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Chapter 2: Corporations

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Corporations

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§ 2.1. Fiduciary Duty — Minority Shareholders in Closely Held Corporations.* Recent Massachusetts decisions, which redefined the duty majority shareholders owe to minority shareholders in closely held corporations, have dramatically altered the nature of corporate fiduciary law.¹ In a leading decision, Donahue v. Rodd Electrotype Co.,² the Supreme Judicial Court held that shareholders in close corporations owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another: one of “utmost good faith and loyalty.”³ In discharging their management and ownership responsibilities, the shareholders must adhere to this strict good faith standard of duty and “may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.”⁴ Since Donahue, the Massachusetts courts have continued to recognize the fiduciary duty of majority shareholders in close corporations.⁵ An important consideration in both Donahue and the subsequent decisions, which imposed a strict standard of fiduciary duty upon majority shareholders, was the ability of these shareholders to manipulate corporate decisions. Such power could be used

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For a detailed discussion and commentary on the Donahue decision, see generally Elefante, Corporations, 1975 ANN. SURV. MASS. LAW, §§ 17.1, 17.2, at 455-76; Recent Developments, Shareholders’ Right of Equal Opportunity to Participate in Corporate Purchase of its own Stock for Corporate Treasury, 61 CORNELL L. REV. 986 (1976); Recent Cases, Stockholders’ Duty of “Utmost Good Faith and Loyalty” Requires Controlling Shareholder Selling a Close Corporation its own Shares to Purchase a Ratable Number of Shares from Minority, 89 HARV. L. REV. 423 (1975); Rights of Minority Stockholders, 60 MASS. L. Q. 318 (1975); Recent Developments, Shareholders in a Close Corporation Owe to One Another Substantially the Same Fiduciary Duty Owed by Partners To One Another, 21 VILL. L. REV. 307 (1976).


¹ Id. at 593, 328 N.E.2d at 515.

³ Id.

⁴ See supra note 1.
to the disadvantage of minority holders, who lack adequate remedies to protect themselves from such abuses.6

The Donahue court, however, did not limit the application of its holding to majority shareholders. The court explicitly acknowledged that in the close corporation setting "the minority may do equal damage through un­scrupulous and improper 'sharp dealings' with an unsuspecting majority."7 During the Survey year, in Smith v. Atlantic Properties, Inc.,8 the Appeals Court of Massachusetts considered whether the Donahue strict standard of fiduciary duty should be extended to minority shareholders of a close corporation. In Smith, the court was called upon to review a Superior Court decision which held that a minority shareholder had committed a breach of his fiduciary duty to the other shareholders in exercising a veto power over corporate action on dividends.9 In affirming the judgment of the Superior Court, the appeals court held that a minority shareholder in possession of a veto power becomes an "ad hoc controlling interest" and, as such, owes to the other shareholders a fiduciary duty in the exercise of that power.10

The significance of the appeals court decision is two-fold. First, the Smith decision broadens the applicability of the Donahue standard of fiduciary duty to any shareholder of a close corporation in a position to control corporate action.11 Second, in determining whether a minority shareholder's exercise of control constitutes a violation of his fiduciary duty, the court adopted an approach which considers both the shareholder's fiduciary obligations and his right to exercise a veto power agreed to by the other shareholders.12

6 "The corporate form . . . supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders. The minority is vulnerable to a variety of oppressive devices, termed 'freeze-outs,' which the majority may employ . . . . In particular, the power of the board of directors, controlled by the majority, to declare or withhold dividends and to deny the minority employment is easily converted to a device to disadvantage minority stockholders." Donahue v. Rodd Electrotype Co., 367 Mass. at 589, 328 N.E.2d at 513.

7 Id. at 593 n.15, 328 N.E.2d at 515 n.17.


9 Id.

10 Id. at 1325-26, 422 N.E.2d at 802.

11 Id. It is unclear, however, from the decision, under what circumstances a minority shareholder becomes an "ad hoc controlling interest." The appeals court, in a footnote, id. at 1327 n.9, 422 N.E.2d at 802-03 n.9, refers to Hetherington, The Minority's Duty of Loyalty in Close Corporations, 1972 DUKE L.J. 921, [hereinafter cited as Hetherington] as a helpful discussion of the fiduciary obligations of a minority shareholder "in a position to control corporate action." Presumably, the determination of when a minority shareholder becomes a controlling interest depends upon the facts of each case.

The dispute in Smith centered on the disposition of the earnings of a close corporation which owned and managed real estate. In December of 1951, Doctor Louis E. Wolfson agreed to purchase land and buildings which subsequently became the corporation's assets. Wolfson offered 25 percent interests in the real estate to Paul T. Smith, Abraham Zimble, and William Burke. Smith, an attorney, performed the legal work necessary to form the corporation, Atlantic Properties, Inc. (Atlantic). Upon Wolfson's request, a provision was included in the articles of organization and by-laws which, in effect, gave to each of the four shareholders an absolute veto over major corporate decisions.

