

Mr. Michael J. Zdeb  
September 16, 2005  
Joint Fall CLE Meeting  
San Francisco, California

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. 4<sup>th</sup> 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.























