Shareholder Oppression & Dividend Policy in the Close Corporation

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I. Introduction

The receipt of a dividend is perhaps the most basic method by which a shareholder earns a return on her investment in a corporation. Because of the dividend's importance, scholars have long focused their attention on the fundamental question of when judicial intervention into a company's dividend policy is warranted. Significantly, however, this academic focus has concentrated almost exclusively on the publicly-held corporation. In that context, a number of authorities have argued that there is little need for the judiciary to involve itself in compelling the payment of dividends, primarily for two reasons.

First, if a public corporation retains profits rather than declaring dividends, "the price of the firm's shares will rise accordingly." A shareholder desiring a current return can always create a "homemade" dividend by selling some stock
and capturing the appreciated value. Second, if corporate management pursues a dividend policy that is contrary to shareholder interests, dissatisfied investors will sell their holdings. Widespread selling will decrease a company's stock price and will expose management to the threat of removal. Commentators have argued, therefore, that senior managers' self-interest in retaining their valuable employment positions will independently restrain poor dividend decisions without the need for judicial oversight.

It is somewhat obvious that these two rationales are premised on the existence of a well-functioning market. A market is necessary to convert stock into homemade dividends, and a market is necessary to put "dissatisfaction" pressure on management. Both rationales protect public corporation investors from suboptimal dividend decisions, and both suggest that there is little need for judicial interference in public corporation dividend policy.

In the close corporation setting, however, these market-based rationales are wholly inapplicable. A close corporation, by definition, lacks a market for its stock. As a consequence, a close corporation minority investor can rarely capture the appreciation in the value of its shares, as willing purchasers are typically scarce or nonexistent. Moreover, the majority shareholder's control over dividend policy is free of market constraints. When close corporation dividend policy is at issue, therefore, a "hands-off" attitude by the judiciary makes considerably less sense. Although other scholars have previously made this observation, the academic discussion has not proceeded substantially beyond the observation itself. It is important, therefore, to return to the fundamental question and to consider it in the close corporation setting—that

4. Id.
5. See infra notes 83–85 and accompanying text (explaining that the presence of a well-functioning market warrants less intrusive judicial review).
6. See, e.g., Donahue v. Rodd Electrotype, 328 N.E.2d 505, 514 (Mass. 1975) ("In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation."); infra note 33 and accompanying text (noting that close corporation stock lacks a market).
7. The terms "majority" and "minority" are used in this Article "to distinguish those shareholders who possess the actual power to control the operations of the firm from those who do not." Hetherington & Dooley, Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem, 63 Va. L. Rev. 1, 5 n.7 (1977). Such power is most often determined by the size of the shareholdings. Id.
8. See infra notes 68–70 and accompanying text (explaining that the absence of a market makes it difficult to liquidate close corporation holdings).
9. See infra note 88 and accompanying text (noting the observations of various commentators).
is, when is judicial intervention into a close corporation’s dividend policy warranted?

To some extent, a consideration of this question has been aided by the development of the shareholder oppression doctrine. The doctrine of shareholder oppression attempts to safeguard the close corporation minority investor from the improper exercise of majority control.\(^\text{10}\) By identifying and protecting the "reasonable expectations" of close corporation shareholders, including the reasonable expectation of dividends, the oppression doctrine combats majority shareholder efforts to exclude a minority investor from the company’s financial and participatory benefits.\(^\text{11}\) Although the doctrine usefully acknowledges that close corporation shareholders can have reasonable expectations of dividends, the doctrine provides no guidance on whether an asserted expectation is "reasonable," and thus enforceable, in the particular circumstances before a court.\(^\text{12}\) One could argue, therefore, that the shareholder oppression doctrine has simply rephrased the fundamental question. Asking whether judicial intervention into a close corporation’s dividend policy is warranted, in other words, is functionally equivalent to asking whether a shareholder’s expectation of dividends is reasonable under the circumstances.\(^\text{13}\)

This Article squarely addresses the issue of close corporation dividend policy and the question of when judicial intervention is warranted. More specifically, this Article analyzes close corporation dividend disputes through the lens of the shareholder oppression doctrine. By examining when a shareholder’s expectation of dividends is reasonable and enforceable, this Article moves beyond the mere observation that close corporations require greater judicial scrutiny. Indeed, this Article discusses the basic types of dividend disputes that arise in close corporations and provides guidance to courts for resolving such disputes.

To put this Article in context, one should understand that the vast majority of corporations in this country are close corporations.\(^\text{14}\) Family-owned

\(^{10}\) See, e.g., Bonavita v. Corbo, 692 A.2d 119, 124 (N.J. Super. Ct. Ch. Div. 1996) (noting that the "thrust" of the oppression-triggered dissolution statute "is protection from the abusive exercise of power"); id. at 128 ("[I]t is the ‘wielding of ... power’ in a manner which ‘destroy[s] a stockholder’s vital interest and expectations’ that constitutes oppression.").

\(^{11}\) See infra Part II (describing the shareholder oppression doctrine).

\(^{12}\) See infra Part III.C (discussing the limits of the reasonable expectations standard).

\(^{13}\) More precisely, judicial intervention into a close corporation’s dividend policy is warranted when majority conduct frustrates a shareholder’s expectation of dividends, and when a court determines that the expectation was reasonable in the circumstances.

\(^{14}\) See HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 257, at 695 (3d ed. 1983) ("Numerically, the vast majority of business corporations are closely-held.").
businesses (which close corporations often are) "represent ninety-five percent of all United States businesses and are responsible for nearly fifty percent of the jobs in the United States."15 Moreover, the number of new business incorporations in this country has reached peak levels.16 As a consequence, the issues discussed in this Article affect an enormous number of companies as well as individuals.

Part II of this Article provides needed background information by discussing the nature of the close corporation, the development of the shareholder oppression doctrine, and the effect of a denial of dividends on close corporation shareholders. Part III contends that courts should evaluate close corporation dividend disputes under the oppression doctrine's reasonable expectations standard, rather than under the traditional, majority-deference approach. Because there is no market for close corporation stock, and because the dividend decisions of majority shareholders are often tainted by conflicts of interest, this part argues that a judicial framework based on deference to the majority is unworkable in the close corporation setting. The shareholder oppression doctrine, however, is premised on the notion that the majority's dividend decisions—decisions that might otherwise be innocuous in public corporations—can be devastating to minority investors in close corporations. The doctrine recognizes, in other words, that majority deference is inappropriate in the close corporation context. This Part concludes, therefore, that the reasonable expectations standard is a superior approach for evaluating close corporation dividend controversies.

Parts IV and V explore the basic types of close corporation dividend disputes and seek to develop a principled framework for resolving them. Part IV involves de facto dividend claims—that is, claims that the majority shareholder is receiving a disproportionate share of the company's profits, often in the form of salary and other employment-related benefits. Although de facto dividend disputes may result from the fault of the majority, the fault of the minority, or from no fault at all, this Part utilizes a hypothetical bargaining model to conclude that the disproportionate receipt of company profits should always be viewed as oppressive and worthy of judicial intervention. Moreover, this Part reveals that the judicial relief provided in many de facto dividend controversies is often incomplete.

Part V focuses on disputes over dividend suppression when de facto dividends are not involved. Put differently, even when a majority shareholder


16. See U.S. SMALL BUS. ADMIN., SMALL BUSINESS ECONOMIC INDICATORS 18 (1998) ("[N]ew business incorporations are . . . at their peak record levels for the last ten years.").
does not receive a disproportionate amount of the company’s profits through salary or otherwise, a minority shareholder may, at some point, reasonably expect dividends—particularly when a business has been profitable for some period of time but has not yet distributed those profits to shareholders. This Part borrows from the field of financial economics in arguing that an expectation of dividends should be deemed reasonable when the majority attempts to reinvest the company’s profits in projects that provide below "cost of capital" returns—that is, projects with expected rates of return that are insufficient given their levels of risk. As this Part explains, a majority shareholder will have an incentive to make below cost of capital investments whenever those investments provide employment benefits to the majority that more than offset the insufficient financial return. Such investments, however, disadvantage minority shareholders who, for either voluntary or involuntary reasons, do not work for the company. By again utilizing a hypothetical bargaining model, this part advocates an approach that no court presently follows: whenever the majority seeks to make below cost of capital investments, oppression liability should arise.