Disagreement soon arose between Wolfson and the other shareholders, as a group, over the disposition of Atlantic's earnings. Wolfson desired to

Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976). Under that approach, the validity of the exercise of control by a shareholder is determined by the purposes for which that power is employed. The burden is placed upon the controlling shareholders to demonstrate a legitimate business purpose for the actions complained of by other shareholders. Judicial intervention is appropriate only when the controlling shareholders fail to demonstrate a legitimate business purpose, or, where one is asserted and the other shareholders establish that it could have been achieved by a less harmful course of action. Id. at 851-52, 353 N.E.2d at 663. See Elefante, Corporations, 1976 Ann. Surv. Mass. Law, § 9.1, at 264-71.

14 Id. at 1321, 422 N.E.2d at 799.
15 Id. Each paid Wolfson $12,500, 25 percent of the down payment. Id.
16 Id. Wolfson, Zimble, Burke and Smith were the incorporators and also became the directors of Atlantic. Smith v. Atlantic Properties, Inc., Equity No. 86596, at 2 (Mass. Super. Ct. Suffolk, April 24, 1979) [hereinafter cited as Trial Court decision]. Wolfson was named President; Zimble was named Treasurer; Smith was named Clerk. Id. After incorporating, Atlantic purchased the land and buildings. Id.

Note, the findings of the trial court were adopted in full by the appeals court. 1981 Mass. App. Ct. Adv. Sh. at 1323, 422 N.E.2d at 800.

17 Wolfson testified that he requested inclusion of the veto provision: "in case the people, the other shareholders whom I knew, but not very well, ganged up on me." 1981 Mass. App. Ct. Adv. Sh. at 1326, 422 N.E.2d at 802.

18 The veto provision included in the Articles of Organization and By-Laws of Atlantic Properties, Inc. which provided:

No election, appointment or resolution by the Stockholders and no election, appointment, resolution, purchase, sale, lease, contract, contribution, compensation, proceeding or act by the Board of Directors or by any officer or officers shall be valid or binding upon the corporation until effected, passed, approved, or ratified by an affirmative vote of eighty (80%) percent of the capital stock issued outstanding and entitled to vote.

Id. at 1321, 422 N.E.2d at 799.

Since Atlantic had four shareholders each with a 25 percent interest, the veto provision amounted to a requirement of unanimous shareholder approval of all shareholder and director actions.

19 Trial Court decision, supra note 16, at 4-5. After its first year of operation, Atlantic began to show profits. Id. at 3.
devote the earnings to repair and upgrading of the corporation's buildings, although his plans for doing so were vague and indefinite. During the period from 1951 to 1964, he consistently refused to vote for any dividends, despite warnings from the other shareholders that failure to declare dividends might result in the imposition of a penalty tax by the Internal Revenue Service (IRS) for an unreasonable accumulation of earnings. The other shareholders considered Wolfson's ideas unnecessary and unrealistic, and unanimously desired the declaration of dividends. They did agree, however, to make the most urgent repairs.

Since neither faction could force its will on the other, the corporation steadily increased its earned surplus. The fears of the other shareholders were realized in 1966, when the IRS imposed penalty taxes upon Atlantic for excess accumulations in 1962, 1963, and 1964. Although Wolfson settled the case, he continued his opposition to declaring dividends. Pre-

The court found that an additional cause of disagreement and ill will among the shareholders may have been the refusal of the other shareholders to consent to Wolfson's transferring his shares in Atlantic to a charitable foundation. Id. The other shareholders were opposed to dealing with a trustee of a charitable organization, who would have the authority to exercise Wolfson's veto power. Id. The directors, including Wolfson, adopted a provision to restrict the transfer of shares by giving the corporation the right of first refusal as to any shares to be sold. Id. Wolfson's subsequent requests to transfer his shares to the foundation were rejected. Id. at 11. The court found that Wolfson "never attempted to develop any specific, comprehensive, and feasible plan for repairs and improvements for the other stockholders to consider." Id. at 10.

21. Id. at 4, 5.
22. Smith also stated that if the tax were imposed as a result of Atlantic's failure to declare dividends, he would seek to hold those shareholders who voted against a declaration of dividends personally responsible for the amount of the tax. Id. at 6.

Section 532 of the Internal Revenue Code provides that a tax is imposed on the accumulated taxable income of every corporation "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." I.R.C. § 532. See generally id. §§ 531-37.

23. Trial Court decision, supra note 16, at 5.

24. Between 1958 and 1961, the other shareholders voted in favor of repairing various roads, pumps and smokestacks, having new roofs put on several buildings, and investigating the cost and feasibility of repairing or renovating portions of the property. Id. at 6.


By 1961, Atlantic had approximately $172,000 in retained earnings, of which approximately $92,000 was in cash. Trial Court decision, supra note 16, at 3-4.

