Chapter 17: Corporations

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CHAPTER 17

Corporations

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§ 17.1. The Impact of Donohue v. Rodd Electrotype Co. on the Law of Corporate Freeze-Outs. The decision of the Supreme Judicial Court in Donohue v. Rodd Electrotype Co. is of major importance. The Court in Donohue held that the stockholders of a closely held corporation owe one another substantially the same fiduciary duty—the utmost good faith and loyalty—in the operation of the enterprise that partners owe to one another, and that, when a corporation purchases shares from a member of the stockholder-director group controlling the corporation, the standard can not be met unless the offer to purchase is made pro rata to all stockholders.

The section following this one includes a general analysis of the Donohue decision. This section addresses the narrower topic of the probable impact of Donohue on the law of corporate freeze-outs, particularly those involving public corporations. As a starting point, this section will review the law of corporate freeze-outs. The discussion of freeze-outs will be followed by a review of a freeze-out technique frequently contemplated by public corporations today: the "going private" transaction. After the "going private" analysis, there will be a review of Massachusetts decisions regarding freeze-outs prior to Donohue, and then a discussion of the impact of Donohue itself on freeze-out transactions. A comment of post-Donohue transactions, focusing on the relationship between state corporate law and federal securities law in the area of freeze-outs, will conclude the article.

I. A Review of the Law of Corporate Freeze-Outs

Interest in the law of corporate freeze-outs has been increased recently by a new freeze-out technique attempted by public corporations

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2 Id. at 1315-16, 328 N.E.2d at 515.
3 Id. at 1323, 328 N.E.2d at 521.
4 See § 17.2 infra.
in the last several years: "going private." Attempts to "go private" have increased significantly as a result of the stock market boom in the late sixties and the subsequent depressed market conditions during the first half of the current decade. This recent wave has raised new questions peculiar to "going private" freeze-outs, and revived the question whether and in what circumstances majority stockholder-officer-directors may eliminate the interests of minority stockholders in a corporation.

The term "freeze-out" is used here to describe a transaction in which the equity interest of minority stockholders in a corporation is eliminated. As the term implies, a freeze-out has as a purpose the elimination of the minority. "Freeze-out" is used here in a narrower sense than it was used by the Court in Donohue: it does not include a variety of devices, such as the distribution of profits through salaries rather than dividends, that insiders can use to deprive minority stockholders of the economic benefit of their investment without actually forcing the liquidation of that investment.

Freeze-outs, as so defined, can be accomplished in three principal ways. First, an existing corporation can effect either a long-form or a short-form merger with corporations owned by the majority stockholders, in which all stockholders or the minority stockholders receive

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6 For a few recent examples of corporations that have been sued in attempting to "go private," see Marshel v. Concord Fabrics, Inc., BNA SEC. REG. & L. REP., No. 342, at F-1 (2d Cir. February 13, 1976); Green v. Santa Fe Indus., BNA SEC. REG. & L. REP., No. 342, at G-1 (2d Cir. February 18, 1976); Kaufmann v. Lawrence, 386 F. Supp. 12 (S.D.N.Y. 1974); Rapoport v. Merle Norman Cosmetics, Inc., Civil No. 74-248 (C.D. Cal., filed January 30, 1974).


8 Vorenberg, Exclusiveness of the Dissenting Stockholder's Appraisal Right, 77 HARV. L. REV. 1189, 1192-93 (1964) [hereinafter cited as Vorenberg]. For an indication of the difficulty courts often face in ascertaining the majority's predominant purpose, see McPhail v. L. S. Starrett Co., 257 F.2d 388, 394 (1st Cir. 1958).

The use of the term "freeze-out" has been criticized on the ground that it is pejorative in nature since it "bespeaks wrongful exclusion." Borden, supra note 5, at 988. As used herein, the term implies that the exclusion of the minority was purposeful, but not necessarily wrongful.


10 See id. at 1309-10, 328 N.E.2d at 513.

11 See G.L. c. 156B, § 82. In a recent decision, Green v. Santa Fe Indus., BNA SEC. REG. & L. REP., No. 342, at G-1 (2d Cir. February 18, 1976), the Second Circuit held that plaintiff had stated a cause of action under Rule 10b-5 although the merger in question was effected in compliance with the requirement of the Delaware short form merger statute.
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cash or debt instruments in exchange for their shares.13 Second, the same result can be achieved by a sale of the assets of the corporation to another corporation owned by insiders.14 Third, a freeze-out can be accomplished in two steps: a tender offer by the corporation, followed by a merger, sale of assets, or reverse stock split designed to eliminate nontendering minority stockholders.15 The two-step method has been most common in the case of "going private transactions."16

Historically, judicial hostility toward freeze-outs was based on the notion that stockholders had a vested right in the profits of an enterprise.17 Although nearly all modern corporation statutes have been amended to specifically authorize transactions that can have the result of eliminating the interest of some stockholders,18 thereby vitiating the vested rights theory, substantial objections to freeze-outs remain. In a freeze-out, one stockholder in effect decides when another must sell his stock.19 Thus, even if the forced sale does not violate a vested right of the seller, it does substitute another's will for that of the seller in a transaction in which the seller customarily expects to exercise his own choice. Moreover, there is the obvious suspicion that in deciding to sell on behalf of the minority, a controlling stockholder will not be acting in the interest of the minority.20 The self-interest of controlling stockholders is so easy to identify and so obviously adverse to the interests of eliminated minority stockholders in most cases, that experience suggests that those in control have resolved the conflict of interest in favor of their own interests. In allocating the present and future value of the corporation among all stockholders, controlling stockholders are unlikely to make a pro rata allocation.21

