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Special Problems of Family Owned Businesses: State Law Causes of Action for Shareholder Oppression and Duties in the Family Owned Business: Litigation Issues

I. Special Problems and Unique Characteristics of the Closely Held Enterprise

- a. Majority Rule. Majority Rule and small number of shareholders: my 51% is valuable and your 49% is not worth a The majority is in a position to dictate all activities and enjoyment of economic benefits (declare dividends, hire and pay salaries and benefits, pay excessive salaries, enter into contracts with affiliates, forcing redemptions and recapitalizations, mergers....)
- b. Business Judgment Rule. Under the doctrine, courts will give great deference to the business decisions of those in formal authority. Unless there are showings of fraud or self-interest, a court will not substitute its judgment for that of the business leaders (board of directors and majority).
- c. Lack of marketability for interests. Lack of a ready market for interests representing a near perpetual restraint and the dominant characteristic of the closely held enterprise. Unlike a shareholder in a public corporation or one in which a ready market for the interests exists, a shareholder in the typical family business has no effective or realistic means of disposing of his interest in the event of a disagreement.
- d. Tax considerations on manner of distributions limiting the manner of enjoying economic benefits: focus on employment and income tax deductible means of distributing the profits of the enterprise. Given the lack of dividends in closely helds, a minority shareholder in the family has no means of either withdrawing his capital or obtaining a return in the usual case.
- e. Family dynamics and active participation of members in business. The business and the family dynamics often become intertwined, with the result that a dispute in one area of the relationships causes issues in the business. It is not unusual to find instances of the family dispute becoming the reason for the discharge or other freeze out in the business of the disaffected family member.
 - i) Examples of situations that are likely to lead to disputes and the prospect of litigation:

Personality clashes with autocratic parent and death of parent dissolving 'glue' that keep matters under control (also know as avoidance and denial); marital discord (the divorce and the brother-in-law problem); inactive shareholders with presumptions of entitlements and active shareholders resentful of others sharing in success and efforts; minority shareholders entering into competing businesses as a means of avoiding majority control or sharing; majority taking opportunities for themselves or giving them to other family members; failure to identify and plan succession; treating family business as checkbook of family; etc.

ii) Classic Cases:

Pedro v. Pedro, 463 N.W.2d 798 (Minn. App. 1992) [Three brothers and father, accounting issues and brother disagreement with complaining brother fired and employees told that he had a nervous breakdown].

McCauley v. Tom McCauley & Sons, Inc., 724 P. 2d 232 (N.M. 1986) [Ex-wife suing husband and former in-laws after being excluded from living on ranch].

Terry J. Cooke v. Fresh Express Foods Corporation, Inc., 7 P. 3d 717 (Ore. 2000) [Father and daughter fire her husband during divorce action].

Kiriakides v. Atlas Food Systems and Services, Inc., 343 S. C. 587 (S.C 2001) [Brother dispute began over sale of land by one brother to son of other at what one considered less than the fair market value with dispute escalating into dispute in operation of business].

Masch Meier v. Southside Press, Inc., 435 N.W. 2d 377 (Iowa App. 1998) [Elimination of position and distribution due to family disagreements].

II. Development of Oppression Doctrine

- a. 1933: The first statutory reference is in the Business Corporation Act of Illinois allowing for judicial dissolution on a finding of oppression.
- b. Subsequent to the 1933 Illinois Act the Model Business Corporation Act (now the 3d version at Section 14.30) and modern statutes have included a finding of oppression as grounds for a judicial order of dissolution.
- c. Dissolution on oppression is viewed as a drastic remedy and courts are reluctant to order it absent harsh circumstances.
- d. Alternative for Corporation and Majority: Fair value buy-out, either court ordered within the equitable powers of the court or pursuant to a statutory alternative remedy to dissolution.
- e. As remedies less drastic than dissolution have developed, the conduct needed to show to obtain a remedy has evolved.

For example: developments in Illinois and Shirmer v. Bear, 672 N.E. 2d 1171 (Ill. 1996) [Illinois Supreme Court affirmed a trial court order of a buy out in the context of a majority shareholder excluding a minority from the board in a meeting not following the corporate formalities in a freeze out context. The Illinois Supreme Court noted that the then newly adopted statutory remedy of a buy-out was also within the equitable authority of the court. In addition, the court upheld a remedy (buy out) in circumstances that probably would not have supported a finding of oppression sufficient to justify dissolution.]