26. Trial Court decision, supra note 16, at 8.

27. Id. The amount of the settlement was $11,767.71 in taxes and interest. Id. Wolfson had settled the case without the prior approval of the other shareholders. Id. They ratified the settlement, without prejudice to any right of action they might have had against Wolfson for causing the assessment by failing to vote in favor of declaring dividends. Id.

28. Id. at 9. Since its organization, the corporation paid dividends only twice, once in 1964 and once in 1970. Each dividend totalled $10,000. Id. at 4. Salaries totalling $25,000 were paid
dictably, in 1970, the IRS imposed further penalty taxes on Atlantic for the taxable years 1965 through 1968. These taxes were upheld by the United States Tax Court, which found that tax avoidance was a factor in Wolfson's refusal to vote for the declaration of sufficient funds to avoid the penalty.

In 1967, the majority shareholders initiated a proceeding in the Superior Court of Massachusetts, seeking: (1) a determination of the dividends to be paid by Atlantic; (2) the removal of Wolfson as a director, and (3) an order that Atlantic be reimbursed by him for the penalty taxes and related expenses incurred. In Smith, the trial court found that Wolfson's refusal to vote in favor of dividends was caused more by a desire to avoid taxes and a dislike for the other shareholders than by any genuine desire to undertake a program for improving Atlantic's property. Concluding that Wolfson "acted in bad faith and abused his discretion," the trial court held that he committed a breach of his fiduciary duties as a director and as a shareholder. In reaching its conclusion that Wolfson stood in a fiduciary relation-

to the directors in 1959 and 1960. Id. No other payments were made to the shareholders. Id. at 10.

Atlantic Properties, Inc. v. Commissioner, 62 T.C. 644, 660-61 (1974), aff'd, 519 F.2d 1233, 1236 (1st Cir. 1975). Atlantic brought suit in the Tax Court challenging the Commissioner's determination of deficiencies against it. 62 T.C. at 644. The Tax Court held that Atlantic was subject to the accumulated earnings tax, id. at 660-61, as it failed to establish a reasonable need to accumulate its earnings and profits in the years in controversy, and lacked any specific, definite and feasible plans for use of the accumulations. See Treas. Reg. § 1.537-1 (b)(1) (1980).

Atlantic Properties, Inc., 62 T.C. at 660. In an attempt to refute the presumption that its accumulation of earnings and profits was for the purpose of avoiding the income tax, the corporation argued that the history of deadlock precluded the distribution of dividends. The Tax Court acknowledged the deadlock, but held that while those shareholders who acted in good faith and consistently voted in favor of dividends were absolved of any tax avoidance motive, id. at 659, the finding of a tax avoidance motive on Wolfson's part was enough to place liability on the corporation. Id. at 660-61.

Smith v. Atlantic Properties, Inc., Equity No. 86596 (Mass. Super. Ct. Suffolk, April 24, 1979). The proceeding was later supplemented to reflect developments after the filing of the original complaint.

This conclusion was supported by the findings that from 1951 to 1968, Wolfson's gross income and taxable income were significantly greater than the incomes of the other shareholders. Thus, he had less need for the dividends to insure his own economic well-being. Id. Also, since he was in a higher tax bracket, Wolfson derived the greatest tax advantage by avoiding additional income from dividends. Id.

The court also found that Wolfson never attempted to develop any specific, comprehensive, and feasible plan for repairs and improvements for the other shareholders to consider. Id. at 10.

Id. at 15.

ship to the other shareholders, the court relied exclusively on the broad language of the Donahue decision. The court determined that Wolfson was individually liable to Atlantic for over $47,000 in taxes and interest, and ordered the directors to declare a reasonable dividend.

Both parties appealed from the judgment.

In an unanimous decision, the appeals court affirmed the decision of the trial court and applied a strict standard of fiduciary duty to minority shareholders of a close corporation. In determining that imposition of this standard was appropriate, the appeals court stressed that Wolfson was able to exercise a veto concerning corporate action on dividends. The court found that Atlantic’s veto provision had “substantially the effect of reversing the usual roles of the majority and minority shareholders. The minority . . . becomes an ad hoc controlling interest.” The court then considered the extent to which a minority shareholder may exercise that control without a violation of his fiduciary duty. In reaching its determination that Wolfson had breached that duty, the court adopted an approach previously employed by the Massachusetts courts to settle disputes involving alleged breaches of fiduciary duty by majority shareholders of close cor-


Mass. 518, 523, 80 N.E. 450, 452 (1907).

Trial Court decision, supra note 16, at 15-16, where the court states: “As a stockholder in a close corporation, Wolfson owed to the other stockholders a duty of utmost good faith and loyalty. Donahue noted that this duty is more stringent than the fiduciary duty owed by directors or shareholders to the corporation. Therefore, since this Court has found that Wolfson, as a director, has breached his fiduciary duty to the corporation, Wolfson as a shareholder clearly has breached his duty of utmost good faith and loyalty to Smith, Burke and the Zimbles.” Id. at 16 (citations omitted).

Id. at 18.