The effects often created by a freeze-out are also produced by a converse transaction, the insider bail-out. The insider bail-out is a transaction in which the corporation purchases the stock of one or more stockholders. Where a corporation is controlled by a group of stockholders, a bail-out may allow the group to retain control because the selling shareholder's shares are not placed into the hands of

13 See G.L. c. 156B, §§ 78(b)(6), 82(a)(1).
14 See G.L. c. 156B, § 75.
15 Note, supra note 5, at 910.
18 See, e.g., notes 9-11 supra.
19 Vorenberg, supra note 8, at 1202.
another person. The transaction in *Donohue* involved such a bail-out.\textsuperscript{22} Freeze-outs and bail-outs are similar in that controlling groups are able to offer only insubstantial corporate benefits in favor of either transaction.\textsuperscript{23}

The failure to justify freeze-outs in terms of corporate benefit indicates that it is unlikely that corporate purposes, rather than personal ones, have motivated the expenditure of corporate funds. Indeed, except for the case of an attempt to "go private," the only corporate purposes that have been acknowledged to exist in such transactions have been the elimination of a dissenter who is blocking a transaction beneficial to the corporation,\textsuperscript{24} and efficiencies achieved by a merger of a subsidiary into a parent.\textsuperscript{25} With those exceptions, the alleged corporate benefits of these freeze-outs are so illusory that, particularly in the case of closely held corporations, a prophylactic rule such as that adopted in *Donohue* may be appropriate.\textsuperscript{26} Freeze-outs are thus transactions in which the principles that majority stockholders owe minority stockholders a measure of loyalty\textsuperscript{27} and that corporate officers and directors may not use their positions to advance their personal interests\textsuperscript{28} are frequently violated.

Despite the unseemly purposes for which they may be used, freeze-outs have not been universally proscribed.\textsuperscript{29} The short explanation for the failure of courts to eliminate them may be discovered in existing corporations statutes, which implicitly authorize the majority to override the minority in asset sales, mergers, and the like, and provide a remedy for the minority through the option of appraisal.\textsuperscript{30} In the light of such statutory schemes, some courts, adopting the view that the statutes mean what they say, have authorized transactions that freeze out minority stockholders.\textsuperscript{31} Under this analysis, the right to seek an appraisal has been viewed as the quid pro quo for authorizing

\textsuperscript{22} 1975 Mass. Adv. Sh. at 1301, 328 N.E.2d at 510.
\textsuperscript{23} "Going private" transactions represent a possible exception to this statement. See text at notes 46-48 infra.
\textsuperscript{24} See Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952); Vorenberg, *supra* note 8, at 1196.
\textsuperscript{27} 1975 Mass. Adv. Sh. at 1316 n.20, 328 N.E.2d at 516 n.20.
\textsuperscript{30} Only West Virginia fails to provide for this remedy. See Vorenberg, *supra* note 8, at 1189.
the majority to override. 32 Furthermore, the argument has been made
that the appraisal remedy is the exclusive means by which a dissenter
may respond to such a transaction. 33 Even commentators who reject
the view that corporation statutes providing for appraisal implicitly
authorize freeze-outs believe that the contrary argument is suffi­
ciently strong to authorize freeze-outs in some circumstances. 34

Although it has been suggested earlier that freeze-outs serving cor­
porate purposes are rare, 35 most commentators concede that such
freeze-outs do exist. 36 Such a legitimate freeze-out was the subject of
litigation in Grimes v. Donaldson, Lufkin & Jenrette, Inc. 37 In Grimes, a
federal district court was asked to enjoin a merger between a parent
corporation (through a newly-formed, wholly-owned subsidiary) and a
subsidiary. The court carefully analyzed the transaction and found
that the merger would benefit both corporations by: (1) combining
complementary businesses, (2) eliminating the inhibition to business
dealings between the two corporations created by possible conflict of
interest claims by minority stockholders of the subsidiary, and (3)
making possible operational savings of up to $300,000 per year. 38

Another decision involving a freeze-out that apparently presented a
legitimate corporate purpose is Matteson v. Ziebarth. 39 In Matteson,
a minority stockholder, who had blocked the acceptance of a favorable
offer to purchase all of the stock of the corporation, was frozen out
through a merger with another corporation controlled by the majority
stockholders. 40 As one commentator observed, seen as a whole, the
transaction had the valid business purpose of enabling an advan­
tageous sale to be made. 41

As the foregoing suggests, there has been no unanimity in the
 treatment of transactions intended to freeze out minority stock­
holders. Amidst views ranging from a complete prohibition on all
freeze-outs to complete legality in all cases where statutory procedures
have been followed, a growing consensus appears to be forming
around the view of Professor Vorenberg, an authority on the law of

32 See, e.g., Chicago Corp. v. Munds, 20 Del. Ch. 142,149,172 A. 452, 455 (1934);
33 See Blumenthal v. Roosevelt Hotel, Inc., 202 Misc. 988, 991, 115 N.Y.S.2d 52,
56-57 (Sup. Ct. 1952).
34 See Vorenberg, supra note 8, at 1204.
35 See text at notes 20-25 supra.
36 See Vorenberg, supra note 8, at 1195-1200, 1204; Note, supra note 5, at 922.
1974).
38 Id. at 96,930.
40 Id. at 290, 242 P.2d at 1029.
41 See Vorenberg, supra note 8, at 1196. The corporation had lost money consistently,
and the record indicated that it was practically forced to sell out. 40 Wash. 2d at
289-90, 242 P.2d at 1028-29.
corporate freeze-outs, that freeze-outs should be permitted only when the majority is able to demonstrate that the freeze-out serves a valid business or corporate purpose.42 The business purpose test as the standard of analysis is an attractive one. It recognizes that freeze-outs are transactions that are likely to be abused and ordinarily should be enjoined. At the same time, it recognizes that freeze-outs may serve purposes other than the furtherance of the majority's interest, and that in those cases they should be permitted.