II. The Doctrine of Shareholder Oppression

A. The Nature of the Close Corporation

A close corporation is a business organization that typically has a small number of stockholders, the absence of a market for the corporation’s stock, and substantial shareholder participation in the management of the corporation. In the traditional public corporation, the shareholder is normally

17. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975); see also Daniel S. Kleinberger, Why Not Good Faith? The Foibles of Fairness in the Law of Close Corporations, 16 WM. MITCHELL L. REV. 1143, 1148 (1990) ("Close corporations have a limited number of shareholders, and most, if not all, of the shareholders are active in the corporation’s day-to-day business.").

There is some variation in the definition of a close corporation. As Professor Eisenberg states:

Exactly what constitutes a close corporation is a matter of theoretical dispute. Some authorities emphasize the number of shareholders, some emphasize the presence of owner-management, some emphasize the lack of a market for the corporation’s stock, and some emphasize the existence of formal restrictions on the transferability of the corporation’s shares.

MELVIN ARON EISENBERG, CORPORATIONS AND OTHER BUSINESS ORGANIZATIONS 338 (8th ed. 2000) (unabridged); see also 1 F. HODGE O’NEAL & ROBERT B. THOMPSON, O’NEAL’S CLOSE CORPORATIONS § 1.02, at 4-7 (3d ed. 2003) [hereinafter CLOSE CORPORATIONS] (noting the following possible definitions of a "close corporation:” a corporation with relatively few
a detached investor who neither contributes labor to the corporation nor takes
part in management responsibilities. 18 In contrast, within a close corporation,
"a more intimate and intense relationship exists between capital and labor." 19
Close corporation shareholders "usually expect employment and a meaningful
role in management, as well as a return on the money paid for [their] shares." 20
Moreover, family or other personal relationships often link close corporation
investors, resulting in a familiarity between the participants. 21

Conventional corporate law norms of majority rule and centralized control
can lead to serious problems for the close corporation minority shareholder. 22
Traditionally, most corporate power is centralized in the hands of a board of
directors. 23 In a close corporation, the board is ordinarily controlled "by the
shareholder or shareholders holding a majority of the voting power." 24

18. 1 CLOSE CORPORATIONS, supra note 17, § 1.08, at 31-32 (describing public
corporation shareholders).

19. Robert B. Thompson, The Shareholder's Cause of Action for Oppression, 48 BUS.

20. Id. (footnotes omitted); see, e.g., Pedro v. Pedro, 463 N.W.2d 285, 289 (Minn. Ct.
App. 1990) ("[T]he primary expectations of minority shareholders include an active voice in
management of the corporation and input as an employee." (citations omitted)); 2 CLOSE
CORPORATIONS, supra note 17, § 7.02, at 4 ("Ownership and management frequently coalesce in
closely held corporations, where not uncommonly all the principal shareholders devote full time
to corporate affairs. Even where one or two shareholders may be inactive, the business is
normally conducted by the others without aid from nonshareholder managers.").

21. See, e.g., Robert B. Thompson, Corporate Dissolution and Shareholders' Reasonable
corporation investors); see also Bostock v. High Tech Elevator Ind., 616 A.2d 1314, 1320-21
personal relationships. Often such business entities are formed by family members or friends.")
(citations omitted).

22. See I F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S OPPRESSION OF MINORITY
SHAREHOLDERS § 1:02, at 3-4 (2d ed. 1999) [hereinafter OPPRESSION] (characterizing majority
rule and centralized management as the "traditional pattern of corporate management," and
noting the dangers that this management pattern presents to close corporation minority
shareholders); Thompson, supra note 19, at 702-03 ("In a closed setting, the corporate norms of
centralized control and majority rule easily can become instruments of oppression.").

23. See REVISED MODEL BUSINESS CORP. ACT § 8.01(b) (2002) [hereinafter RMBCA]
("All corporate powers shall be exercised by or under the authority of, and the business and
affairs of the corporation managed under the direction of, its board of directors . . .").

24. Kleinberger, supra note 17, at 1152; see, e.g., 1 OPPRESSION, supra note 22,
Through this control of the board, the majority shareholder has the ability to take actions that harm the minority shareholder’s interests. Such actions are often referred to as “freeze-out” or “squeeze-out” techniques that “oppress” the close corporation minority shareholder. Common freeze-out techniques include the refusal to declare dividends, the termination of a minority shareholder’s employment, the removal of a minority shareholder from a position of management, and the siphoning off of corporate earnings through high compensation to the majority shareholder. Quite often, these tactics are used in combination. For example, the close corporation investor generally looks to salary more than dividends for a share of the business returns because the “[e]arnings of a close corporation often are distributed in major part in salaries, bonuses and retirement benefits.” When actual dividends are not

§ 1:02, at 3 (“Indeed, in most closely held corporations, majority shareholders elect themselves and their relatives to all or most of the positions on the board.”).

25. See, e.g., Bostock, 616 A.2d at 1320 (“Based upon its voting power, the majority is able to dictate to the minority the manner in which the [close] corporation is run.” (internal quotation omitted)); Meiselman v. Meiselman, 307 S.E.2d 551, 558 (N.C. 1983) (“[W]hen the personal relationships among the participants break down, the majority shareholder, because of his greater voting power, is in a position to terminate the minority shareholder’s employment and to exclude him from participation in management decisions.”); Kiriakides v. Atlas Food Sys. & Servs., Inc., 541 S.E.2d 257, 267 (S.C. 2001) (“This unequal balance of power often leads to a ‘squeeze out’ or ‘freeze out’ of the minority by the majority shareholders.” (footnote omitted)). As a Missouri court explained:

In the instant case [a group of four shareholders], acting in concert, control a majority of the outstanding stock, though no single shareholder owns 51%. Because this control carries the power to destroy or impair the interests of minority owners, the law imposes equitable limitations on the rights of dominant shareholders to act in their own self-interest.


26. See 1 OPPRESSION, supra note 22, § 1:01, at 3 n.2 (“The term ‘freeze-out’ is often used as a synonym for ‘squeeze-out.’”). It has been noted that the term squeeze-out means “the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants.” Id. at 1. Similarly, a “partial squeeze-out” is defined as “action which reduces the participation or powers of a group of participants in the enterprise, diminishes their claim on earnings or assets, or otherwise deprives them of business income or advantages to which they are entitled.” Id. at 1–2. See generally 1, 2 OPPRESSION, supra note 22, §§ 3:01–3:20, 4:01–4:06, 5:01–5:36, 6:01–6:10 (discussing various squeeze-out techniques).

27. See infra text accompanying notes 46–48 (describing judicial definitions of “oppression”).


29. 1 CLOSE CORPORATIONS, supra note 17, § 1.08, at 32; see Kleinberger, supra note 17, at 1148 (“Payout is frequently in the form of salary rather than dividends.”).
paid, therefore, a minority shareholder who is discharged from employment and removed from the board of directors is effectively denied any return on his investment as well as any input into the management of the business. Once the minority shareholder is faced with this "indefinite future with no return on the capital he or she contributed to the enterprise, the majority often proposes to purchase the shares of the minority shareholder at an unfairly low price.

When calculating its taxable income, a close corporation can deduct reasonable salaries paid to its employees to "reduce the amount of income tax that the company pays." Thompson, supra note 21, at 197 n.12 (citing I.R.C. § 162 (1986)). A close corporation cannot, however, deduct any dividends paid to its shareholders. As a consequence, corporate income paid as dividends is subject to double taxation—once as business income at the corporate level, and once as personal income at the shareholder level. Id at 197. Because of "[t]he tax system's discouragement of dividends" in favor of salaries, "most close corporations provide a return to participants in the form of salary or other employee-related benefits." Thompson, supra note 19, at 714 n.90; see also 1 OPPRESSION, supra note 22, § 1:03, at 4–5 ("[A] close corporation, in order to avoid so-called 'double taxation,' usually pays out most of its earnings in the form of salaries rather than as dividends.").