After entry of judgment by the trial court, Wolfson and Atlantic filed a motion for a new trial and to amend the judge’s findings. This motion was denied. Wolfson and Atlantic claimed an appeal from the judgment and the former from the denial of the motion. 1981 Mass. App. Ct. Adv. Sh. at 1324, 422 N.E.2d at 801.

Id. at 1324-31, 422 N.E.2d at 801-04.

Id. at 1325, 422 N.E.2d at 802.

Id. at 1325-26, 422 N.E.2d at 802. While the trial court decision suggested that all shareholders of close corporations owe one another a fiduciary duty, see note 36 supra, the appeals court decision was more narrowly drawn, focusing on the minority shareholder whose conduct is controlling on a particular corporate matter. See supra note 11.

1981 Mass. App. Ct. Adv. Sh. at 1326, 422 N.E.2d at 802. In commenting on the validity of the veto provision under the Massachusetts corporate statute the court observed:

It does not appear to be argued that this 80% provision is not authorized by G.L. c. 156B. See especially § 8(a). Chapter 156B was intended to provide desirable flexibility in corporate arrangements. The provision is only one of several methods which have been devised to protect minority shareholders in close corporations from being oppressed by their colleagues and, if the device is used reasonably there may be no strong public policy considerations against its use . . . . The possibilities of shareholder disagreement on policy made the provision seem a sensible precaution. Id. (citations omitted).
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Applying the Wilkes v. Springside Nursing Home, Inc. "legitimate business purpose" test, the court proceeded to examine the business interests advanced by Wolfson and the other shareholders as reasons for their actions. The court affirmed the trial court's finding that Wolfson failed to demonstrate a legitimate business purpose for his refusal to vote for the declaration of dividends. In concluding that Wolfson had committed a breach of his fiduciary duty, the court reasoned that whatever was the reason for his refusal to vote in favor of declaring dividends, the risks Wolfson ran in subjecting Atlantic to penalty taxes for excess accumulation of earnings were unjustified and "inconsistent with any reasonable interpretation" of his fiduciary duty as a shareholder. Thus, the trial court was upheld in charging Wolfson with the expenses incurred by Atlantic in the tax cases.

The imposition of a strict standard of fiduciary duty upon a controlling minority interest in a close corporation is a logical and necessary progression in the development of corporate fiduciary law in Massachusetts. The appeals court's decision is consistent with and supported by the rationale set forth in Donahue where majority shareholders, those shareholders typically in control of a close corporation, were held to a strict standard.

The corporation in Smith clearly fit the Donahue court's definition of a close corporation. Atlantic never had more than five shareholders; all the shareholders participated in the management of the corporation; and there was no ready market for the corporation's stock. These features of the close corporation are linked to the first basic consideration of Donahue that because a partnership resembles a close corporation, owners in both forms of enterprise have the same fiduciary duties. Although Atlantic was organized in corporate form, its internal features were characteristic of a partnership: ownership and management were in the same hands, ownership was limited to the original parties or stock transferees approved by the

43 Id. at 1327, 422 N.E.2d at 802. See supra note 12 for a discussion of the "legitimate business purpose" test.
45 Id. at 1328, 422 N.E.2d at 803.
46 Id., 422 N.E.2d at 803-04.
47 The rationale in Donahue v. Rodd Electrotype Co. for holding majority shareholders to a strict standard of fiduciary duty is discussed at 367 Mass. at 586-92, 328 N.E.2d at 512-15.
48 The Donahue court deemed a close corporation to be typified by (1) a small number of stockholders, (2) no ready market for the corporate stock, and (3) substantial majority stockholder participation in the management, direction and operation of the corporation. Id. at 586, 328 N.E.2d at 511.
49 Trial Court decision, supra note 16, at 15.
50 Donahue v. Rodd Electrotype Co., 367 Mass. at 586, 328 N.E.2d at 512, where the court states: "Commentators and courts have noted that the close corporation is often little more than an 'incorporated' or 'chartered' partnership."
remaining shareholders,\textsuperscript{51} and the owners were dependent upon one another for the success of the enterprise.

A related feature of the close corporation which led the \textit{Donahue} court to impose a strict standard of fiduciary duty upon majority shareholders was the importance of relationships of trust, confidence and loyalty among the shareholders to the successful operation of the corporation.\textsuperscript{52} In commenting on this critical connection between shareholder relationships and success of the enterprise, the \textit{Donahue} court noted "disloyalty and self-seeking conduct on the part of any stockholder will engender bickering, corporate stalemates, and perhaps, efforts to achieve dissolution."\textsuperscript{53} Likewise, such shareholder conduct would be critical to the success of a corporation like Atlantic, where by virtue of a veto provision each shareholder had the power to control corporate action.\textsuperscript{54} As the fate of Atlantic demonstrates, the absence or breakdown of relationships of trust, confidence and loyalty among the shareholders can result in substantial harm to a close corporation.\textsuperscript{55} Yet, prior to the recognition in \textit{Smith} of the fiduciary duties of a controlling minority shareholder, there was no assurance that a minority shareholder would exercise control in a reasonable manner.