The business purpose test also focuses analysis upon what appears to be the key question: is a corporate purpose being served by the transaction? If a corporate purpose is not being served, there is every reason to believe that the majority is attempting to disadvantage the minority by assigning to itself a disproportionate part of the corporation's value. The viability of the rule, however, is likely to be determined by the manner in which it is applied. If courts applying the business purpose test take an overly narrow or broad view of corporate purpose, the adoption of what is ostensibly a useful standard of analysis will not have accomplished a great deal.

II. "GOING PRIVATE" TRANSACTIONS

The combination of the boom market in securities during the 1967-1972 period and the subsequent decline in that market has produced a new variety of freeze-out that effects a substantial reduction in the number of shareholders of a widely held corporation:43 the "going private" transaction.44

"Going private" transactions tend to take place in a fairly stereotyped historical context. Most often corporations that have "gone private" or desire to "go private" first offered their securities for sale to the public during the hot issues market of the 1967-1972 period.45 In "going public," the corporations, their stockholders, or both sold securities to the public at prices that in retrospect seem to have been inflated. In most cases, the prices at which the stock in such

43 Almost always, it is merely a minority interest that is widely held. See Borden, supra note 5, at 1013-15.
45 See Sommer, supra note 44, at 84,694.
companies has since traded have declined substantially, often to the point at which market values are lower than book values. As a result of this decline in price, the price at which the corporation proposes to reacquire its shares is well below that at which they were originally sold. The price differential, which benefits the same controlling stockholder-directors who took the corporation public, has prompted the suggestion that the transaction is somehow a perversion of the process of raising capital in the public securities markets.

Another of the unique features of “going private” transactions is that the elimination of the public market in the stock of the corporation is often a purpose and usually the result of the transaction. One of the rationales offered by corporate management for “going private” has been that by eliminating the public market for the stock of the corporation, the management is able to avoid tying the corporation to a market determination of the value of its stock. No longer burdened by understated market value, the corporation can revalue upward the price of its stock for use in acquisitions and stock option programs. Although it has been suggested that this argument may be used as a shield for transactions designed to benefit insiders at the expense of the public, there may be circumstances in which the elimination of a public market for the purpose of upward revaluation could be the basis for a finding of a valid business purpose.

That “going private” transactions usually result in the elimination of a market for the securities of the corporation has another implication. “Going private” transactions most often take the form of a tender offer. Although the offer is usually the first of two steps in the elimination of the minority, viewed alone, a tender offer might be seen as something other than a freeze-out. The argument in support of this view is that the tender offer invites a voluntary response and is not of itself a means by which the minority can be forced to do anything. One response to this argument is that where the two step process occurs, the coercion associated with the second step applies with equal force to the first step. Moreover, it has been persuasively argued that from the point of view of a public shareholder any move by the corporation that can eliminate the liquidity of his investment is inherently coercive. Tender offers that may eliminate the public

46 Id. at 84,695.
47 Id.
48 See Note, supra note 5, at 908-09.
49 Id. at 923.
50 Id. at 922-24; see also Kaufmann v. Lawrence, 386 F. Supp. 12, 17 (S.D.N.Y. 1974).
51 See Borden, supra note 5, at 987-88.
52 The second step is a merger or reverse stock split. Id.
53 But see id. at 1004-05.
54 See Borden, supra note 5, at 1004-05. See also Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P.2d 464 (1969).
market for the stock of a corporation may be the most coercive means of "going private" since nontendering stockholders in a successful tender offer cannot obtain even the cash offered for their stock. Thus, tender offers that do not include some protection for the initially nontendering stockholder should clearly be treated as a species of freeze-out. A recent tender offer by Purity Supreme, a Massachusetts corporation, seems calculated to avoid this danger. The offer contains a representation that the broker making a market for the stock would continue to do so. 55

Finally, "going private" transactions are unique in that one of their principal objectives is to avoid the obligations imposed by the federal securities laws on public companies. 56 In "going private," the management of a corporation typically hopes to reduce the number of the corporation's stockholders to the point at which registration 57 and reporting 58 under the Securities Exchange Act of 1934 59 (hereinafter the 1934 Act) are no longer required. An additional objective in "going private" may be to disqualify the corporation's securities for listing on one of the exchanges. As a result of the structure of the 1934 Act, deregistration has the additional results of eliminating the application of the proxy rules 60 and the insider trading rules 61.

In conclusion, it is apparent that, in contrast to other forms of freeze-outs, "going private" transactions may often serve legitimate corporate ends. Those ends may include the opportunity for the private corporation to upwardly revalue its stock, and to avoid the often expensive registration requirements imposed on publicly traded securities.