- f. Judicial Approach (partnership analog) Donahue v. Rodd Electrotpe Co. of New England, Inc., 367 Mass. 578 (1975) A leading case finding that the special relationship of shareholders in a closely held corporation results in the majority having duties to the minority of fair dealing and honesty in the exercise of the

power to control the affairs of the entity. The court analyzed the lack of a market, the controlling power of the majority and closeness of the relationships and concluded that partner like duties existed for the majority.

III. Oppression Definitions and Development

- a. Background. The Illinois Business Corporation Act of 1933 and the Model Business Corporation Act based on it allowed for judicial dissolution if the directors or those in control acted in a manner that was oppressive.

The term “oppression” and the conduct that was considered ‘oppressive’ was left to the courts to determine.

An early Illinois decision, Gidwitz v. Lanzit Corrugated Box Co., 20 Ill. 2d 208 (Ill. 1960), stated “the word ‘oppressive’...does not carry an essential inference of imminent disaster; it can contemplate a continuing course of conduct.” “The word does not necessarily savor of fraud, and the absence of ‘mismanagement, or misapplications of assets,’ does not prevent a finding that the conduct of the dominant directors or officers has been oppressive.” At 215.

- b. Specific formulation of a definition of “Oppression” has taken several forms. A summary of the concept of oppression in 22 states is included as Exhibit 1. The following is an overview of the current views.

- i) “Reasonable Expectations.” The formulation most often used is conduct that defeats the reasonable expectations of the minority as a shareholder. The formulation of this definition that seems most frequently stated is based on the Kemp decision. In Re Kemp & Beatley, Inc., 64 N.Y. 2d 63, 473 N.E. 2d 1173 (N.Y. 1984).

“...oppression should be deemed to arise only when the majority conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner’s decision to join the venture.” at 73.

Other Examples:

Alaska: Smith v. Leonard’s Hardware Inc., 705 P. 2d 443 (1985).

New Jersey: Brenner v. Berkowitz, 134 N.J. 488, 634 A.2d 532 (N.J. 1993) interpreting N.J. Stat. Ann. Sec. 14A:12-7 (1)(c) ...recognizing oppression and describing it as conduct against the minority in his role as shareholder, director, officer or employee that defeats reasonable expectations.

North Carolina: Meiselman v. Meiselman, 309 N.C. 279 (1983) This is a frequently cited early case on the formulation using the ‘reasonable expectations’ approach. The court also noted that privately held expectations that were not made known to the majority would not be considered reasonable.

Minnesota: Haley v. Forcelle, 669 N.W. 48 (Minn. Ct. App. 2003) Express adoption of the standard: Minn. Stat. Ann. Section 302A.751 (3) (a) (West Supp. 1999).

Oregon: Cooke v. Fresh Express Foods Corp. Inc., 7 P.3d 717 (Or. Ct App 2000).

South Dakota: Landstrom v. Shaver, 561 N.W.2d 1 (S.D. 1997) [No finding of oppression].

[Note: Courts will find that the plaintiff's expectations must not only be reasonable, but must also be known to or assumed by the other shareholders and concurred in by them. Privately held assumptions about rights that are not known to the others will not be 'reasonable.' "Only expectations embodied in understandings, express or implied, among the participants should be recognized by the court." Meiselman, at 563].

[Note: The standard or approach of 'reasonable expectations' has been used in a state that did not have an oppression/dissolution statute in the analysis of whether an enhanced fiduciary duty of the majority to the minority was breached. See, Wilkes v. Springside Nursing Home, Inc. 353 N.E.2d 657 (Mass. 1976)]

- ii) "Bad Faith." Some courts have rejected the focus on the reasonable expectations of the minority shareholder, and instead applied a standard that emphasizes the actions of the majority, i.e., fair dealing and good faith in the actions of the majority. Kiriakides v. Atlas Food Systems and Services, Inc. 343 S.C. 587, 541 S.E. 2d 257 (S.C. 2001)

The court in South Carolina believed that the standard of oppressive conduct was a function of the bad faith and conduct of the majority and not the expectations of the minority. However, while it declined to adopt what it considered the expansive 'reasonable expectations' standard, it did find the actions of the majority "oppressive."

Michigan: Franchino v. Franchino, 687 N.W. 2d 620 (Mich. App. 2004) [The court strictly interpreted the Michigan statute to find that terminating the employment of a minority shareholder did not constitute oppression, because such an act does not interfere with the interests as a shareholder. The court would not consider the 'reasonable expectation' [which would have included employment] approach and instead looked to a focus on the bad faith of the conduct of the majority.