The final, and most important, feature of a close corporation focused on by the \textit{Donahue} court was the inherent danger to minority interests of the combination of ownership and management present in a controlling group.\textsuperscript{56} The court focused on the power controlling shareholders have to manipulate corporate decisions to the minority's disadvantage.\textsuperscript{57} Of particular concern to the court was the limited and inadequate remedial options available to minority shareholders as protection against such power.\textsuperscript{58} For example, while an oppressed minority shareholder can bring suit against the majority and its directors, alleging that the directors' conduct constitutes a breach of their fiduciary obligations to the corporation, the court recognized that in practice it is difficult for a minority shareholder to successfully challenge internal corporate decisionmaking.\textsuperscript{59} The fiduciary obligations of the controlling shareholders who are acting as directors, or through a board of directors which they control, run to the corporation and not to individual shareholders. Thus, so long as the transaction complained of is fair to the corporation, a court is unlikely to interfere with the business judgment of directors.

\begin{itemize}
  \item \textit{See supra} note 19.
  \item Donahue v. Rodd Electrotype Co., 367 Mass. at 587, 328 N.E.2d at 512.
  \item Id.
  \item \textit{See supra} note 18.
  \item \textit{See supra} notes 19-31 and accompanying text.
  \item Id. at 588-89, 328 N.E.2d at 513.
  \item Id. at 589-92, 328 N.E.2d at 513-14.
  \item Id. at 589-90, 328 N.E.2d at 513-14.
\end{itemize}
In addition to the limited possibility of judicial relief, the Donahue court noted it is difficult for a minority shareholder to liquidate his investment as, by definition, there is no ready market for shares in a close corporation. Finally, the court recognized it is unlikely that a minority shareholder will be able to take advantage of dissolution as a means of recovering his share of the enterprise assets.

Significantly, the appeals court in Smith based its decision to hold a minority shareholder to a strict standard of fiduciary duty exclusively on the last discussed feature of a close corporation; the ability of a controlling shareholder to manipulate corporate decisions to the disadvantage of other shareholders and the lack of remedies available to the oppressed shareholders. In concluding that the majority shareholders could seek protection from Wolfson, the Smith court reasoned that the veto provision had "reversed" the traditional roles of the majority and minority shareholders; the minority had become an "ad hoc controlling interest." While the nature of the minority's position afforded the minority less opportunity for abuse than the position of control typically held by majority shareholders of close corporations, such opportunities repeatedly arose for the minority shareholder of Atlantic. The appeals court found that the corporation was subject to the penalty taxes because of Wolfson's refusal to vote in favor of declaring any dividends. The court recognized that the ability of a minority shareholder to prevent a corporation from taking action can be as detrimental to the interests of other shareholders as an unfair affirmative policy adopted by controlling majority shareholders.

The complaining majority shareholders of Atlantic were not, however, as lacking in remedies as is the typical minority shareholder of a close corporation. For example, unlike the complaining shareholder in Donahue, Atlantic's majority shareholders had the options of seeking dissolution of the corporation or selling their shares. There are limitations, however, on the availability of these options even to the majority. First, while the majority shareholders could have authorized the corporation to file a petition for dissolution, the trial court concluded that it would be unfair to require them to

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40 Id., 422 N.E.2d at 802.
44 See supra notes 1-31 and accompanying text.
48 See supra note 61.
seek dissolution as the only means of receiving any profits from the corporation. Moreover, merely because in some cases oppressed majority shareholders will have the opportunity to seek dissolution of a close corporation should not alter the logical conclusion that when minority shareholders constitute a controlling force in a close corporation, they should be held to the same standard of fiduciary duty as majority shareholders.

Second, the sale of their shares was not a feasible option for the majority shareholders in *Smith*. Since Atlantic had a financial history of providing little or no return to its shareholders, the majority’s holdings were not an attractive investment. Furthermore, transfer of the ownership of their shares would have been subject to the corporation’s right of first refusal. In effect, the minority shareholders could not have sold their interest in Atlantic without first offering it to the corporation, that is, to Wolfson, the only remaining shareholder. In light of the limited availability of the options of dissolution and sale of their shares, the appeals court correctly ignored these options when it reached its determination that the majority shareholders were entitled to the court’s protection.

The appeals court was, therefore, correct in concluding that the circumstances in *Smith* required recognition of Wolfson’s fiduciary obligations as a shareholder to the other shareholders. While the majority shareholders were entitled to seek the court’s protection, judicial intervention on their behalf required the court to strike a balance between Wolfson’s fiduciary obligations and his right to exercise a veto power granted to him by the other shareholders. In reaching its conclusion that Wolfson’s exercise of the veto was unreasonable and improper, the court turned to the *Wilkes* approach for guidance.

