testing this framework empirically and casting a wider theoretical net to a global perspective on family firm governance and minority shareholder protections will be two important means to further develop the ideas discussed in this paper.

In the meantime, minority owners of small and family firms will have to understand that their capital investment is subject to more than market risk. It is subject also to managerial and legal risk. Minority owners may be subject to managerial dysfunction with minimal legal remedies available.

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**Figure 1**

**Board Dynamics and Legal Protections**\textsuperscript{120}

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<tr>
<th>GOOD BOARD DYNAMICS</th>
<th>STRONG LEGAL PROTECTIONS FOR MINORITY SHAREHOLDERS</th>
<th>DYSFUNCTIONAL BOARD</th>
<th>WEAK LEGAL PROTECTIONS FOR MINORITY SHAREHOLDERS</th>
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<td>(1)</td>
<td>Productive minority shareholder relationships maintained</td>
<td>(3)</td>
<td>Some protection for minority shareholders</td>
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<tr>
<td>(2)</td>
<td>Some risk to stability</td>
<td>(4)</td>
<td>Minority shareholders are abused and may wish to exit the firm</td>
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The business judgment rule originates in Delaware, which, for better or worse, is the leading jurisdiction in the United States regarding corporate governance. See Robert A. Ragazzo, Toward a Delaware Common Law of Closely Held Corporations, 77 Wash. U. L.Q. 1099, 1099 (1999) (describing Delaware corporate law as analogous to a national law of corporations).


2. Id. (reporting 27 million businesses operating in the United States).


6. Id.

7. For 2008, the largest 1000 firms in the United States, predominantly publicly traded corporations—out of 31.6 million businesses—generated over thirty-five percent of all business revenues. Calculated from: Tbl. 746, supra note 5; Fortune 500, CNNMoney (May 5, 2008), http://money.cnn.com/magazines/fortune500/2008/full_list/. Note that the total number of firms reported by the U.S. Census Bureau varies between approximately 27 million, 2007 Survey of Business Owners, supra note 1, and approximately 31.6 million, Tbl. 746, supra note 5, though both are reporting 2008 figures (latest available).

8. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 700 (Edwin Cannan ed., Modern Library 1937) (1776) (“Like the stewards of a rich man, [directors] are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.”).


10. Id. at 333.

11. Id. at 336.


13. Id. at 311.

14. Id. at 313.


16. BUS. ROUNDTABLE, STATEMENT ON CORPORATE RESPONSIBILITY 5-6 (1981).

17. Id. at 6.


19. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). Informally, the business judgment rule dates as far back as 1872, when the Pennsylvania Supreme Court held that directors were not personally liable for decisions, regardless of how absurd or ridiculous they may seem, as long as they were honest and within the powers of their office. Spering’s Appeal, 71 Pa. 11, 24 (1872). Justice Brandeis alluded to the rule when he noted that courts seldom interfere in the internal functions of corporations, “except where the directors are guilty of misconduct equivalent to a breach of trust, or where they stand in a dual relation which prevents an unprejudiced exercise of judgment.” United Copper Sec. Co. v. Amalgamated Copper Co., 244 U.S. 261, 263-64 (1917). Despite the jurisdictions of the preceding citations, the majority of authority regarding the business judgment rule originates in Delaware which, for better or worse, is the leading jurisdiction in the United States regarding corporate governance. See Robert A. Ragazzo, Toward a Delaware Common Law of Closely Held Corporations, 77 Wash. U. L.Q. 1099, 1099 (1999) (describing Delaware corporate law as analogous to a national law of corporations).


24. Citigroup, 964 A.2d at 125.

25. Walt Disney Co., 907 A.2d at 750.

26. Id.

27. Id. at 751 (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)).
Outs in Limited Liability Companies

pleading standards as a cause of action for failure to declare dividends.

Peeples,

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The Evolving Fiduciary Duty Solution for Shareholders Caught in a Closely Held Corporation Trap

purpose of promoting a scheme that benefits themselves alone to the detriment of the minority

market exists

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28 Id. at 755.

29 Citigroup, 964 A.2d at 125.


31 Citigroup, 964 A.2d at 124.


35 See supra note 9 and accompanying text.

36 Donahue, 328 N.E.2d at 512.

37 See id.


40 See Donahue, 328 N.E.2d at 514.

41 See id.

42 See id. at 515.

43 See id. at 515-16. See also Jones v. H.F. Ahmanson & Co., 460 P.2d 464, 476 (Cal. 1969) (holding that when no market exists for the shares of the firm, controlling shareholders may not use their power to control the corporation for the purpose of promoting a scheme that benefits themselves alone to the detriment of the minority shareholders).