- iii) "Burdensome, harsh and wrongful conduct." Another formulation is found in a number of states. Oppression is conduct which "...is burdensome, harsh and wrongful; a lack of fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."

For Example:

Colorado: Colt v. Mt. Princeton Trout, 78 P.3d 1115 (Colo. Ct App. 2003)

Mississippi: Kisner v. Coffey, 418 S0. 2d 58 (Miss. 1982)

Montana: Pankratz Farms, Inc. v. Pankartz, 322 Mont. 133 (2004)

Wisconsin: Jorgensen v. Water Works, Inc. 218 Wis. 2d 761 (Wis. Ct App 1998)

Willis v. Bydalek, 997 S.W.2d 798 (Tex. App. 1999), in the face of a claim relating to loss of employment, the Texas court found that there is no expectation in Texas of continued employment and "...firing alone is simply not the sort of 'burdensome, harsh, or wrongful conduct' or 'visible departure from the standards of fair dealing' that may constitute shareholder oppression." At 802.

iv) Other Views:

California: Dissolution may be sought if those in control of the corporation have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders. Cal Corp Code Section 1800 (b)(4) In at least one case, a California court held that in determining whether 'persistent unfairness,' the reasonable expectations of the minority was not the standard. Instead, the focus of the inquiry was to be on the conduct of the majority. Bauer v. Bauer, 46 Cal. App. 4th 1106 (Cal. Ct. App. 1996).

New Mexico: McCauley v. Tom McCauley & Sons, Inc. 724 P.2d 232 (N.M. Ct. App. 1986) The court viewed 'oppression' as an "expansive term" used to cover a multitude of circumstances involving improper conduct. It viewed the term as one that could include frustration of legitimate expectations or acts of such severity as to warrant the relief requested.

North Dakota: Balvik v. Sylvester, 411 N.W.2d 383 (N. D. 1987) similar formulation as New Mexico.

- c. Fiduciary Duty Approach and Partnership Analog. A number of courts, including those in jurisdictions with statutes regarding dissolution on a finding of oppression, have used an analog to the partnership context when dealing with majority actions injuring the interests of minority shareholders.

This approach also focuses on the conduct of the majority as opposed to the expectations of the majority.

The leading case finding that the majority had fiduciary duties toward the minority (analyzing the closely context and using partnership analog) was Donahue v. Rodd Electrotpe Co. of New England, Inc. 367 Mass. 578 (1975).

"Because of the fundamental resemblance of the close corporation to eh partnership, the trust and confidence which are essential to this scale and manner of enterpi4rse, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another." At 593.

“Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.” At 594.

- IV. Freeze Out Conduct. Freeze out is the term frequently applied to the actions of the majority directed at the minority in order to deprive the minority family member of some rights in respect of the entity.
- a. Examples of techniques employed in freeze out situations:
- i) Withholding dividends and distributions (in particular distributions for taxes in S corporations - and LLCs).
 - ii) Elimination of employment and benefits of minority or in-law (firing the brother in law after dad dies).
 - iii) Excessive compensation to majority, and hiring majority family members without experience, etc.
 - iv) Exclusion from participation in decisions and withholding of information.
 - v) Favorable contracts with affiliates, use of spouses as consultants, marking up expenses from third parties through 'service companies' of majority, etc.
 - vi) Recapitalizations (reverse stock splits), mergers (cash out or fractional elimination), amendments to articles of incorporation resulting in cash out of minority at low prices and exclusion of minority from continuing enterprise.
 - vii) Usurping corporate opportunities (ancillary businesses, expansion opportunities, acquiring property to rent to businesses, etc.).
 - viii) Dilution of voting and economic interests in issuance of other classes of stock or convertible debt, options, etc.
 - ix) Use of corporate assets for majority (credit cards, airplanes, vacations homes, country clubs, fuel tanks on majority property, etc).
 - x) Loans to family members (and failure to enforce collection).
 - xi) Sale of business interest without inclusion of minority or with siphoning of price to majority.
- V. Loss of employment as the classic problem. The firing of a family member is usually a traumatic and drastic event in the family business. Aside from morale issues (which may or may not be positively affected within the business), the loss of compensation is frequently the loss of any meaningful economic benefit in respect of the share interest of the discharged family member.
- a. Oppression/Reasonable expectation of employment as part of right of ownership in a family business.
- i) Case law primary dealt with “investment” and not inheritance of an interest.