30. As the Supreme Court of North Dakota stated:

Balvik was ultimately fired as an employee of the corporation, thus destroying the primary mode of return on his investment. Any slim hope of gaining a return on his investment and remaining involved in the operation of the business was dashed when Sylvester removed Balvik as a director and officer of the corporation.

Balvik v. Sylvester, 411 N.W.2d 383, 388 (N.D. 1987). Similarly, commentators have noted the following:

An investor taking a minority investment position in a close corporation, expecting to receive a return on the investment in the form of a regular salary, would face the risk that, after a falling out among the participants, the directors would terminate the minority shareholder's employment and deprive that investor of any return on the investment in the corporation.

1 CLOSE CORPORATIONS, supra note 17, § 1.15, at 89; see also Naito v. Naito, 35 P.3d 1068, 1072 (Or. Ct. App. 2001) ("Employment with the corporation was, as a practical matter, the only way that shareholders could receive any immediate benefit from their shares.").

31. Thompson, supra note 19, at 703; see 1 CLOSE CORPORATIONS, supra note 17, § 1.16, at 96 ("If, for example, the minority shareholder is fired from the employment that was providing the return on the investment in the close corporation, the minority may face an indefinite period with no return on the investment."); Charles W. Murdock, The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares, 65 NOTRE DAME L. REV. 425, 448–49 (1990) (discussing valuation of minority shares).

32. See, e.g., Donahue, 328 N.E.2d at 515 ("Majority 'freeze-out' schemes which withhold dividends are designed to compel the minority to relinquish stock at inadequate prices. When the minority stockholder agrees to sell out at less than fair value, the majority has won." (citations omitted)); 2 CLOSE CORPORATIONS, supra note 17, § 8.13, at 68 ("[A] squeeze out usually does not offer fair payment to the 'squeezees' for the interests, rights or powers which they lose."); Thompson, supra note 19, at 703–04 (noting that in a classic freeze-out, "the majority first denies the minority shareholder any return and then proposes to buy the shares at a very low price").
In the public corporation, the minority shareholder can escape these abuses of power by simply selling its shares on the market. By definition, however, there is no ready market for the stock of a close corporation.\(^{33}\) Thus, when dividend suppression or some other action results in the unfair treatment of a close corporation shareholder, the shareholder "cannot escape the unfairness simply by selling out at a fair price."\(^{34}\)

**B. The Cause of Action for Oppression**

Over the years, state legislatures and courts have developed two significant avenues of relief for the "oppressed" close corporation shareholder. First, many state legislatures have amended their corporate dissolution statutes to include "oppression" by the controlling shareholder as a ground for involuntary dissolution of the corporation.\(^{35}\) Moreover, when oppressive conduct has occurred, actual dissolution is not the only remedy at the court’s disposal. Both state statutes and judicial precedents have authorized alternative remedies that are less drastic than dissolution.\(^{36}\) As the alternative forms of

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33. See *Donahue*, 328 N.E.2d at 514 ("In a large public corporation, the oppressed or dissident minority stockholder could sell his stock in order to extricate some of his invested capital. By definition, this market is not available for shares in the close corporation."); *Brenner v. Berkowitz*, 634 A.2d 1019, 1027 (N.J. 1993) ("[U]nlike shareholders in larger corporations, minority shareholders in a close corporation cannot readily sell their shares when they become dissatisfied with the management of the corporation."); *Bostock v. High Tech Elevator Ind.*, 616 A.2d 1314, 1320 (N.J. Super. Ct. App. Div. 1992) ("[A] minority interest in a close corporation is difficult to value because the shares are not publicly traded and a fair market is often not available."); 2 *CLOSE CORPORATIONS*, supra note 17, § 9.02, at 4–5 ("[A] shareholder in a close corporation does not have the exit option available to a shareholder in a publicly held corporation, who can sell his shares in a securities market if he is dissatisfied with the way the corporation is being operated."); *Thompson*, supra note 19, at 702 ("The economic reality of no public market deprives investors in close corporations of the same liquidity and ability to adapt available to investors in public corporations.").

34. Kleinberger, supra note 17, at 1149; cf. *Walensky v. Jonathan Royce Int'l, Inc.*, 624 A.2d 613, 615 (N.J. Super. Ct. App. Div. 1993) ("The interest owned by a minority shareholder in a closely held corporation is often a precarious one. In fact, it has been characterized by this court as being one of "acute vulnerability."" (citations omitted)).

35. See *Thompson*, supra note 19, at 708–09 (noting that thirty-seven states include oppression or a similar term in their corporate dissolution statutes). *See generally* Murdock, supra note 31, at 452–61 (describing the development of oppression as a ground for dissolution).

36. *See, e.g.*, *MINN. STAT. ANN.* § 302A.751 subd. 1 (West Supp. 2000) (authorizing any equitable relief and specifically authorizing a buyout of the shareholder’s interest); *N.J. STAT. ANN.* § 14A:12-7 (West Supp. 1999) (providing a nonexclusive list of possible relief that includes the order of a buyout and the appointment of a provisional director or custodian); *Brenner v. Berkowitz*, 634 A.2d 1019, 1033 (N.J. 1993) ("Importantly, courts are not limited to
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relief have broadened over the years, orders of actual dissolution have become less frequent. The most prevalent alternative remedy today is a buyout of the oppressed investor’s holdings. Thus, oppression has evolved from a statutory ground for involuntary dissolution to a statutory ground for a wide variety of relief.

Second, particularly in states without an oppression-triggered dissolution statute, some courts have imposed an enhanced fiduciary duty between close corporation shareholders and have allowed an oppressed shareholder to bring a direct cause of action for breach of this duty. In the seminal decision of Donahue v. Rodd Electrotype Co., the Massachusetts Supreme Judicial Court adopted such a standard:

the statutory remedies [for oppression], but have a wide array of equitable remedies available to them.”; Balvik v. Sylvester, 411 N.W.2d 383, 388–89 (N.D. 1987) (listing alternative forms of relief for oppressive conduct such as appointing a receiver, granting a buyout, and ordering the declaration of a dividend); Masinter v. Webo Co., 262 S.E.2d 433, 441 n.12 (W. Va. 1980) (listing ten possible forms of relief for oppressive conduct such as ordering the reduction of excessive salaries and issuing an injunction against further oppressive acts). But see Giannotti v. Hamway, 387 S.E.2d 725, 733 (Va. 1990) (stating that the dissolution remedy for oppression is “exclusive” and concluding that the trial court is not permitted “to fashion other... equitable remedies”).


38. See 1 CLOSE CORPORATIONS, supra note 17, § 1.16, at 97 (noting that buyouts “are the most common remedy for dissension within a close corporation”); Murdock, supra note 31, at 470 (“The most common form of alternative remedy is the buy-out of the minority shareholder.”); see also Thompson, supra note 21, at 231 (“The increased use of buyouts as a remedy for deadlock or dissension is the most dramatic recent change in legislative and judicial thinking on close corporations problems.”). A buyout of the oppressed investor’s holdings is typically at “fair value.” See infra notes 149, 170 and accompanying text (discussing fair value buyouts).

39. See Thompson, supra note 21, at 206 (“The inclusion of ‘oppression’ or similar grounds as a basis for involuntary dissolution has opened up a much broader avenue of relief for minority shareholders in close corporations wracked with dissension.”); Thompson, supra note 19, at 708–09 (“[I]t makes more sense to view oppression not as a ground for dissolution, but as a remedy for shareholder dissension.”).