The appeals court examined the purposes for which the minority shareholder allegedly exercised his veto power, as well as the resulting harm to the corporation and the majority shareholders, and determined that Wolfson breached his fiduciary duty as a shareholder. Wolfson was unable to demonstrate a legitimate business purpose for his conduct of refusing to vote in favor of declaring dividends. There was ample support for the

67 Trial Court decision, supra note 16, at 18.

68 The availability of the dissolution option to some majority shareholders had no impact on the appeals court’s determination that a minority shareholder in possession of a veto power over corporate action should be held to a strict standard of fiduciary duty. 1981 Mass. App. Ct. Adv. Sh. at 1326 n.6, 422 N.E.2d at 802 n.6.

69 See supra note 28.

70 See supra note 19.


72 *Id.* at 1328, 422 N.E.2d at 803.

73 The defendants in *Wilkes* were also unable to demonstrate a legitimate business purpose for their actions. Wilkes v. Springside Nursing Home, 370 Mass. at 852, 353 N.E.2d at 663-64. In *Wilkes*, a minority shareholder of a close corporation brought an action against the majori-
court's conclusion that Wolfson had not established a legitimate business purpose for his actions. The court found that he failed to submit any comprehensive or feasible capital improvement and repair plans to the other shareholders and did not supply them with necessary information regarding the cost and need for his proposed plans. Furthermore, Wolfson was frequently warned by the others that the IRS would assess penalty taxes against the corporation unless it disposed of some of its earnings. Given Atlantic's financial well-being, Wolfson could have agreed to vote dividends in an amount adequate to at least reduce the danger of the imposition of the penalty tax, without draining Atlantic of the funds needed to finance the improvements he desired to make. Thus, in repeatedly refusing to vote in favor of declaring dividends, Wolfson's actions were taken with full knowledge of the risks to which he was subjecting the corporation. Accordingly, the court concluded that rather than exercising his veto power in furtherance of a legitimate business purpose, Wolfson's primary concerns in refusing to consent to the declaration of dividends were to avoid personal tax liability and to annoy the other shareholders.

By contrast, the court found that the majority shareholders had acted in good faith, evincing both a willingness to vote in favor of necessary improvements and a strong desire to declare dividends. While recognizing that the majority shared to some extent responsibility for the voting deadlock by failing to accept Wolfson's suggestions with much sympathy, the

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74 Trial Court decision, supra note 16, at 11.
75 Once the IRS establishes the unreasonableness of a corporation's accumulation of earnings, the burden is on the corporation to refute the presumption that the accumulation was for the purpose of avoiding the income tax with respect to its shareholders. I.R.C. § 533. To demonstrate that the accumulation was for reasonably anticipated business needs, the corporation must show that the future needs of the business required such accumulation, and that it had specific, definite, and feasible plans for the use of the accumulation. Treas. Reg. § 1.537-1(b)(1) (1980).
76 See supra note 25.
77 Trial Court decision, supra note 16, at 11.
78 Id. at 12.
court found that the principal cause of the tax penalty assessments was the inaction on dividends caused by Wolfson's exercise of the veto power.\textsuperscript{11}

The appeals court's reliance upon the \textit{Wilkes v. Springside Nursing Home, Inc.} approach suggests that the validity of a minority shareholder's exercise of control ought to be determined according to the purpose for which he is acting. Where a minority shareholder demonstrates a legitimate business purpose for his conduct, absent a showing of bad faith or abuse of discretion, the courts should not interfere with the business judgment of that shareholder.\textsuperscript{12} There are several arguments which support a limited involvement of the courts in the internal disputes of close corporations.

First, where the organizers of a corporation agree to a veto provision as broad as that included in Atlantic's charter, a court should not interfere with the reasonable exercise of the veto power by any shareholder. A minority shareholder who has "bargained" with his co-shareholders for the adoption of such a provision is entitled to exercise the veto to promote his views as to what course of action is in the corporation's best interest.\textsuperscript{13} Thus, in a shareholder dispute over the wisdom of a particular corporate policy, an ad hoc controlling minority interest is entitled to the same deference which a court would show to majority shareholders in establishing the business policy of a close corporation.\textsuperscript{14}

A cautious judicial approach to determining when a shareholder has breached a fiduciary duty to co-shareholders is the foundation of the \textit{Wilkes "legitimate business purpose" test}. In \textit{Wilkes}, the court considered the implications of the \textit{Donahue} holding for the scope of freedom of action of controlling shareholders in close corporations.\textsuperscript{15} In particular, in \textit{Donahue} the Supreme Judicial Court intimated that the fiduciary duty imposed upon majority shareholders governed \textit{all} their actions relative to the operation of the corporation as they affected minority shareholders.\textsuperscript{16} The same court in