Many cases, however, go forward under the oppression theory and involve family members' holding inherited interests.

ii) Loss of employment is frequently a negation of any economic benefit from ownership and found to be oppressive. Firing a brother-in-law without "cause" can be oppression of the family member/shareholder.

1. Example: Two sisters and brother, with brother and spouse of each sister employed in the business. If the only distributions are in respect of employment, would not the discharge of one of the in-laws deny any benefit to the shareholder? Frequently the advantage and the expectation in a family or other closely held business is that there will be employment for the shareholder and members of the shareholder's family. Such an expectation could then be shown to be both reasonable and known to all of the participants by virtue of family understandings and past conduct.

2. Is there a right of employment?

a. No right of employment:

South Carolina, Texas, Michigan decisions not finding employment a matter of shareholder rights absent some agreement or corporate level decision. In effect, the 'reasonable expectation' standard was not adopted to find employment an expectation to be protected under the oppression theory.

The courts in South Carolina and Michigan viewed their respective statutes as focusing the analysis only on the interests as a shareholder and therefore have not adopted the expectations of the shareholder in capacities other than that of a shareholder.

b. Employment as Potential Protectible Expectation:

New York: In Re Kemp; In Re Topper v. Park Sheraton Pharmacy, Inc. 433 N.Y.S. 2d 359 (Sup. Ct. 1980)...court said "...examination of 'oppressive conduct' need not be confined merely to effect on the shareholder in his role as shareholder."

New Jersey: minority in capacity as shareholder, director, officer or employee....N.J. Stat. Ann. Sec. 14A: 12-7 (1)(c).

Illinois: No reference to status as employee. However, reasonable expectations can be taken into account in establishing a remedy for oppressive conduct. 805 ILCS

Pedro v. Pedro, 489 N.W.2d 798 (Minn. App. 1992) (Pedro II), reviewed denied (Minn. 1992). Is there a guaranty of lifetime employment? A right of any employment? It depends: Berremán v. West Publishing Company, 615 N.W.2d 362 (Minn. App. 2000) No.

3. Employee and Beneficiary of Trust

Not directly a shareholder

Can oppression be brought? Practical problems and need to make demands on trustees and potentially join various parties.

California: Specific recognition in a close corporation that beneficiaries of voting trusts or certain shareholder agreements can bring an action directly. Cal. Corp. Code Section 1800 (e) (2005).

4. A reasonable expectation of continued employment (the frustration of which will constitute oppression or conduct unfairly prejudicial) where there:

- a. is a capital investment;
- b. employment was considered part of the financial participation;
- c. the salary is a defacto dividend; and
- d. the prospect of employment was a significant motivation for the participation.

Absent misconduct or incompetence, of such expectation is generally known and accepted. The frustration of such employment will be actionable.

O'Neal; Close Corporation, §1.07

Haley v. Forcelle 669 N.W. 2d 48 (Minn. App. 2003) [Exclusion of co-founder who held 27% and had guaranteed debt. Injunctive Relief granted].

Berremán v. West Publishing Company 615 N.W. 2d 362 (Minn. App. 2000) [Lower expectations in case of long-term employee with stock options subject to buy-back].

Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super.141 (1979) [Following Illinois and Virginia approach to oppression, but finding no reasonable expectation of continued employment. Son-in-law, in divorce proceeding, failed to learn business and get along with other shareholder employees].

- b. Failure to Make Distributions. A shareholder discharged for misconduct, nevertheless obtains relief for oppression in the form of a failure to make distributions.
- c. Conflict with the employment at will doctrine. The termination of an employed family member (in particular if a shareholder) brings together two conflicting legal doctrines: the protection of the minority and the idea that employment in most jurisdictions is 'at will.' The legal status as a shareholder (and the expectation of employment for the family member and family) can result in an oppression remedy despite the concept of 'at-will employment.' Kemp; Pedro; Balvik; and Douglas Moll: Shareholder Oppression v. Employment at Will in the Close Corporation: The Investment Model Solution, 1999 U. Ill. L. Rev. 517 (1999).