III. THE IMPACT OF DONOHUE ON FREEZE-OUTS IN MASSACHUSETTS

Prior to the decision in Donohue, it would have been difficult to advise a client with any confidence whether Massachusetts law permits a freeze-out. One of the few decisions that seems to have any bearing on freeze-outs is Joseph v. Wallace Murray Corp. 62 In Joseph, a minority stockholder sought to enjoin a short-form merger that seemed to be the final step in the acquisition of that corporation by another. The minority holder originally dissented from the merger and demanded

an appraisal of his stock, but later sought to set the transaction aside altogether. The defendant's plea in bar, upheld by the Court, was that the plaintiff's pursuit of his statutory appraisal right constituted an election. The holding of the Court seems to be only that where a stockholder, having full knowledge of the facts, elects to seek appraisal, the election is conclusive. The Court also seemed to say that, absent fraud or illegality, the remedy of appraisal is exclusive, as section 98 of chapter 156B of the General Laws provides. The plaintiff apparently did not explicitly contend that the freeze-out could not be justified under any circumstances, although it is difficult to be confident that the Court fully described the contentions raised. In any event, the Court did not directly consider the question whether and in what circumstances a freeze-out was authorized.

The Court did, however, distinguish its earlier decision in *Cole v. Wells.* The *Cole* case involved an asset sale by which the majority stockholders of a corporation attempted to convert the corporation into a business trust. The plaintiff, a minority stockholder, alleged that the purpose of the transaction was to appropriate more profits and assets to the majority than they would otherwise receive. Although the transaction did not involve a freeze-out, and although the Court dealt principally with the issue whether the plaintiff had elected his remedy by first claiming appraisal, the Court also held that if the allegations of the bill were true, the transaction would be a fraud on the corporation and could be set aside. *Cole* was apparently distinguished in *Joseph* on the ground that, unlike the plaintiff in *Cole,* the plaintiff in *Joseph* knew all the facts before seeking appraisal.

Thus, prior to *Donohue,* the Court had provided no certain guidance as to how it would analyze a freeze-out. Similarly, the Court's treatment of dealings by a corporation in its own shares provided no clear answers. The Court had previously been critical of efforts of majority stockholder-directors to improve their control positions by causing the corporation to sell stock to them. The Court has even suggested that in some circumstances sales of stock by the corporation to insiders must be pursuant to a pro rata offer. Similarly, the Court has held that directors may not properly cause the corporation to

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63 *Id.* at 480, 238 N.E.2d at 362.
64 *Id.*, 238 N.E.2d at 363.
65 *Id.*, 238 N.E.2d at 362.
67 *Id.* at 511, 113 N.E. at 189.
68 *Id.* at 506, 113 N.E. at 189.
69 *Id.* at 515, 113 N.E. at 192.
70 354 Mass. at 480, 238 N.E.2d at 362-63.
purchase stock with a view to shifting control. These decisions suggested that the Court might have viewed freeze-outs as another species of transaction in which corporate insiders attempted to use corporate powers to shift or perpetuate control.

Other lines of decision, however, suggested that the Court would take a different view of a freeze-out, particularly in the light of the *Joseph* decision. Foremost among them is the line of cases, culminating in the *Donohue* decision, in which the Court dealt with corporate purchases of stock from insiders. In applying the rule that such purchases would be permitted where there was no prejudice to the rights of other stockholders, the Court was extremely insensitive to the impact of such purchases upon the minority shareholders in those corporations.

In other cases as well, the Court had taken a relatively mechanical view of the realities of corporate existence. For example, in *Lewis v. H.P. Hood & Sons, Inc.*, the Court upheld a purchase of a portion of the stock owned by a retiring corporate employee made pursuant to a charter provision making common stock callable. The Court reasoned that those purchasing the stock knew of its call feature and had to accept the consequences. It further held, without analysis, that the purchase had been made in "good faith." These decisions suggested that, with respect to a freeze-out, the Court might have adopted the view that there could be no wrong in carrying out a transaction specifically authorized by statute.

Thus, the decisional law relative to transactions that raised issues of corporate fiduciary duty was ambiguous. The state of affairs, coupled with the lack of a direct treatment of a freeze-out in any previous case, provided great latitude for the *Donohue* decision. *Donohue* is useful in predicting the future treatment of corporate freeze-outs. For close corporations, it is clear that the *Donohue* decision means that freeze-outs will rarely, if ever, be allowed. The duty of utmost good faith and loyalty that the stockholders of such corporations now owe to one another would seem to preclude any transactions wherein one group of stockholders eliminated another. One possible exception might be on facts like those presented by *Matteson v. Ziebarth*, in which a minority stockholder might be considered to have violated his duty of loyalty to the remaining stockholders by

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75 See Note, 59 YALE L.J. 1177, 1179 n.18 (1950).
77 Id. at 676, 121 N.E.2d at 853.
78 Id.
stubbornly blocking a transaction in the best interests of all stockholders. In such circumstances, the majority might be justified in freezing out the lone dissenter in the interest of the corporation. It is difficult to conceive of any other set of circumstances in which the Court would be likely to find an interest that outweighed the right of the minority to the loyalty of the majority.

Since the Donohue decision is expressly limited both in holding and rationale to close corporations, analyzing its probable impact on the law as it relates to publicly held corporations involves a degree of speculation. Nonetheless, Donohue may well signal a change in the Court's approach to the relations of stockholders in widely held corporations because it suggests that (1) the Court will look more critically at the purposes and effects of corporate transactions, (2) the Court will give substantive content to fiduciary principles, and (3) majority stockholders will be held to a fiduciary standard in dealing with the corporation and minority stockholders.