\begin{itemize}
  \item \textsuperscript{11} Id.
  \item \textsuperscript{12} The court is, however, given substantial discretion under the \textit{Wilkes} test in determining whether a shareholder who asserts a legitimate business purpose has still committed a breach of fiduciary duty owed to the complaining shareholder. The complaining shareholder is afforded an opportunity to demonstrate that the defendant shareholder could have achieved his legitimate business purpose through an alternative course of action less harmful to the complaining party's interest. The court is to "weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative." \textit{Wilkes v. Springside Nursing Home, Inc.}, 370 Mass. at 851-52, 353 N.E.2d at 653. \textit{See} \textit{Elefante, Corporations, 1976 ANN. SURV. MASS. LAW}, § 9.1, at 268.
  \item \textsuperscript{13} \textit{See} Hetherington, \textit{supra} note 11, at 944.
  \item \textsuperscript{14} \textit{See id.}, where in commenting on shareholder disputes over the merits of business policy the author notes: "the majority is entitled to follow the course it thinks best, despite the most earnest disagreement by the minority. He who has the votes makes policy."
  \item \textsuperscript{16} \textit{Donahue v. Rodd Electrotype Co.}, 367 Mass. at 593 n.18, 328 N.E.2d at 515 n.18.
\end{itemize}
Wilkes, however, expressed a concern that "untempered application of the strict good faith standard . . . will result in the imposition of limitations on legitimate action by the controlling group in a close corporation which will unduly hamper its effectiveness in managing the corporation in the best interests of all concerned." Accordingly, the court recommended a "balancing" of the majority's rights to "selfish ownership" in the corporation against the concept of their fiduciary obligation to the minority.

These same considerations should guide the courts in evaluating the conduct of a controlling minority interest. While a minority shareholder who possesses a veto power is in a position to abuse the other shareholders, that shareholder is also entitled to a range of discretion to exercise the veto in promotion of legitimate business purposes. Judicial reluctance to intervene in a policy dispute would not work an injustice upon complaining majority shareholders seeking protection from a minority shareholder. As was noted by the court in Smith, having agreed to a broad veto provision at the time of incorporation, the majority shareholders knew that they were placing Wolfson in a position to exercise the veto to promote policies which he favored over the majority's preferences. Wolfson was held to have breached his fiduciary duty to the majority because he failed to establish a legitimate business purpose for his voting pattern, and not simply because he exercised the veto in favor of a business policy opposed by the majority.

An additional reason for a limited role of the courts in settling internal corporate disputes is the difficulties which arise following the determination that a shareholder has breached his fiduciary duty. Depending upon the nature of the conflict between the shareholders, a substantial amount of judicial supervision may be required to implement the court order resolving the dispute. For example, in Smith the trial judge reserved jurisdiction in the Superior Court for five years to allow supervision of the corporation's

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18 Wilkes v. Springside Nursing Home, Inc., 370 Mass. at 851, 353 N.E.2d at 663, where the court recognizes the following as matters in which controlling shareholders should be afforded "some room to maneuver in establishing the business policy of the corporation:" "in declaring or withholding dividends, deciding whether to merge or consolidate, establishing the salaries of corporate officers, dismissing directors with or without cause, and hiring and firing corporate employees."

19 1981 Mass. App. Ct. Adv. Sh. at 1326 n.8, 422 N.E.2d at 802 n.8, where the court states: "The other shareholders, two of whom were attorneys, should have known that it was as open to Dr. Wolfson reasonably to exercise the veto provision . . . in favor of a policy of reinvestment of earnings in Atlantic's properties . . . as it was from them (possessed of the same veto) to use reasonably their voting power in favor of a more generous dividend and salary policy."

20 Trial Court decision, supra note 16, at 9.
dividend policy. A similar level of intervention would be required if in settling a dispute a court has to involve itself in the financial management of a corporation.

A final reason supporting a limited involvement of the courts in resolving internal corporate disputes is the adverse effect such involvement could have on the use and effectiveness of veto provisions as a means of protecting the interests of minority shareholders in close corporations. A veto provision is one of several methods which have been devised to protect minority interests from oppression by majority shareholders. This apparently was the motivation of the minority shareholder in Smith in requesting inclusion of a veto in the corporation’s charter. When properly drafted, a veto provision is an effective means of affording a minority interest a voice in the management of a close corporation, as well as a form of protection against the power traditionally vested in majority shareholders to determine corporate policy.

The abuse of the veto provision and the resulting harm to the corporation in Smith suggest that while a broad veto provision may accommodate an individual shareholder’s desire for protection or participation in management, that shareholder’s needs may be satisfied at the expense of a workable, flexible corporate decisionmaking process. In order to retain a workable management pattern, an attorney who is asked to draft a veto provision for a close corporation should consider the following options.

First, veto provisions increase the chance that a deadlock will occur in a corporation’s management. The likelihood of deadlock is enhanced if a broad, all-encompassing veto power is granted to shareholders. For example, in Smith the veto power extended to virtually every significant corporate action of the directors and the shareholders. Also, a broad veto power provides a minority shareholder with more opportunities to use the power to extort unreasonable and unfair concessions from the other shareholder.