VI. Remedies for Minority Shareholders: Non Statutory Based Actions

- a. Derivative Action for Breach of Fiduciary duties by majority. The action by minority in the name of the corporation for breaches of duty by the directors, officers and controlling shareholders is frequently an unsatisfactory approach for the minority family participant.
 - i) Burden of prosecuting the action without resources; difficulties of establishing the conduct of the majority and access to information; and likelihood that remedy will not produce a direct benefit for the minority.
 - ii) Derivative claims are not direct claims of the minority, but rather are in the name of the corporation.
- b. Direct Actions:
 - i) The partnership analog and finding of direct duties between those in control and the minority. The idea is to have a cause of action that lies directly against the majority or those in control, with the damage or relief flowing directly to the minority and measured by the harm to the minority's interests.
 - 1. General Rule: no duty arises solely based on the idea of share ownership in the corporate setting. Generally, family members are free to pursue their own interests. Each shareholder represents his own interest and without more does not have duties to the other shareholders. For example, shareholders are free to compete, sue in the capacity of creditor, sell their interest, purchase from the entity, etc.
 - 2. Exceptions:
 - a. Majority and Controlling Shareholders. Those who dominate the affairs of a closely held corporation have duties that attach to the control, that is, in the exercise of the power to control the affairs they have a duty to do so for the benefit of all of the shareholders and not for their own benefit. Hayes v. Olmsted & Assocs., Inc., 21 P.3d 178 (Or A;;. 2001) Nonetheless, those in control can vote their share interests in their own interest. For Example: Zidell v. Zidell, Inc., 560 P. 2d 1086 (Or. 1977); Boss v. Boss, 200 A.2d 231 (R.I. 1964) [majority

shareholders can vote share interests for own personal benefit even though under a fiduciary duty to act as a director and officer for the interests of all shareholders]

- b. Direct Duty to Minority. Unlike the duty to exercise the power of control for the benefit of all shareholders, in the context of the closely held corporations, the majority can have direct duties that relate specifically and distinctly to the minority family member. The relationship is often analogized to that of partners. For example: See Donahue; O'Neal and Thompson: Oppression of Minority Shareholders: Protecting Minority rights in Squeeze-Outs and Other Intracorporate Conflicts, 2d Section () Section 7:04 ("Enhanced or modified fiduciary duties in close corporations") and Section 7:05 ("Analogizing a close corporation to a partnership"); Doherty v. Kahn, 682 N.E. 2d 163 (Ill. App. 1st 1996) finding in a close corporation the existence of fiduciary duties running directly among shareholders); Zidell; Pedro v. Pedro; Guy v. Duff & Phelps, Inc. 772 F. Supp. 1086 (N.D. Ill 1987); Crosby v. Beam, 548 N.E. 2d 217 (Ohio 1989) . The limitations of the partnership analog are discussed in Richard M. Blaikock, Note, Fiduciary Duties Owed by Frozen-Out Minority Shareholders in Close Corporations, 30 Ind. L. Rev.763 (1997)

- 3. Attorneys Fees and Punitive Damages. Often counsel will fashion a claim in a pleading on the basis of a breach of fiduciary duty in order to be able to request fees and punishment type damages. While such maybe effective in terms of pleading, the burden of proof in many jurisdictions for a finding of a breach requires "clear and convincing evidence."

VII. Statutory Oppression and Remedies

- a. Buy Out and Alternative Remedies. Many statutes (approx. 33) and the MBCA contain provisions for a variety of relief that can be ordered by the court.
 - i) In Illinois, a threshold or prima facia case of conduct amounting to 'oppression,' can result in not only a buy-out order but a number of other alternatives to judicial dissolution, including:
 - ii) The performance, prohibition, alteration, or setting aside of any action of the corporation or of its shareholders, directors, or officers of or any other party to the proceedings;
 - iii) The cancellation or alteration of any provision in the corporation's articles of incorporation or by-laws;
 - iv) The removal from office of any director or officer;
 - v) The appointment of any individual as a director or officer;
 - vi) An accounting with respect to any matter in dispute;

- vii) The appointment of a custodian to manage the business and affairs of the corporation to serve for the term and under the conditions prescribed by the court;
- viii) The appointment of a provisional director to serve for the term and under the conditions prescribed by the court;
- ix) The submission of the dispute to mediation or other forms of non-binding alternative dispute resolution;
- x) The payment of dividends;
- xi) The award of damages to any aggrieved party;
- xii) The purchase by the corporation or one or more other shareholders of all, but not less than all, of the shares of the petitioning shareholder for their fair value and on the terms determined under subsection (e); or
- xiii) The dissolution of the corporation if the court determines that no remedy specified in subdivisions (1) through (11) or other alternative remedy is sufficient to resolve the matters in dispute. In determining whether to dissolve the corporation, the court shall consider among other relevant evidence the financial condition of the corporation but may not refuse to dissolve the corporation solely because it has accumulated earnings or current operating profits.