40. See Thompson, supra note 19, at 726 (discussing direct shareholder actions); see also id. at 739 (“It should not be surprising that the direct cause of action is developed particularly in states without an oppression statute, and [it] provides a vehicle for relief for minority shareholders in a close corporation where the statutory norms reflect no consideration for the special needs of such enterprises.”). See generally Murdock, supra note 31, at 433–40 (discussing the development of the shareholder fiduciary duty).

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. In our previous decisions, we have defined the standard of duty owed by partners to one another as the "utmost good faith and loyalty." Stockholders in close corporations must discharge their management and stockholder responsibilities in conformity with this strict good faith standard. They 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.42

Following the lead of the Donahue court, several courts outside of Massachusetts have also imposed an enhanced fiduciary duty running from shareholder to shareholder in a close corporation.43 The development of the statutory cause of action and the enhanced fiduciary duty "reflect the same underlying concerns for the position of minority shareholders, particularly in close corporations after harmony no longer reigns."44 Because of the similarities between the two remedial schemes, it has been suggested that "it makes sense to think of them as two manifestations of a minority shareholder’s cause of action for oppression."45 In the close corporation context, therefore, it is sensible to view the parallel development of the statutory cause of action and the enhanced fiduciary duty action as two sides of the same coin—that is, the shareholder’s cause of action for oppression.

42. Id. at 515 (citations omitted) (footnotes omitted). The Donahue duty of "utmost good faith and loyalty," however, was later scaled back by the same court. Due to concerns that the "untempered application of the strict good faith standard enunciated in Donahue... 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," the Supreme Judicial Court of Massachusetts suggested a balancing test in Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976). If the controlling group can demonstrate a "legitimate business purpose" for its actions, no breach of fiduciary duty will be found unless the minority shareholder can demonstrate "that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority’s interest." Id.


44. Thompson, supra note 19, at 739.

45. Id. at 700. See generally id. at 738–45 (describing the "combined cause of action for oppression").
C. Measuring Oppression Through "Reasonable Expectations"

The development of a shareholder's cause of action for oppression requires courts to determine when "oppressive" conduct has occurred. In wrestling with this issue, the courts have developed three principal approaches to defining oppression. First, "some courts define oppression as 'burdensome, harsh and wrongful conduct . . . 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 corporation is entitled to rely.'" Second, some courts link oppression to breach of an enhanced fiduciary duty owed from one close corporation shareholder to another. Third, a number of courts tie oppression to the frustration of the reasonable expectations of the shareholders. Of these three approaches, the reasonable expectations standard garners the most approval, and courts have increasingly used it to determine whether oppressive conduct has taken place. The highest courts in several states have adopted the reasonable expectations approach and commentators have generally been in favor of the reasonable expectations standard.

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47. See, e.g., supra notes 40–42 and accompanying text (describing the enhanced fiduciary duty imposed by courts).

48. See 2 CLOSE CORPORATIONS, supra note 17, § 9.29, at 178 (noting courts' use of the reasonable expectations standard); see, e.g., In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984) (equating oppression with conduct that "defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise").

49. See, e.g., 2 CLOSE CORPORATIONS, supra note 17, § 9.30, at 181 ("One of the most significant trends in the law of close corporations in recent years is the increasing willingness of courts to look to the reasonable expectations of shareholders to determine whether 'oppression' or similar grounds exist as a justification for involuntary dissolution or another remedy.").

The New York decision of *In re Kemp & Beatley, Inc.* has been particularly influential in giving some context to the reasonable expectations framework. In *Kemp*, the Court of Appeals stated that "oppressive actions... refer to conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise." As the court continued:

A court considering a petition alleging oppressive conduct must investigate what the majority shareholders knew, or should have known, to be the petitioner's expectations in entering the particular enterprise. Majority conduct should not be deemed oppressive simply because the petitioner's subjective hopes and desires in joining the venture are not fulfilled. Disappointment alone should not necessarily be equated with oppression.

* * *

Rather, 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.

* * *

51. See Haynsworth, supra note 37, at 37 ("The third definition of oppression, initially derived from English case law, and long advocated by Dean F. Hodge O'Neal as well as other leading close corporation experts, is conduct which frustrates the reasonable expectations of the investors."); Thompson, supra note 21, at 211 ("Recognition of the intimate, illiquid relationship within a close corporation therefore provides the necessary foundation for judging whether relief should be granted and, if so, what relief is appropriate; the shareholders' reasonable expectations has become the standard which best facilitates that approach.").


53. Id. at 1179.
A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.\(^\text{54}\)

It is important to understand the distinction between "general" reasonable expectations and "specific" reasonable expectations. At bottom, the shareholder oppression doctrine protects close corporation stockholders with a set of special judicial rules that go beyond the protections that public corporation law provides.\(^\text{55}\) An important corollary to this proposition, however, is that close corporation shareholders do not lose any of the

\(^{54}\) Id.; see also Meiselman v. Meiselman, 307 S.E.2d 551, 563 (N.C. 1983) (defining reasonable expectations). As the Meiselman court stated:

In order for plaintiff's expectations to be reasonable, they must be known to or assumed by the other shareholders and concurred in by them. Privately held expectations which are not made known to the other participants are not 'reasonable.' Only expectations embodied in understandings, express or implied, among the participants should be recognized by the court.

\(^{55}\) Under public corporation rules, courts rarely interfere with employment, management, and dividend decisions, as the business judgment rule is often invoked to protect the majority's discretion. See, e.g., Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) ("[C]ourts fairly consistently have been disinclined to interfere in those facets of internal corporate operations, such as the selection and retention or dismissal of officers, directors or employees, which essentially involve management decisions subject to the principle of majority control."); Ralph A. Peeples, The Use and Misuse of the Business Judgment Rule in the Close Corporation, 60 Notre Dame L. Rev. 456, 477 (1985) ("The hiring, firing, and compensation of employees are ultimately board decisions and have always qualified as management decisions protected by the business judgment rule."); infra note 80 (describing the role of the business judgment rule). When these matters are challenged in the close corporation context, however, the majority's decisions are subject to greater scrutiny than a business judgment rule approach. See infra note 101 (discussing the more searching judicial review that is present in many close corporation disputes).
protections that general corporate law provides—that is, at a minimum, they receive the baseline public corporation protections. In a public corporation, of course, the mere status of "shareholder" entitles one to a proportionate stake in the company's earnings as well as to various other rights. One can assert, therefore, that every shareholder—whether in a public corporation or a close corporation—reasonably expects that her position as a stockholder entitles her to a proportionate share of the company's profits. Whenever this "general" reasonable expectation is frustrated in a close corporation, oppression liability should arise.

A proportionate share of the company's earnings, however, is only one component of the typical close corporation shareholder's investment. Unlike in a public corporation, the investment return in a close corporation often includes employment and management benefits as well. "Specific" reasonable expectation is frustrated in a close corporation, oppression liability should arise. Just as in a public corporation, of course, the status of 'shareholder' entitles an investor to such benefits as a proportionate share of the corporate earnings (e.g., a proportionate share of the dividends, if declared), a right to any stock appreciation, a right to inspect company books and records (with a proper purpose), a right to vote on shareholder issues, and a right to be recognized as a shareholder.


56. See, e.g., Del. Code Ann. tit. 8, § 220(b) (2002) (detailing the inspection rights available to "[a]ny stockholder"); id. § 251(c) (describing the right of "stockholders" to vote on mergers or consolidations); Meiselman v. Meiselman, 307 S.E.2d 551, 565 (N.C. 1983) (listing the following as examples of "traditional rights and remedies to which shareholders have been entitled": right to receive notice of shareholder's meetings, right to cumulative voting, right to examine books and records, and right to compel payment of dividends). As the author previously observed:

> Just as in a public corporation, of course, the status of 'shareholder' entitles an investor to such benefits as a proportionate share of the corporate earnings (e.g., a proportionate share of the dividends, if declared), a right to any stock appreciation, a right to inspect company books and records (with a proper purpose), a right to vote on shareholder issues, and a right to be recognized as a shareholder.