44 Santarelli v. Katz, 270 F.2d 762, 768 (7th Cir. 1959).

45 Id. at 769.


50 See id.

51 Matheson & Maler, supra note 48, at 685; Ragazzio, supra note 19, at 1102 (noting that Nixon did not directly involve an oppression allegation and therefore Delaware courts might apply stricter fiduciary duties in a case squarely involving oppression); see also Robert B. Thompson, The Shareholder’s Cause of Action for Oppression, 48 BUS. LAW. 699, 711-18 (1992-1993) (examining what constitutes oppression).

52 “Dividends” should be considered from a broad perspective. Most typically in close corporations, returns on investment are in the form of compensation for management duties rather than through dividends. “[D]ividends and compensation merely represent two different methods to transfer the close corporation’s earnings to its owners.” Ralph A. Peeples, The Use and Misuse of the Business Judgment Rule in the Close Corporation, 60 NOTRE DAME L. REV. 456, 471 (1985). A dispute among the director-shareholders will often result in one of the director-shareholders being “fired” and bringing a breach of fiduciary duty cause of action against the remaining director-shareholders with essentially the same pleading standards as a cause of action for failure to declare dividends. See Franklin A. Gevurtz, Squeeze-Outs and Freeze-Outs in Limited Liability Companies, 73 WASH. U. L.Q. 497, 199-500 (1995) (noting the similarities between the two causes of action); see, e.g., Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 664 (Mass. 1976) (holding that majority shareholders in a close corporation did not demonstrate a legitimate business purpose for severing a minority shareholder from the payroll of the corporation or for refusing to elect him as a salaried officer and director, particularly where the corporation had never paid a dividend and had a long standing policy of equating ownership with management rights and employment). But see Mueller v. Cedar Shore Resort, Inc., 643 N.W.2d 56, 63 (S.D. 2002) (holding that when discharged minority shareholders sue for oppression, the court must weigh the minority shareholders’ expectations against the corporation’s ability to exercise its business judgment and run its business efficiently).

53 Thompson, supra note 51, at 703.

54 See id.

55 Gevurtz, supra note 52, at 500.


57 Id. at 694-95.

58 Id.

59 Id. at 695-96.
Del. 2009) (Table 54x142) general corporation language in discussing duties owed within an LLC. Interference dissenters' shares). Henderson, v. Hamway Co (1995) (discussing cases in which courts ordered a buyback in lieu of dissol
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723 (Ill. App. Ct. 1982) (holding that the withholding of dividends is fraudulent, oppressive, or totally without merit).
100 Cal. Rptr. 2d 313 (Cal. Ct. App. 2000).
Topper, 433 N.Y.S.2d at 362.
See Peeples, supra note 52, at 503.
Means, supra note 47, at 1227.
See Peeples, supra note 52, at 503.
Id.
See Means, supra note 47, at 1227.
See id.
Id. at 1228.
Id. at 1180.
Id. at 1180-81.
Id. at 731.
See Eggart, supra note 76, at 217.
See Henderson, supra note 84, at 219-20.
Santee Oil Co., Inc. v. Cox, 217 S.E.2d 789, 792 (S.C. 1975) (summarizing Delaware decisions in valuing dissenters’ shares).
Eggart, supra note 76, at 218.
See id. at 243.
Peeples, supra note 52, at 475.
93 A.2d 136, 139 (Del. 2008).
Id. at 141. It is interesting to note that throughout its Wood v. Baum opinion, the Delaware Supreme Court used general corporation language in discussing duties owed within an LLC.
Miller, supra note 91, at 127 n.6.
Miller, supra note 90, at 1613.

60 Id. at 699. See also Zidell v. Zidell, Inc., 560 P.2d 1086, 1089-90 (Or. 1976) (holding, under substantially similar circumstances, that the minority shareholder-plaintiff failed to meet his burden of proving bad faith on the part of the directors in determining the amount of corporate dividends); Romanik v. Lurie Home Supply Center, Inc., 435 N.E.2d 712, 723 (Ill. App. Ct. 1982) (holding that the decision whether to declare a dividend when sufficient funds are available is within the sole discretion of the board of directors; noting also that courts are reluctant to interfere with the exercise of the directors’ business judgment unless the withholding of dividends is fraudulent, oppressive, or totally without merit).
61 100 Cal. Rptr. 2d 313 (Cal. Ct. App. 2000).
62 Id. at 314-15.
63 Id. at 315.
64 Id. at 319-20.
66 See Peeples, supra note 52, at 502.
68 Topper, 433 N.Y.S.2d at 362.
69 See Peeples, supra note 52, at 503.
70 Means, supra note 47, at 1227.
71 See Peeples, supra note 52, at 503.
72 Id.
73 See Means, supra note 47, at 1227.
74 See id.
75 Id. at 1228.
76 Id.