Note: The Illinois Supreme Court in the interpretation of the predecessor statute acknowledged that in an action for oppression, the court had all of the powers available to a court of equity to fashion appropriate relief other than dissolution, while affirming a lower court ordered buy-out. Shirmer v. Bear, 672 N.E. 2d 1171 (Ill. 1996).

b. Compensation and Position Reinstatement

See Haley v. Forcelle, 669 N.W. 48 (Minn. Ct. App. 2003)

See Musto v. Vidas, 281 N.J. Super 548 (N.J. App. 2000)

- i) The order of reinstatement and compensation directly responds to the "expectation" of participation and financial return. It does not deal with the underlying issues and inter-relationship of family and business dynamics. Nor does it seem likely any order share of a buy-out can adequately deal with the deterioration that frequently precedes the litigation.
- ii) Judicial Buy-Out. The most likely relief ordered as a result of an oppression finding (or a decision to separate the parties – as a practical matter) is an order for the defendants to buy the shares of the petitioning minority.

c. Election to Buy Out Plaintiff's Interest. At least 14 states have statutes that allow for the defendant in an oppression action to elect to buy-out the petitioner's shares. Most of these statutes also provide a mechanism for the court to stay proceedings related to the oppression and move to a determination of "fair value." In Illinois, this is known as an "F" election; see 805 ILCS 5/12.56(f).

Similar Statutes:

Alabama,	10-2B-14.34
Arizona	10-1434
Connecticut	33-900
Florida	07.1436
Hawaii	14-415
Idaho	30-1-1434
Iowa	490.1434
Mississippi	79-4-14.34
Nebraska	21-20,166
New Hampshire	93-A:14.34
Utah	16-10A-1434
W. Virginia	31D-14-1434]

d. Buy-out; Election and Practical Issues.

i) The buy-out election as with the order as relief allows for the defendants to elect to avoid dissolution by buying the petitioner's shares. In the case of an election, the effect is to avoid litigation on the underlying conduct. The election generally must be filed within 90 days of the petition and generally is irrevocable (absent a finding of equitable reasons to set it aside by the court). If the parties are unable to agree on a value within a time period, the court is directed to conduct a hearing as to the fair value. The court can order the buy-out and the terms on which it will occur.

ii) Date for Value.

Sec 805 ILCS 12.56; N.J.S.A. 14A: 2-7(8)(a)

In the elective approach, the date for valuation is the day before the petition is filed. Generally, the court can determine another date, but experience is that judges are reluctant to do so. Model Business Corporation Act 14.34 (b)

If the buy-out is not elective, the date generally is the date of commencement or other date deemed ignitable by the court.

iii) In the judicial order of a buy-out and determination of "fair value," the date of the valuation is set by the court.

1. The selection of the date to be used can have a dramatic effect on the outcome due to depreciation or appreciation at the time of the petition or thereafter, or as a result of the filing itself and the subsequent litigation. The presence of the litigation and the effect on the business can be significant, generally negative. The distraction of the litigation, the impact on morale of employees, the concerns of creditors, lenders and suppliers, and the lost of opportunity from the distraction and the use of funds to litigate, all have to be taken into account.

2. Alternative dates can include the date of the oppressive actions, the day before the filing of the petition or the date of the court order to conduct a fair value hearing.

3. In the case of the termination of the employment of a senior family member, or in-law, or in the face of an opportunity for an increase in value, it may be that a date more current would avoid the loss of appreciation (and the potential motive for the oppression and the election). The petitioner's argument for a more current date will be that such avoids rewarding the defendant's for oppressive conduct (attempting to take increase in value) and acknowledges that the petitioner has remained at risk of the loss of his equity prior to the order and buy-out.
4. Given the protected nature of the litigation, a variety of considerations come into play in setting the date:

For example:

- a. Loss of intervening salary and benefits;
- b. Intervening events; potential sale of business; litigation against corporation; loss of customers; loss of employees; death of shareholder and impact on liquidity of business;
- c. "S" earnings (and tax attribution) and distributions (or lack thereof);
- d. assets or apportionment and stripping by majority;
- e. competition by minority; replacement of employment by terminated family member;
- f. unusual economic events or results not representative of financial performance; and
- g. availability of financial data or market comparables.

See Musto v. Vidas 281 N.J. Super 548 (N.J. App. 2000) [Events subsequent to the petition were not considered (possible sale at higher value and lack on distributions in interim) where valuation approach considered future income and capitalization method].