57. See, e.g., Burton v. Exxon Corp., 583 F. Supp. 405, 418 (S.D.N.Y. 1984) ("It is true that stockholders are owners of the corporation and expect to share in its profits."); Michaud v. Morris, 603 So. 2d 886, 888 (Ala. 1992) ("Certain basic expectations of investors are enforceable in the courts, and among those is a right to share proportionally in corporate gains."); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 397 (Or. 1973) ("It is also true that the Bakers, as stockholders, had a legitimate interest in the participation in profits earned by the corporation.").

58. See, e.g., Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct.Law Div. 1979) ("Unlike their counterparts in large corporations, [close corporation minority shareholders] may expect to participate in management or to influence operations, directly or indirectly, formally or informally."); Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1319 (N.Y. 1989) (Hancock, J., dissenting) ("A person who ... buys a minority interest in a close corporation does so not only in the hope of enjoying an increase in value of his stake in the business but for the assurance of employment in the business in a managerial position."); Balvik v. Sylvestor, 411 N.W.2d 383, 386 (N.D. 1987) ("[I]t is generally understood that, in addition to supplying capital and labor to a contemplated enterprise and expecting a fair return, parties comprising the ownership of a close corporation expect to be actively involved in its management and operation."); Sandra L. Schlafge, Comment, *Pedro v. Pedro: Consequences for Closely Held Corporations and the At-Will Doctrine in Minnesota*, 76 Minn. L. Rev. 1071,
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expectations refer to these "extra" components of the close corporation shareholder's investment return—extra to the extent that they are in addition to the stockholder's entitlement to a proportionate share of the company's earnings. Unlike a status-triggered general reasonable expectation, a specific reasonable expectation is not held by every close corporation participant who can be characterized as a "shareholder." To the contrary, a specific reasonable expectation is personal in nature, as it requires proof that a close corporation majority shareholder and a particular minority shareholder reached a mutual understanding about a certain entitlement (for example, employment, management) the minority is to receive in return for its investment in the business. By safeguarding specific reasonable expectations of employment,

1094 (1992) ("Section 302A.751 [the Minnesota statute protecting minority shareholders] recognizes that shareholders in a closely held corporation legitimately expect a return of their investment, often in the form of a management position and a salary."); supra notes 18, 20 and accompanying text (noting that close corporation shareholders typically expect to have employment and management roles in the company).

59. As one court stated:

The original participants in a close corporation enter into their agreement on the basis of the assessments of each other's talents, assets, intentions and characters and their agreement must, therefore, be regarded as personal in nature. Unless there is an unmistakable expression of their intent to the contrary, the agreement will not 'run with the shares.'

Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1019 (Sup. Ct. 1984); see also Bahls, supra note 15, at 326 ("The intent of original shareholders to operate the business is usually personal in nature. An expectation that one will participate in management of the business does not necessarily mean that one's son, daughter, ex-spouse, or other transferee will have the same opportunity."); Robert W. Hillman, The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relevant Permanence of Partnerships and Close Corporations, 67 M-I N. L. REV. 1, 86 n.265 (1982) ("Ordinarily, expectations are personal and therefore would not be transferable. . . . Thus, an individual who acquires stock by gift or inheritance would not also take the expectations of the original owner.").

60. See, e.g., Douglas K. Moll, Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective, 53 VAND. L. REV. 749, 810 (2000) ("[T]he aggrieved shareholder must offer evidence indicating that the stockholders shared a basic understanding at the venture's inception of an entitlement to certain specific benefits (e.g., employment, management participation) due to their commitments of capital to the business."). As one commentator stated:

Both [public corporation and close corporation] investors expect appreciation in the value of their investment. Investors in publicly held corporations receive dividends as a form of return on this investment, while investors in closely held corporations may expect to receive a salary and a management position as a condition of their investment (emphasis added)).

Schlafge, supra note 58, at 1077 n.29.

It should be noted that, in many cases, this evidentiary requirement will not be difficult to satisfy. See Moll, Reasonable Expectations, supra note 56, at 1006, 1009–10 (describing the apparent laxity of the evidence requirement). Nevertheless, in some oppression disputes, the
management, or other entitlement, the oppression doctrine is offering special protection to close corporation shareholders—"special" to the extent that public corporation shareholders do not receive similar protection. 61

D. Oppression and the Denial of Dividends

In a public corporation, one could argue that dividend decisions do not significantly affect the value of an investor’s stockholdings. After all, economic theory suggests that any decision to retain earnings within the company rather than to pay dividends will have a positive effect on the overall value of the firm—an effect which translates into an increase in the value of the company’s shares. 62 Assuming that retained funds are reinvested at the firm’s cost of capital, 63 the theory suggests that a minority shareholder of a public corporation is largely indifferent as to whether dividends are declared or not (ignoring taxes and transaction costs). 64 If a dividend of one dollar per share is shareholder is unable to proffer sufficient evidence. See, e.g., Merola v. Exergen Corp., 668 N.E.2d 351, 354-55 (Mass. 1996) (refusing to find that a termination of a shareholder-employee was a breach of fiduciary duty in part because "there was no general policy regarding stock ownership and employment, and there was no evidence that any other stockholders had expectations of continuing employment because they purchased stock").

61. See supra note 55 and accompanying text (discussing the lesser protection afforded to public corporation shareholders). To some extent, of course, the public corporation shareholder does not need any "special" protection. After all, public corporation shareholders invest only with the general reasonable expectation that their investment entitles them to a proportionate share of the company’s earnings. See, e.g., Terry A. O’Neill, Self-Interest and Concern for Others in the Owner-Managed Firm: A Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations, 22 SETON HALL L. REV. 646, 663 (1992) ("The shareholder of a publicly traded corporation invests money . . . with a view to receiving money, as opposed to steady employment or associational benefits, in return."). For this limited interest, a market exit provides adequate protection. See, e.g., 1 OPPRESSION, supra note 22, § 2:15, at 38 ("In a large public-issue corporation, a shareholder who is dissatisfied with the way the business is being operated can sell his stock at no great financial loss."); Schlafge, supra note 58, at 1073 n.14 (noting that the interest of the public corporation shareholder is "limited to the amount of their dollar investment in their shares, which can be sold at any time on the public market, and is not tied to their salary and other employment benefits").

62. See, e.g., Steven Stern, Comment, Proposals to Help the Minority Stockholder Receive Fairer Dividend Treatment from the Closely Held Corporation, 56 NW. U. L. REV. 503, 508 (1961) ("[I]f the directors of a large, public-issue corporation deem it wise to retain earnings for expansion or for other business purposes, such corporate action is often reflected by an increased value of the firm’s shares on the open market whereby all shareholders benefit equally.").

63. See infra Part V.A (discussing the cost of capital).

64. The theory, often referred to as the "irrelevance proposition," is developed in a classic article by Merton H. Miller & Frank Modigliani, Dividend Policy, Growth, and Valuation of Shares, 34 J. Bus. 411 (1961). The irrelevance proposition states that a dollar of retained
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paid, a minority shareholder is enriched by one dollar per share. If that same amount is instead retained in the company, the company’s value increases by one dollar per share and, correspondingly, the value of the minority’s stock increases by one dollar per share. 65 By selling the stock, the minority can capture that increase in value. The minority’s wealth, in other words, increases by one dollar per share regardless of whether a payout or reinvestment decision is made, as the dollar takes the form of either a cash dividend or of stock appreciation. 66

earnings “adds a dollar to the value of the enterprise and, if reinvested at the company’s current rate of return, is worth the same to investors whether paid out to them for reinvestment or retained by management for reinvestment.” Brudney, supra note 2, at 87 n.4; id. at 87 (stating that the irrelevance proposition assumes “a world in which information flows freely and that is free of taxes, transaction costs, and institutional imperfections”); infra note 66 and accompanying text (discussing the irrelevance proposition).