In the context of close corporations, the Court in Donohue abandoned the no-prejudice analysis of stock redemptions. The no-prejudice rule required that the transaction be set aside if it were found to be prejudicial to the rights of creditors or other stockholders. It had been pointed out in the past that a stock redemption, even at a fair price, might prejudice other stockholders by reducing the asset of the corporation—cash—that has the clearest value and that is available for the payment of dividends. Despite this possibility, the Supreme Judicial Court continued to uncritically assume that if the redemptions were at a fair price, no one was harmed. The Donohue decision represents a significant break with that approach because, for the first time, the Court concedes that the purchase of stock from a single stockholder operates as a preferential distribution of the assets of the corporation, even where the price is fair. In changing its view of the possible consequences of such transactions, the Court may be moving toward a more critical view of the rationales commonly offered to justify various corporate transactions.

The Donohue decision may also presage an inclination by the Court...
to move away from an *ad hoc* analysis of fiduciary responsibilities. Throughout its decisions dealing with corporate law, the Court has stated that the directors and officers bear a fiduciary duty to the corporation and its stockholders. Yet the Court has rarely given substantive content to that duty. In the *Donohue* decision, the Court obviously changed the general standard of fiduciary duty owed by stockholders to each other in a close corporation. Of perhaps greater significance, however, may be the willingness of the Court to amplify its understanding of that duty by adding that no purchase of stock may be made from a member of the controlling group without first offering to make the purchase pro rata. The Court's promulgation of a rule of general application makes *Donohue* a great deal more helpful than it would otherwise have been.

In the case of a freeze-out, including an effort by a publicly held corporation to "go private," *Donohue* thus suggests that if the Court does not simply adopt a rule that such transactions are always permitted or always proscribed, it will at least be inclined to do more than analyze the fairness of the transaction on an *ad hoc* basis. The approach of the Court in *Donohue*, if applied consistently, suggests that the Court will instead adopt a standard, like the business purpose test, with which to measure "going private" transactions. Although standards like the business purpose test are hardly precise, they do focus analysis on relevant factors and tend to substantially confine the region of dispute.

Finally, the *Donohue* decision strongly implies that the law of Massachusetts will for the first time fully recognize that the stockholders of a corporation stand in a fiduciary relationship to each other. Prior to *Donohue*, the law of Massachusetts seems to have been represented by the decision of *Mairs v. Madden*. *Mairs* involved an offer by an outsider to purchase all the stock of the corporation. After receiving the offer, the majority stockholder-directors bought up the stock of minority stockholders without disclosing the existence of the offer. The purpose underlying the purchase of the minority stock was to prevent acceptance of the tender offer. The Court held that allegations setting forth these facts, with the additional assertion that

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92 Id. at 381, 30 N.E.2d at 245.
both the sellers and buyers were stockholders, did not state a cause of action, since no fiduciary relationship was alleged.  

Donohue explicitly overruled Mairs and related cases as they apply to close corporations.  

In Donohue, the Court also suggested, when it contrasted the strict standard with the more lenient standard applicable to public corporations, that the Mairs rationale would not be followed in the case of public corporations.  

In making that comparison, the Court referred not to the Massachusetts rule, but to the rule "set out in many jurisdictions" that the majority has the right to control but in doing so occupies a fiduciary relation to the minority.  

The citation in support of the fiduciary standard includes cases involving freeze-outs by dissolution, and clearly implies that in such circumstances the standard will apply in Massachusetts.  

Thus, should a case involving a "going private" transaction reach the Court, in all likelihood the analysis will begin with the understanding that the majority shareholders occupy a fiduciary relationship with respect to the minority. The Court is therefore likely to examine the fairness of the transaction to the minority: whether the minority may properly be forced out, and, if so, whether the consideration offered for their shares is fair.

IV. Some Comments on "Going Private" from a Post-Donohue Point of View

If the Donohue decision does indeed presage the adoption of a more critical view of freeze-outs even in the context of a public corporation, a critical view of the arguments against "going-private" transactions may nevertheless be in order. The developing debate concerning such transactions has been focused on both empirical and policy questions. On the empirical level, there have been competing claims concerning the actual economic impact of SEC compliance. Those opposing "going private" transactions have tended to belittle the arguments made by the proponents of "going private" concerning the costs of compliance with SEC reporting requirements.

On a policy level, the debate seems to turn on what one considers to be the "corporation." Professor Borden, an authority on "going pri-
vate," has forcefully made the argument, which a practitioner advising a public company would also be likely to make, that the responsibilities of management to the public securities market tend to divert attention from running the business of the corporation, and to result in decisions that may not be in the best interest of the corporation as a business entity.100 In making this argument, Professor Borden seems to view the "corporation" as a composite of a number of different constituencies, only one of which is the corporation's public stockholders.

On the other hand, Securities and Exchange Commissioner Sommer seems to view the corporation from the point of view of the public investor. Commissioner Sommer believes that the interests of the corporation are necessarily advanced by compliance with the federal securities laws.101 Under this theory, a corporation that "goes private" is harmed by the termination of the burdens and attendant protections of the federal securities laws. Thus, avoiding the securities law requirements cannot be a valid business purpose for the transaction.102

Those opposing "going private" transactions also draw support for their views from the historical context of most transactions, which as pointed out above, has tended to involve repurchases by a corporation at prices greatly below those at which the shares were previously sold to the public by insiders. The ability of insiders to sell stock to the public at a relatively high price, and later to reacquire the same stock at a much lower price, understandably troubles those concerned with the maintenance of strong public securities markets. Investors who experience or read about such transactions may well infer that the market has somehow been manipulated by insiders to the detriment of the public.103 Nonetheless, one must question whether this conclusion overemphasizes the importance of the immediate past. Whatever the industry's responsibility for the existence of the hot issues market may be, neither the securities industry nor corporate managements have created or wished the general decline in stock prices in the last few years. One suspects that most corporate managers who took their companies public had every intention of remaining public. Subsequent developments have doubtlessly disappointed the management of such companies even more than their public stockholders. It may thus be unfair to corporate management to suggest that there is something invidious about "going private."