Lawson Mardon Wheaton v. Smith 407 (1999) [Court admitted evidence of subsequent acquisition of business].

- iv) Election Issues. Many have criticized the election as being the equivalent of a call option on the shares of the minority and that the presence of the election has influenced minorities to avoid filing oppression actions.
 1. Recently, Illinois amended its statute to provide that the elective purchase will be available to the defendants only if the election is included in the petition. Whether this will influence a court not to order a buy-out under the general relief provisions remains to be seen. 805 ILCS Section 7.90 (effective July 1, 2005).

2. The call option function can be particularly negative in jurisdictions that allow for the discounting of the minority position in the determination of the “fair value.” In deed, even if the discounts are a matter for the trial court, the potential application forces the parties to have expert testimony on the topic and spend resources arguing for or against the application.
3. What was originally seen as a means of getting to a resolution with less burden (the election), does not appear to have succeeded. The argument over value, use of discounts and the impact of the conduct of the parties on the value has merely shifted the focus of the dispute from proving ‘bad conduct’ to proving the impact of the same conduct on values. In either case, a great deal of conduct is presented and disputed.
4. In most cases of oppression, the petitioning family member also files counts for breach of fiduciary duty. The elective statutes frequently provide that the court shall enter a stay of the proceedings pending the determination of the value.
 - a. However, at least in Illinois, the stay is not mandatory but must be proceed by a hearing as to the appropriateness of the stay and the extent of it.
 - b. The stay has been held not to extend to other causes of action or parties not involved in the buy-out. As a result, dual tracking can occur and the parties litigate breaches simultaneous with the determination of value.
 - c. The practical effect is to have discovery and motion practice continue, while experts are hired and value disputed, all the while generating significant litigation costs and fees.
 - d. Beyond the fees and costs, the presence of claims of breach of duty beyond the oppression raise other issues:
 - (i) Duplication of damages where the breaches also are reflected in the determination of “fair value” or the loss of value due to the conduct of the parties. The court in the order for a determination may include in the concept of “fair value” not only the value of the enterprise but also a consideration of any conduct that impacted the value.
 - (ii) The determination of the value will not necessarily end the litigation, as the breach claims and other counts may survive. The idea that the election can avoid cost and litigation then gets turned on its head. In addition, a finding of impact of bad conduct on the value can have estoppel or res judicata effect.

- (iii) See, Jahn v. Kinderman, No 1-02-2335 (Illinois First Appellate Dis. July 2004). The trial court stayed the proceedings on the fiduciary duty count and proceeded to try the valuation following an election for a buy-out. However, during the valuation hearing the court allowed testimony of the conduct of the parties over the objection of the defendants. Following the hearing the court found the value, and then later denied any further proceedings on the basis that the conduct and evidence in the valuation hearing did not rise to the level of breaches of duty. The plaintiff complained that the approach of the trial court denied a full hearing on the breaches (and the prospect of attorneys' fees and punitive damages). The appellate court affirmed the trial court procedure and finding that the conduct admitted in the valuation case and central to the breach count that was stayed, did not rise to the level of oppression or a breach of duty.

[Note: The valuation found by the trial court was approximately \$54 million, and more than mid way between the valuations of the parties, favoring the plaintiffs. In discussions with plaintiffs' counsel, I have expressed the view that judicial economy (the avoidance of yet a second trial) and the favorable result on the valuation probably were indicative of the plaintiffs in effect getting the benefit of the doubt on the breach matters without a second trial. I can't prove it, but it sure seems likely.]

- v) Other considerations.
1. The "fair value" standard does not necessarily deal with the impact of the buy out on the minority. The value of the interest frequently will not produce sufficient capital to enable the departing family member to replicate the life style previously enjoyed; compensate for the lost prestige or ability to participate in the business, or compensate for the difference in earning ability.
 2. The ability of a family member to obtain comparable employment is often a question following a buy out.
 3. The buy out can put a financial strain on the on-going business and impact the ability to grow and reward the remaining family members.
 - a. The lack of earned surplus was not found to be an objection to a corporate redemption in the face of an order to purchase the shares of a dissenting shareholder. Evanento v. Farmers Union Elevator, 191 N.W.2d 258 (N.D. 1971).
 - b. In oppression buy-outs, the court can consider the reasonable expectations of the parties under most statutes and the impact on the corporation in fashioning

the terms of the buy-out. At least in one case, a trial court indicated that it would follow the terms of the shareholder agreement and order the payments over a ten year period, impose a duty not to compete and require the corporation to grant a security interest in certain assets (which were subordinate to the bank lender).