Taxes, of course, might affect a shareholder’s preference for dividends versus reinvestment. Presently, a dividend is treated as ordinary income and is taxed immediately as such. Capital appreciation that is generated from profitable reinvestment, however, is taxed as a capital gain only when the stock is sold. This difference in tax treatment may be significant to an investor, particularly when ordinary income and capital gains are taxed at different rates. See, e.g., Brudney, supra note 2, at 91 (“The premised equivalence between a dollar of dividends and a dollar of increment in the price of a share is destroyed by the different rates of federal income tax . . . .”); id. (“A dollar in dividends is taxable at ordinary income rates, which for individual stockholders are effectively higher than the capital gains rates . . . [and] the tax on ordinary income . . . must be paid sooner than the tax on capital gains, which are realized later than the dividend.”). Moreover, whereas an investor does not personally incur any transaction costs when a dividend is received, an investor does incur transaction costs (e.g., broker fees) when a stock is sold to realize capital gains. See id. at 92 n.19 (mentioning “brokerage commissions on sales” as one transaction cost that investors typically assume when stock is sold).

65. Once again, this assumes that the retained funds are reinvested at the firm’s cost of capital. See William A. Klein & John C. Coffee, Jr., Business Organization and Finance: Legal and Economic Principles 372–73 (8th ed. 2002) (discussing a reinvestment hypothetical); supra notes 63–64 and accompanying text (discussing the irrelevance proposition).

66. Professor Brudney has stated the following:

The view that dividend policy is irrelevant to share prices rests on the assumption that a dollar per share of potential dividends retained and reinvested will cause the price of a share to increase by one dollar . . . . If these assumptions are true, then so long as the enterprise has a favorable reinvestment opportunity, the decision to pay or to withhold a dividend is a matter of indifference . . . .

Brudney, supra note 2, at 86–87; see, e.g., David Michael Israel, Note, The Business Judgment Rule and the Declaration of Corporate Dividends: A Reappraisal, 4 Hofstra L. Rev. 73, 89 (1975) (“As long as the corporation profitably reinvests its earnings at a rate commensurate with inherent risks and expectations, the common stockholder will not be prejudiced by the absence of direct cash dividends. The increasing market price itself is the return on his investment . . . .”); supra note 64 and accompanying text (discussing the irrelevance proposition); see also Fischel, supra note 2, at 702–03 (“The irrelevance proposition assumes that once a firm’s investment policy is known, shareholders are indifferent as to a dividend
In the close corporation, of course, this theory of "dividend irrelevance" is harder to accept, as there is no liquid market that allows for the realization of capital appreciation. When funds are retained and reinvested in the company rather than paid out as dividends, the minority has little ability to capture the increased value of its shares, as "[t]he holder of a minority interest in a close corporation may not be able to find anyone willing to purchase that interest at any serious price." For the minority shareholder to receive a return on investment, therefore, dividends are needed, as capital appreciation is difficult (if not impossible) to realize.

Where all of the shareholders are salaried employees of the close corporation, the payment of actual dividends is less important. The salary and

67. See supra note 64 (discussing the irrelevance proposition).

68. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 230-31 (1991) (noting that "the lack of an active market in shares" prohibits close corporation shareholders from creating "homemade dividends" by selling stock); 2 Close Corporations, supra note 17, § 9.20, at 9-96 ("[T]he failure to pay dividends is a much more critical matter to a shareholder in a close corporation than to one in a publicly held corporation because stock in a close corporation does not have a market which reflects capital appreciation."); Stern, supra note 62, at 508 ("The increased value of [a close corporation minority shareholder's] unlisted shares will not be reflected in the market."); supra note 6 and accompanying text (noting that close corporation stock lacks a market).

69. 2 Close Corporations, supra note 17, § 9.20, at 9-96 to 9-97. As one commentator observed:

In a publicly held corporation, increased profits or corporate expansion is likely to be reflected in an increase in the value of the shares of the corporation on the open market. The corporate investor, however, seldom has an interest in the shares of an unlisted, closely held corporation since the purchase of such shares would place him in the same position as the minority shareholder who sells out. Such an investor cannot depend upon dividend declarations by the controlling interests and he cannot be assured of a market for his shares should he later desire to sell.... The minority shareholder has no... control to offer and, for the above noted reasons, has difficulty selling his holdings.

Stern, supra note 62, at 508 n.36; see id. at 508 ("[T]he minority shareholder in a closely held corporation may not find anyone willing to purchase his stock since few investors will want to take on his unfavorable bargaining position."); see also Raynolds v. Diamond Mills Paper Co., 60 A. 941, 945 (N.J. Ct. Ch. 1905) ("In the case of corporations of this class [close corporations] sales of stock outside the small coterie of officers and managers are generally hard to make, excepting upon disadvantageous terms.").

70. See supra notes 68-69 and accompanying text (discussing the lack of a market); see also 1 Oppression, supra note 22, § 3:04, at 19 ("Even if the minority shareholder is in a sufficiently strong financial position to hold onto stock during a dividend squeeze, the squeezer is still deprived of any return on the investment during the years that dividends are withheld."); cf. Israel, supra note 66, at 86 ("The effect of a policy whereby management retains more of the earnings, while the market fails to respond with capital gains, is to eliminate the shareholder's return on his investment.").
other employment-related compensation provides the expected return.\textsuperscript{71} Where the majority shareholder is employed by the company and the minority investor is not, however, dividends become critical, as they provide the minority shareholder with its only source of return.\textsuperscript{72} Not surprisingly, the wrongful suppression of dividends is a common ground upon which the courts grant oppression relief.\textsuperscript{73}

III. Evaluating Dividend Policy in the Close Corporation

Before a discussion of the basic types of close corporation dividend disputes can occur, one must consider the appropriate framework for evaluating the propriety of a majority's dividend decision. The inquiry is complicated, primarily for two reasons. First, despite the widespread acceptance of the reasonable expectations approach, a good deal of pre-oppression case law exists that defers to the majority's business judgment on dividend decisions. Second, even assuming that the reasonable expectations standard applies, it is often

\textsuperscript{71} See Landorf v. Glottstein, 500 N.Y.S.2d 494, 499 (Sup. Ct. 1986) (stating that, in a close corporation, "dividends are often provided by means of salaries to shareholders"); 1 CLOSE CORPORATIONS, supra note 17, § 1.08, at 32 (noting that close corporation shareholders "usually expect (or perhaps should expect) to receive an immediate return in the form of salaries as officers or employees of the corporation rather than in the form of dividends on their stock"); supra note 29 and accompanying text (discussing employment benefits as expected return); infra note 197 and accompanying text (same).

\textsuperscript{72} See, e.g., 1 OPPRESSION, supra note 22, § 3:04, at 18–19 ("Withholding dividends is particularly effective when the participant has no other connection with the corporation such as employment that might provide an alternative source of income."); Nagy v. Riblet Prods. Corp., 79 F.3d 572, 577 (7th Cir. 1996) ("Many closely held firms endeavor to show no profits (to minimize their taxes) and to distribute the real economic returns of the business to the investors as salary. When firms are organized in this way, firing an employee is little different from canceling his shares." (emphasis added)); Little v. Waters, No. 12155, 1992 WL 25758, at *8 (Del. Ch. Feb. 11, 1992) ("[T]his failure to pay dividends can be especially devastating in a Subchapter S [close] corporation setting, as this case is, since the corporation passes its income through to its shareholders even though the corporation has not made any distributions to the shareholders."); Landorf v. Glottstein, 500 N.Y.S.2d 494, 499 (Sup. Ct. 1986) ("In a close corporation, since dividends are often provided by means of salaries to shareholders, loss of salary may be the functional equivalent of the denial of participation in dividends.").

unclear whether a frustrated expectation of dividends is reasonable in the circumstances.