It seems, therefore, that an opponent of "going private" transactions from this historical point of view should be contending that the interest in investor confidence in the public securities market is such

100 See Borden, supra note 5, at 1002-13.
101 See Sommer, supra note 44, at 84,695.
103 See Sommer, supra note 44, at 84,699.
that corporate management cannot be allowed to take advantage of the decline in stock prices even for the benefit of the corporation as a going concern. Concern for investor confidence may be perfectly appropriate from the point of view of an agency such as the SEC, which is charged with regulating the securities industry. Indeed, in the face of repeated holdings by the federal courts that "going private" transactions as such violate no existing policy of the federal securities laws, the SEC has proposed regulations that would limit the ability of issuers to "go private." Nonetheless, given the existence of such regulations on the federal level, there remains a substantial question whether state courts interpreting state corporate laws ought to concern themselves with the federal policies dealing with the public securities market.

The securities-market-oriented view of "going private" transactions may well be too narrow a view for a state court reviewing such a transaction from the perspective of the business purpose test. The presumption that the interests of the "corporation" and the public investor are or ought to be coextensive seems misplaced. As Professor Borden has pointed out, the interest of a public investor in a corporation tends to be relatively short-term and market-oriented. Such an interest might be well-served by a freeze-out on terms in excess of the prevailing market price. Even where the short-term investor stands to lose part of his investment when a corporation "goes private," the fact alone should not preclude the transaction when the long-term owners and the corporation pose valid business reasons for doing so.

If the business purpose test for freeze-outs were adopted, a prohibition on "going private" transactions would also have the peculiar result of making the analysis turn on the means—a public issue—by which the stockholders who are frozen-out acquired their shares. Further, in view of current thinking that suggests that of all freeze-outs, "going private" transactions have the greatest tendency to be justifiable under the business purpose test, a prohibition on those transactions, and not on freeze-outs in general, is illogical.

As important as the policies underlying the securities laws are, a prohibition on freeze-outs in general and "going private" transactions in particular seems to permit the tail of securities law to wag the dog.

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106 But see Berkowitz v. Power/Mate Corp., 135 N.J. Super. at 45, 342 A.2d at 570; People v. Concord Fabrics, Inc., 83 Misc.2d at 122, 371 N.Y.S.2d at 552.
107 See Borden, supra note 5, at 1015-18.
108 See text at note 86 supra.
109 See text at notes 46-48 supra.
of corporate law. Only if one assumes that the securities laws in all contexts promote a more just regime in the corporate world would such a result make sense. The Donohue decision suggests that state corporate principles are capable of dealing with the situation without the necessity of a per se rule, which would unduly restrict the Court's flexibility.

§17.2. Closely Held Corporations: Fiduciary Duty of Majority Stockholders. The Supreme Judicial Court's decision in Donohue v. Rodd Electrotype Co.\(^1\) will have a substantial impact on corporate practice in Massachusetts. The facts of the case reflect a typical state of affairs in closely held corporations. At the time suit was filed, a total of 248 shares of Rodd Electrotype Co. stock were outstanding. Fifty of the shares were owned by the plaintiff—Mrs. Donohue—and her son.\(^2\) The remaining 198 shares were owned by members of the Rodd family: Harry Rodd, president of the corporation, owned 81 shares, and Rodd's three children owned 39 shares each.\(^3\) At a special meeting of the board of directors, Harry Rodd resigned as a director of the corporation. The remaining directors authorized a purchase by the corporation of 45 of Rodd's 81 shares at a price of $800 per share.\(^4\) The ostensible reason for the repurchase was to induce Rodd, who was 78 years old, to relinquish an active role in the corporation's affairs.\(^5\) Rodd completed divestiture of his stock by either selling or giving the remaining shares to his children.\(^6\)

The plaintiff was unaware of the corporate purchase of Rodd's shares for approximately nine months, when a special meeting of the corporation was convened.\(^7\) At that meeting, the plaintiff refused to ratify the transaction, and she and her son offered their shares to the corporation on the same terms as Rodd had received.\(^8\) The corporation refused the offer and the plaintiff brought suit on the ground that the defendant controlling group caused the defendant corporation to purchase the shares in violation of their fiduciary duty to her.\(^9\)

The trial judge, following the well-established no-prejudice rule,\(^10\)

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\(^2\) Id. at 1302 n.8, 328 N.E.2d at 510 n.8.
\(^3\) Id. at 1301, 328 N.E.2d at 510.
\(^4\) Id.
\(^5\) Id.
\(^6\) Id. at 1302, 328 N.E.2d at 510. The Court stated that with respect to the gift of the stock to the children, it could be inferred that such gift was a "part of the 'deal' for the stock purchase." Id. at 1302 n.7, 328 N.E.2d at 510 n.7.
\(^7\) Id. at 1303, 328 N.E.2d at 510.
\(^8\) Id.
\(^9\) Id. at 1296, 328 N.E.2d at 508.
held that the purchase of Rodd's stock by the corporation did not prejudice plaintiff's rights.\textsuperscript{11} The trial judge accepted the reason advanced for the repurchase by the defendants.\textsuperscript{12} He further found that the price paid for the stock was less than the liquidating value of the shares of the corporation, so that the repurchase increased the value of each of the corporation's remaining shares.\textsuperscript{13} The Appeals Court affirmed the decision of the trial judge.\textsuperscript{14} On appeal from the ruling below, the Supreme Judicial Court held that the stockholders of a closely held corporation owe the same duty to each other that partners owe each other, and that members of a controlling group of stockholders may not cause the corporation to purchase the shares of a member of that group without offering to purchase, on a pro rata basis and at the same price, the shares of the remaining stockholders.\textsuperscript{15} The Court suggested that the plaintiff was entitled to two alternative forms of relief: (1) a judgment requiring Harry Rodd to remit the cash he had received for his stock, with interest; or, (2) an order requiring the corporation to purchase the plaintiff's shares for the same price as that paid for Rodd's.\textsuperscript{16}