- vi) Mullenberg v. Bikon Corporation, 143 N.J. 168 (N.J. 1996) [Petitioner, majority shareholder, was required to sell shares to majority. Unusual remedy but the court found language in New Jersey (N.J.S.A. 14A-7(8)) to authorize it and with the wide variety of remedies a court could order].

e. Foreign Corporations:

In bringing an action, is the court to apply the definition of oppression and remedies of the state in which the action is brought or the law of the state of organization?

- i) §302 Restatement of Conflicts 2d, generally provides that in matters of governance, it is the law of the jurisdiction of organization that is applied to matters of governance.
- ii) However, if the state of the situs of the action has a more significant interest in the particular matter (the occurrence, conduct, the parties), the local law may be applied.

VIII. Fair Value. The standard of value that is employed in most buy-out statutes (either judicially ordered or as an election) is based on the concept of "fair value".

- a. The concept is not considered the same as "fair market value" in most jurisdictions. The primary difference is whether or not the valuation should be on the basis of the proportionate share of the enterprise or whether the interest of the minority should be discounted for its lack of control and lack of a ready market. Given that such discounts can reduce a proportionate share of the business by anywhere from 30 to 60%, it is not surprising that the topic has been the subject of numerous articles and cases.
- b. See, Moll, Shareholder Oppression and "Fair Value": of Discounts, Dates, and Dastardly Deeds in the Close Corporation, 54 Duke L.J. 293 (November 2004). This is a particularly good article on the short comings of both the concept of a forced buy-out as well as a good analysis of the arguments for the absence of discounts. A survey of the status of the discount approach is included as an Exhibit 2.
- c. Illinois: In Illinois, the birth place of the statutory oppression concept, the definition of "fair value" is treated as a question of fact and left to the discretion of the trial court. The result has been extensive litigation over the use of discounts, with the competing experts employed by counsel setting the definitions and standards. See C. Murdock, Squeeze-outs, Freeze-outs, and Discounts: Why Is Illinois in the Minority in Protecting Shareholder Interests?, 35 Loy. U. Chi L.J. 737, 760-62 (2004).

IX. Duty of Minority

- a. In the family business, the issue often arises as to whether the minority have any duties that flow from their role as a shareholder. As with the majority, the law generally has not imposed a duty on a shareholder to other shareholders absent a position of trust or control as in the closely held context. Shareholders are free to vote their own personal economic interests.
- b. In general, such finding a duty would come as a surprise to most lawyers. That is, a duty arising solely out of the role of being a minority shareholder.
- c. However, in Illinois there have been several developments. The context involves minority shareholders competing or taking property presumably belonging to the corporation with knowledge of the value to the corporation and other shareholders.
 - i) Rexford Rand Corp. v Ance, 58 F3d 1215 (7th Cir 1995), minority shareholder and former employee subsequently filing to use the businesses name when corporate failed to renew.
 - ii) Hagshenas v Gaylord, 199 Ill App 3d 60, 557 NE2d 316 (2d D), appeal denied, 133 Ill 2d 556, 561 NE2d 691 (1990), 50/50 shareholder dispute and shareholder leaving to form a competing business. William Lynch Schaller, Competing After Leaving: Fiduciary Duties of Closely Held Corporation Shareholders after Hagshenas v Gaylord, 84 Ill Bar J 354 (1996).
 - iii) Legislative Response. As of July 1, 2005, a shareholder can waive the right to vote, be an officer or director, or control the affairs of the corporation, and thereby be found to have no duty to the corporation or other shareholders arising solely out of the capacity of being a shareholder. 805 ILCS Section 7.90.

Concept of waiving right to vote to negate prospect of fiduciary duties.
- d. The case development following Hagshenas in Illinois caused many representing minority shareholders in family businesses to hesitate before advising that they could leave and compete with the business. Some suggested that it was the most effective form of non-competition arrangement that could be imposed on a disenchanting minority family member. Now, if the waiver approach is used (and is upheld), a minority presumably can leave the family business and compete with it. Given the locked in nature of the investment, there may be cases where the ability to compete could be more economically beneficial to the family member.
- e. As a planning tool, the waiver can be negated by a provision in the articles of incorporation.
- f. The waiver however, does not deal with the prospect of proprietary information, trade secrets, or other property or rights of the corporation or other shareholders.

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