A. The Traditional Approach to Compelling Dividends

Courts have generally viewed the declaration of dividends as "discretionary and within the business judgment of the board of directors." Without an abuse of discretion, a court typically will decline to substitute its own judgment and will avoid ordering a distribution of dividends. Historically, such an abuse of discretion was found "only if there was evidence of fraud or bad faith or a clear case of unreasonableness." Significantly, the burden to demonstrate such abuses was placed on the complaining shareholder, and that "onerous" burden was rarely met. Indeed,

74. HENN & ALEXANDER, supra note 14, § 327, at 913; see also Fischel, supra note 2, at 716 ("Invoking the business judgment rule, courts have generally held that the decisions concerning the issuance and amount of a dividend are entrusted solely to the discretion of the board of directors."); infra note 80 and accompanying text (discussing the application of the business judgment rule).

75. See HENN & ALEXANDER, supra note 14, § 327, at 913 ("[O]nly when abuse of discretion is shown will courts substitute their own judgment and order a distribution of dividends.").

76. Id. at 914; see Burton v. Exxon Corp., 583 F. Supp. 405, 415 (S.D.N.Y. 1984) ("The decision [to declare a dividend] enjoys a presumption of sound business judgment which will not be disturbed by a court in the absence of a disabling factor, i.e., fraud or gross abuse of discretion."); Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 659 (Del. Ch. 1975) ("Before a court will interfere with the judgment of a board of directors in refusing to declare dividends, fraud or gross abuse of discretion must be shown."); Gay v. Gay's Super Markets, Inc., 343 A.2d 577, 580 (Me. 1975) ("To justify judicial intervention in cases of this nature, it must, as a general proposition, be shown that the decision not to declare a dividend amounted to fraud, bad faith or an abuse of discretion on the part of the corporate officials authorized to make the determination."); Brudney, supra note 2, at 104 ("[T]he prevailing legal doctrine holds dividend policy to be a matter of managerial discretion or business judgment with which the judiciary cannot interfere absent fraud or some visible conflict of interest in the particular case accompanied by demonstrated and unnecessary mulcting of some stockholders."); Israel, supra note 66, at 74–75 ("Thus, absent a clear showing of fraud, bad faith, or other serious misconduct, a court will decline to override the collective business judgment of the board of directors and compel the declaration of a dividend, regardless of the apparent wisdom or fairness of the dividend policy." (footnotes omitted)).

77. See, e.g., Gay's Super Markets, Inc., 343 A.2d at 580 ("The burden of demonstrating bad faith, fraud, breach of fiduciary duty or abuse of discretion on the part of the directors of a corporation rests on the party seeking judicial mandatory relief respecting the declaration of dividends."); HENN & ALEXANDER, supra note 14, § 328, at 915, 917 (noting that the complaining shareholder shouldered the burden of proof).

78. See, e.g., HENN & ALEXANDER, supra note 14, § 328, at 918 ("Of the many cases brought, relief has been granted in relatively few instances."); see also id. at 915 (describing the
the business judgment rule\textsuperscript{79} was (and still is) often employed by courts to insulate the majority's dividend decision from any meaningful judicial review.\textsuperscript{80}

This traditional, majority-centered approach to close corporation dividend disputes is out of step with modern understandings about the nature of close corporations and the expectations of investors who commit their capital to such ventures. The traditional view's reliance on the business judgment rule is an uneasy fit in the close corporation context, and its minimal inquiry into the propriety of the majority's decision is inconsistent with the thrust of the shareholder oppression doctrine. For both of these reasons, courts should reject the traditional view in favor of the reasonable expectations approach as the standard for evaluating dividend decisions in close corporations.

\section*{B. The Need to Reject the Traditional Approach}

\subsection*{1. The Uneasy Fit of the Business Judgment Rule}

The business judgment rule is a corporate law principle that insulates a manager from liability so long as its decision was made "on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."\textsuperscript{81} Under the business judgment rule, courts review the majority's substantive business decision with a minimal level of scrutiny.\textsuperscript{82}

\textsuperscript{79} See infra notes 81--82 and accompanying text (discussing the business judgment rule).

\textsuperscript{80} See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513 (Mass. 1975) ("[T]he plaintiff will find difficulty in challenging dividend or employment policies. Such policies are considered to be within the judgment of the directors."); Israel, supra note 66, at 73 ("The application of the business judgment rule to the declaration of corporate dividends is one of the oldest and most widely accepted principles of corporation law."); Peeples, supra note 55, at 469 ("The declaration of dividends is always at the discretion of the board of directors. The business judgment rule protects such a decision."); Robert A. Ragazzo, Toward a Delaware Common Law of Closely Held Corporations, 77 Wash. U. L.Q. 1099, 1125 n.126 (1999) ("The business judgment rule is seldom overcome on dividend questions."); supra note 74 and accompanying text (discussing the application of the business judgment rule); see also Brudney, supra note 2, at 100 n.46 ("The directors' decision to retain funds for expansion is generally presumed to have been made in good faith.").

\textsuperscript{81} Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

\textsuperscript{82} See Easterbrook & Fischel, supra note 68, at 93 ("Statements of the rule vary; its terms are far less important than the fact that it is a specially deferential approach."); James D.
a. The Absence of a Market for Close Corporation Shares

In dividend disputes in public corporations, business judgment rule deference is arguably appropriate. A well-functioning market can discipline a majority shareholder for its "poor" dividend decisions because dissatisfied minority investors can sell. Significant selling will decrease the company's stock price3 and, at some level, will expose company management to the dangers of displacement through proxy fights or takeovers.84 Because senior managers generally value their positions, this threat of displacement will curb

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3 Cox, Equal Treatment for Shareholders: An Essay, 19 CARDOZO L. REV. 615, 628 (1997) (mentioning the "deferential presumptions dictated by the business judgment rule"). As Professors Cary and Eisenberg have observed, "under the [business judgment] rule the substance or quality of the director's or officer's decision will be reviewed, not under the basic standard of conduct to determine whether the decision was prudent or reasonable, but only under a much more limited standard." WILLIAM L. CARY & MELVIN ARON EISENBERG, CASES AND MATERIALS ON CORPORATIONS 603 (7th ed. 1995) (unabridged). In general, that more limited standard is mere rationality—i.e., a substantive business decision need only be "rational," as opposed to "reasonable," to be considered proper. See id. ("[T]he prevalent formulation of the standard of review of a substantive decision under the business-judgment rule is that the decision must be 'rational'."); Cox, supra, at 629 (noting that "the standard business judgment rule approach . . . uphold[s] unequal treatment on a showing of rational business judgment"). Under such a minimal standard of review, almost any justification advanced by the majority to defend its allegedly oppressive actions will survive judicial scrutiny. See CARY & EISENBERG, supra, at 604 ("The rationality standard of review is much easier for a defendant to satisfy than a prudence or reasonability standard . . . . It is common to characterize a person's conduct as imprudent or unreasonable, but it is very uncommon to characterize a person's conduct as irrational."); Krishnan S. Chittur, Resolving Close Corporation Conflicts: A Fresh Approach, 10 HARV. J.L. & PUB. POL'Y 129, 154 (1990) ("So long as the controlling stockholder's conduct is not outrageous—that is, a plausible business reason can be articulated—his decisions are protected by the business judgment rule."); id. at 155 (noting that, under the business judgment rule, "[c]orporate management has never been obliged to disclose its true motivation, and can easily manufacture a 'legitimate' corporate purpose for its action" (footnote omitted) (internal quotation omitted)); see also Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971) ("A board of directors enjoys a presumption of sound business judgment, and its decisions will not be disturbed if they can be attributed to any rational business purpose."); Kamin v. Am. Express Co., 383 N.Y.S.2d 807, 812 (Sup. Ct. 1976) (granting defendants' motion to dismiss on business judgment rule grounds).

83. As one commentator noted:

The typical public-issue corporation is interested in a healthy trading of its shares on the open market. Regular payment of dividends is one method of keeping its investors satisfied. If the directors fail to keep their shareholders satisfied, shareholders will want to sell their holdings. This in turn will create a greater supply for the corporation's shares on the market without a corresponding increase in demand. The net result would be a depreciation in market value.

Stern, supra note 62, at 507 n.31; see infra note 223 and accompanying text (discussing the relationship between dividend policy and stock price).