The \textit{Donohue} case provided the Court with an opportunity to reconsider the validity of the no-prejudice rule. Under the no-prejudice rule, agreements by a corporation to purchase its own stock are "'subject . . . to the limitations that the purchase must be made in good faith and without prejudice to creditors and stockholders.'"\textsuperscript{17} The purchase price of Rodd's stock was less than the liquidation value of that stock on the corporation's books. Under a traditional no-prejudice analysis, this fact would have validated the transaction. Nonetheless, despite the seemingly advantageous terms of the purchase, it appeared that the transaction in total had caused injury to the minority stockholders. The purchase of the stock substantially reduced the liquid assets of the corporation and enabled the selling stockholder to convert his shares into the only corporate asset—cash—having a certain value. Moreover, it appeared that the rationale offered for the purchase was insubstantial from a corporate standpoint because the purchase of a portion of Harry Rodd's ownership in the company did not wrest control from the previously controlling Rodd family group.\textsuperscript{18} Thus,
legitimate injury had been sustained by the minority shareholders, whereas the purchase accomplished little for the corporation.

To create a cause of action for such an injury, the Court could have expanded the no-prejudice rule. Instead, the Court chose to abandon that rule, and adopt the strict fiduciary duty rule. This approach was necessitated by the similarity of interests existing between partners in a partnership on the one hand and the managers and directors of a close corporation on the other. In the Court's view, the mere corporate form was an insufficient basis for the maintenance of different standards of duty.

The Donohue decision obliquely suggests a change in the Court's view of the relationship among the stockholders of publicly held corporations. Whatever form that that change may take, it is clear that the most direct impact of the Donohue decision will be on stock repurchases by close corporations. There are doubtlessly many outstanding purchase agreements of the Donohue variety. The Donohue decision will now draw the validity of those agreements into question.

The Court indicated that the requirement that the remaining stockholders receive an equal opportunity to sell to the corporation would not obtain in cases in which such stockholders gave advance consent. Where such consent takes the form of a provision in the articles of incorporation or by-laws, Donohue seemed to indicate that mere participation in the corporation would bind such remaining stockholders. This result follows from the assumption that, by participating, a stockholder can be deemed to have consented to the provision in question. Nevertheless, the application of this assumption to any agreement in which all stockholders are not parties is questionable. It would seem that such an agreement would bind only signatory stockholders unless some other act could be construed to bind the others. The obvious act of stockholder approval would be the approval of the agreement to purchase by the stockholders of the corporation, particularly if the approval had been unanimous. Yet, even this act of approval may not suffice to bind the stockholders. Since the right to equal opportunity is a personal right and not a derivative one, a stockholder who, although not a party to a stockholder's agreement,
had voted to approve it, might still be entitled to equal opportunity in a personal capacity. That is, in voting to authorize the corporation to enter a stock purchase agreement with other stockholders, the stockholder only approved the participation of the corporation, and did not waive his personal right vis-a-vis other stockholders to be treated equally in the distribution of corporate assets. Thus, in any case in which less than all stockholders are themselves parties to a stock purchase agreement, Donohue may mean that a corporate purchase of a controlling member's shares will give rise to a right of equal participation by nonparty stockholders.

The Donohue case will also cause a reevaluation of other means by which minority stockholders can be disadvantaged by the majority. Recognizing this possibility, Justice Wilkins filed a brief concurring opinion in which he questioned the advisability of extending the Donohue rationale to areas such as salary and dividend policy. In the face of this comment, the majority's failure to so limit Donohue clearly suggests that it intended to permit consideration of these topics, and most probably envisions further consideration of related areas of corporate policy. The suggestion that Donohue is intended to have a broad impact is buttressed by the overall flavor of the majority opinion. For example, in a footnote intended to limit the opinion to transactions to which the corporation is a party, the Court stated:

We stress that the strict fiduciary duty which we apply to stockholders in a close corporation in this opinion governs only their actions relative to the operations of the enterprise and the effects of that operation on the rights and investments of other stockholders.

The Court's inclusion of the qualifying word "only" does little to dispel the notion that it intended to extend the strict fiduciary duty rule to a broad range of transactions.

The broad impact that Donohue may have upon closely held corporations is perhaps advisable in view of the many devices legitimated only by the corporate form, in which majority stockholders may disadvantage minority stockholders. The Court's list of such devices includes the manipulation of salary and dividend policies, property transactions between the stockholders and the corporation, the manipulation of corporate employment, stock purchases, and the issuance of stock. Under prior law, each of these devices has been analyzed solely from the viewpoint of the duty of the officers and directors controlling the corporation or involved in the transaction to the

24 Id. at 1333, 328 N.E.2d at 521.
25 Id. at 1315 n.18, 328 N.E.2d at 515 n.18 (emphasis in original).
26 Id. at 1309-13, 328 N.E.2d at 513-14.
At least in the case of close corporations, Donohue may require a reanalysis from the point of view of the stockholders' duties to one another. The standard to be applied in such analysis will presumably be the partnership standard of utmost good faith and loyalty.