91 Id. at 18. The final judgment of the appeals court required Atlantic’s directors to confer and stipulate as to a general dividend and capital improvements policy for the ensuing three fiscal years. If the stipulation was not filed within a specified period, a hearing would be necessary, after which time the court would direct the adoption and carrying out of a policy adequate to minimize the risk of further penalty tax assessments.

The court could reserve jurisdiction to take the same action for each subsequent fiscal year until the parties were able to reach agreement on a program.

92 In Smith, the Appeals Court stated that a veto provision is valid under state law, noting that “if the device is used reasonably, there may be no strong public policy considerations against its use.” 1981 Mass. App. Ct. Adv. Sh. at 1326, 422 N.E.2d at 802.


94 See text and note at note 17 supra.

95 See text and notes at notes 96 to 98 infra.

96 See note 18 supra for the text of the veto provision.
Accordingly, it would be prudent for an attorney to restrict the scope of a veto power to those areas where it is of particular value to a minority shareholder. Commentators have recommended that a veto provision be limited to fundamental corporate acts and changes in corporate structure.\textsuperscript{99}

Restricting the scope of a veto power to particular corporate decisions may, however, still subject a corporation to irreconcilable, and damaging, shareholder disputes. Thus, the attorney may wish to consider providing a non-judicial means, such as arbitration, for settling those disputes which do arise.\textsuperscript{99} Arbitration is a recognized method for resolving internal corporate disputes and an attractive alternative to litigation. By a provision in the articles of incorporation,\textsuperscript{100} shareholders can agree that in the event of disagreement over certain matters, the manner in which their shares will be voted shall be determined by an arbitrator, whose decision will bind all parties.\textsuperscript{101} While agreements to arbitrate future disputes were not enforceable at common law,\textsuperscript{102} many states, including Massachusetts, have provided by statute that such agreements may be specifically enforced.\textsuperscript{103}

Finally, an attorney contemplating use of a veto provision should weigh the pros and cons of this device against the features associated with other methods of protecting the interests of a minority shareholder in a close corporation. Among the most obvious of these are charter or by-law provisions providing for mandatory dividends,\textsuperscript{104} and shareholder agreements over such matters as dividends, corporate employment, and compensation.\textsuperscript{105} As the fate of the close corporation in Smith suggests, adopting a broad veto

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\textsuperscript{97} See PAINTER, CORPORATE AND TAX ASPECTS OF CLOSELY HELD CORPORATIONS, 338 (2d ed. 1981) [hereinafter cited as PAINTER] where the author notes: "The broader the veto power, the greater the possibility that it may be used in a 'power play' rather than for legitimate purposes."

\textsuperscript{99} See id. at 166-67, 201-02. See also O'NEAL, supra note 93, at §§ 4.10, 4.24. Fundamental corporate acts over which the veto power might extend include the issuance of new shares, changes in the amount of dividends, corporate repurchase of outstanding shares, and changes in employment and compensation of corporate officers and employees. Fundamental changes in corporate structure would include changes in the number of directors, amendment of the articles or by-laws, merger, consolidation, the sale of assets, dissolution, and the filing of consent to a petition in bankruptcy or reorganization.

\textsuperscript{100} See PAINTER, supra note 97, at 345-54; O'NEAL, supra note 93, at §§ 9.08-9.25. For a discussion of arbitration in the corporate setting see Note, Mandatory Arbitration as a Remedy for Intra-Close Corporate Disputes, 56 VA. L. REV. 271 (1970). See also Note, Arbitration as a Means of Settling Disputes within Close Corporations, 63 COLUM. L. REV. 267 (1963).

\textsuperscript{101} PAINTER, supra note 97, at 351, where the author recommends including the provision in the articles so as to bind successors and assigns of the original parties to the agreement.

\textsuperscript{102} See, e.g., Ringling Bros. v. Ringling, 29 Del. Ch. 610, 53 A.2d 441 (Sup. Ct. 1947).

\textsuperscript{103} PAINTER, supra note 97, at 346.

\textsuperscript{104} G.L. c. 251, § 1. For a list of other states which provide for the enforcement of agreements to arbitrate future disputes, see O'NEAL, supra note 93, § 9.14 n.8.

\textsuperscript{105} See O'NEAL, supra note 93, at § 5.20; PAINTER, supra note 97, at 181-82.
provision as the means of protecting the interest of one shareholder may result in substantial, unanticipated harm to the other shareholders and to the corporation.

While Smith itself is an extreme example of the risks associated with employing a veto provision as a device for protecting the interests of a minority shareholder in a close corporation, the appeals court's decision, recognizing the fiduciary obligations of a minority shareholder in a position to control corporate action, is relevant to any attorney called upon to draft special charter and by-law provisions addressed to the needs of a minority shareholder. To the extent that such a provision permits the minority shareholder to manipulate corporate decisions to the disadvantage of the other shareholders, the Smith decision offers a means by which oppressed majority shareholders may seek judicial intervention on their behalf. Finally, the decision may stand as a deterrent to abusive exercise of control by minority shareholders.