The Donohue case may have an impact on at least one other kind of transaction—where majority shareholders cause the issuance of additional stock, thereby solidifying the majority's control position and diluting the position of other stockholders. Historically, the Supreme Judicial Court has been sensitive to this particular abuse of corporate position and has held that a stock issuance that served personal interests, rather than corporate interests, violates the duty of the controlling stockholder-directors to the corporation. The Court in Donohue indicates that in addition to this derivative right, the stockholders of a closely held corporation will personally have the right to challenge the issuance of stock to the majority stockholders. As a result, although the stockholders of all close corporations do not have preemptive rights in all stock issuances, they now have a personal right to relief where the majority has caused a stock issuance in violation of its duty of utmost good faith and loyalty.

Significantly, Donohue also seems to imply that salary-dividend policies in close corporations will be reanalyzed. The Court points out that judicial reluctance to interfere with management in the declaration of dividends has resulted in a requirement that a challenging stockholder prove an abuse of a director's discretion. At the same time, the courts have been less reluctant to decide the reasonableness of salaries because courts can use a more objective standard in making that determination. Obviously, through the manipulation of salary-dividend policies, the majority stockholders can direct corporate earnings to themselves and deny them to the minority. The strict fiduciary standard adopted by the Court should call for closer scrutiny of the fairness of dividend and salary decisions, and thereby lessen the possibilities for abuse that existed under the old standard.

The Court expressly extended the strict fiduciary duty to all the stockholders of the corporation. The Court accomplished this result by asserting that an unscrupulous minority might do equal damage to an unsuspecting minority. No doubt there are cases in which minor-

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27 See cases cited at note 18 supra.
30 G.L. c. 156B, § 20.
31 See text at notes 24-26 supra.
33 Id. at 1311 n.15, 328 N.E.2d at 514 n.15.
34 Id. at 1315 n.17, 328 N.E.2d at 515 n.17.
35 Id. See Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957).
ity stockholders ought to be limited in their dealings with the corporation or the majority stockholders. An across-the-board application of the strict fiduciary duty rule to minority stockholders, however, would appear to ignore some of the ways in which corporations and partnerships do differ. For example, where a corporation sells property to or buys it from a noncontrolling stockholder, the buying or selling stockholder cannot be said to control both sides of the transaction. Presumably, the corporation would authorize an officer or director to deal with the minority stockholder. In most instances, the minority stockholder would not be in a position to influence either the decision to buy or sell or the exact terms of the agreement. In such circumstances it is hard to see why a minority stockholder should be treated any differently than an unrelated buyer or seller. If such a transaction is subjected to a standard of utmost good faith and loyalty, a minority stockholder, who has dealt with the corporation, may find that he has guaranteed the benefit of the transaction to the corporation. It is questionable whether any policy, other than analytical symmetry for its own sake, requires this result.

One apparent attempt to limit the impact of Donohue arises in the Court's express limitation of the strict fiduciary duty rule to transactions in the shares of a corporation to which the corporation itself is a party. The Court thus avoided comment on the issue raised by cases like Perlman v. Feldman in which controlling stockholders have sold their shares to third parties. Although the Court's reluctance to involve itself in the issue is admirable, the Court's analogy to partnerships will almost surely overcome the attempted limitation. It has long been established that one of the fundamental results flowing from the personal nature of partnerships is that the identity of the participants may not be altered without unanimous consent. By separating ownership from management, corporations typically change that result. Nonetheless, the Court's emphasis on the personal relationships among stockholders would seem to suggest that, like a member of a partnership, a stockholder in a close corporation would not be allowed to destroy that relationship by substituting another in his place. Many close corporations, of course, might recognize the reality of the partnership analogy by effectively preventing the transfer of stock except to existing stockholders or approved successors. Donohue may ultimately turn this safeguard into a rule of law; namely, that the stockholders of close corporations cannot transfer their stock to outsiders without the consent of the other stockholders.

The Donohue decision is thus likely to have a substantial impact on

the law of both close corporations and corporations generally. The holding of the case, that minority stockholders must be given the opportunity to participate in a corporate stock purchase from a member of the controlling group, will raise questions as to the continuing validity of the many stock purchase plans now in effect in close corporations. The teaching of Donohue, that the stockholders of a close corporation owe one another a duty of utmost good faith and loyalty, will obviously have an even greater impact. Unless the Court retreats from its position, this rule indicates that the ability of majority stockholders to use the corporate form of doing business to disadvantage the minority will be sharply reduced.

Finally, the Court's analogy to the fiduciary standard imposed upon partners may have the greatest impact by applying to closely held corporations the principles that have developed to govern the relationships of partners among themselves. It will be interesting to see whether practitioners conclude that the distinction between partnerships and close corporations for state law purposes has largely disappeared. For example, if corporate forms may not be employed to vary personal relationships, will practitioners also conclude that corporate formalities, such as the election of directors, need not be followed in close corporations? If the legal principles applicable to close corporations come to closely resemble those applicable to partnerships, the question whether for tax purposes Massachusetts close corporations are associations or partnerships may also be raised. These and other issues remain undecided in the wake of the Donohue decision. Solutions await further judicial analysis, prompted by the potentially broad implications that the case clearly contemplates.