84. See infra notes 86, 88 and accompanying text (discussing the effect of a market).
dividend decisions that fail to maximize shareholder value. When a well-functioning market exists, therefore it provides an effective restraint on the majority’s dividend decisions and there is a correspondingly diminished need for additional judicial review.

In close corporations, however, the constraints provided by the market are absent. Without meaningful judicial review, there is insufficient oversight of the controlling group’s dividend decisions. In the close corporation context,

85. See infra notes 86, 88 and accompanying text (discussing the effect of a market); see also Stern, supra note 62, at 507 ("[D]irectors of a large, public-issue corporation will normally find it desirable to declare a regular dividend when profits are sufficient in order to keep their shareholders satisfied and to assure a favorable market for their shares.").

86. As one commentator observed:

Whether to declare a dividend and the amount of such dividend are among the countless decisions managers must make as agents for shareholders. An inefficient dividend decision is no different than any other suboptimal managerial decision. If managers adopt a lower (or higher) payout policy than shareholders desire, the price of the firm’s stock will trade at a lower price than otherwise identical firms with different dividend policies . . . . If a firm’s share price falls far enough as a result of suboptimal dividend policy, the firm will become a likely candidate for a proxy fight or a tender offer . . . . The risk of such a takeover attempt provides management with an incentive to set dividend policy in the best interest of its shareholders. Managers who do not respond to this incentive will be replaced by more capable managers who will pursue a preferable dividend policy.

Fischel, supra note 2, at 713–14 (footnotes omitted). Professors Hetherington and Dooley express similar sentiments:

Market restraints are most visible and workable in the case of publicly held corporations. If management is inefficient, indulges its own preferences, or otherwise acts contrary to shareholder interests, dissatisfied shareholders will sell their shares and move to more attractive investment opportunities. As more shareholders express their dissatisfaction by selling, the market price of the company’s shares will decline to the point where existing management is exposed to the risk of being displaced through a corporate takeover . . . . The mere threat of displacement, whether or not realized, is a powerful incentive for managers of publicly held corporations to promote their shareholders’ interests so as to keep the price of the company’s shares as high and their own positions as secure as possible.

Hetherington & Dooley, supra note 7, at 39–40 (footnote omitted); see Chittur, supra note 82, at 158 (asserting that the business judgment rule is evidence of faith in the free market). Interestingly, Professor Israel takes a different view:

Nor is it likely that the mechanism of the market place will exert sufficient pressure on management to force a reevaluation of its dividend and investment policies. Insulated from the stock market due to the corporation’s capacity to internally generate as much as 85% of its capital requirements . . . . management is free to embark upon any policy it deems advisable and need not be responsive to the shareholder or the market.

Israel, supra note 66, at 95.

87. See supra note 6 and accompanying text (discussing the absence of a market for close corporation stock).
therefore, the judicial deference embodied in the business judgment rule makes less sense:

With the large corporation, the business judgment rule can be used to prevent the courts from second-guessing corporate managers. Their review is not necessary because other more effective schemes regularly protect the shareholders. But with the close corporation the same thing is not true. For instance, in a large corporation, the failure to pay dividends sufficient to satisfy the shareholders will reflect itself in a lowered stock price and the danger of a proxy fight or a takeover. Thus there is no incentive for management to follow such a policy, and it is quite logical to remove substantially all discretion from the courts on the matter of forcing dividends from large corporations. In the small corporation, on the other hand, the dividend policy will most frequently reflect the personal and perhaps peculiar financial needs of the controlling shareholders. There will be no market to reflect dissatisfaction with this policy. Furthermore, a failure to pay dividends may be used by the controlling group in small corporations to force minority shareholders to sell their shares at a bargain price. Here it can be seen that it makes considerably less sense to adopt a judicial hands-off attitude.  

88. Henry G. Manne, Our Two Corporation Systems: Law and Economics, 53 VA. L. REV. 259, 280 (1967); see also Stern, supra note 62, at 507 n.32 ("Since the directors [of a close corporation] have no desire to create a market demand for their stock, they will not find it necessary to pay regular dividends in order to appeal to . . . investors."). Professors Easterbrook and Fischel have made similar observations:

It could be argued that judges should treat the acts of managers of close corporations with suspicion . . . because of the absence of the disciplinary effects of the stock market and other market mechanisms. One rationale for the business judgment rule is that managers who make errors (and even those who engage in self-dealing) are penalized by market forces while judges who make errors are not. Thus managers have better incentives to make correct business decisions than do judges. But if neither managers nor courts are disciplined by market forces, this justification has less force.

*   *   *

For example, the decision to terminate an employee in a publicly held corporation is a classic example of the exercise of business judgment that a court would not second guess. In a closely held corporation, by contrast, termination of an employee can be a way to appropriate a disproportionate share of the firm’s earnings. It makes sense, therefore, to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgment rule. The same approach could be used with salary, dividend, and employment decisions in closely held corporations where the risks of conflicts of interest are greater.


The market for corporate control serves to constrain managers’ conduct that does not maximize shareholder wealth. It therefore serves to align the interests of
Because the market-based rationale for the business judgment rule is absent in the close corporation context, close corporation dividend decisions call for more judicial scrutiny than the conventional business judgment rule deference.

b. The Presence of a Conflict of Interest

It is a fundamental principle of corporate law that a decision does not receive the protection of the business judgment rule if the decisionmaker is "tainted" by a conflict of interest in the transaction. When a close corporation majority shareholder makes a decision to forego dividends, it is important to recognize that a conflict of interest is often present. That conflict stems from the majority's desire to preserve and enhance its own employment position within the company. Indeed, for many (if not most) close corporation investors, the desire for employment is the principal enticement motivating managers more closely with the interests of shareholders in publicly traded corporations. The market for corporate control does not affect, however, the incentives of managers of closely held corporations.

Rosenfield v. Metals Selling Corp., 643 A.2d 1253, 1262 n.18 (Conn. 1994). Another commentator similarly argued:

The close corporation is not comparably reviewed or controlled by the market because it has no publicly traded stock. There is little possibility of a proxy fight or a takeover bid . . . . The absence of judicial review remains unsubstituted. Because of the absence of judicial review, the business judgment rule is not an expression of faith in the free market; worse, it is often an abdication of judicial responsibility to protect the powerless.

Chittur, supra note 82, at 158; see, e.g., Hetherington & Dooley, supra note 7, at 48 ("The preferred status of the majority [in a close corporation] is more likely to be an inadvertent product of failure to appreciate the importance of market forces in the regulatory scheme for business organizations."); see also Chittur, supra note 82, at 156–61 (arguing that the business judgment rule is inappropriate for the close corporation); F. Hodge O'Neal, Close Corporations: Existing Legislation and Recommended Reform, 33 Bus. Law. 873, 884–85 (1978) (criticizing the application of the business judgment rule to close corporations). In contrast, Professors Easterbrook and Fischel have also noted the following:

On the other hand, the smaller number of participants in closely held corporations ensures that managers bear more of the costs of their actions and facilitates contractual arrangements between the parties to reduce the likelihood of self-dealing. The differences between publicly and closely held corporations, in other words, do not suggest unambiguously that the level of judicial scrutiny should vary or, if it does, in what direction.

Easterbrook & Fischel, supra, at 291–92.

89. See text accompanying supra note 81 (discussing the application of the business judgment rule).

90. See infra Part V.B (discussing the majority's conflicts of interest).
their decision to commit capital to a venture.\textsuperscript{91} Compared to similar employment in other contexts, a close corporation job is frequently associated with a higher salary,\textsuperscript{92} a prestigious management position,\textsuperscript{93} and intangible benefits stemming from working for oneself.\textsuperscript{94} Because of the value of close

\textsuperscript{91} See, e.g., \textit{In re Kemp & Beatley, Inc.}, 473 N.E.2d 1173, 1178 (N.Y. 1984) ("As a matter of fact, providing employment for himself may have been the principal reason why he participated in organizing the corporation."); \textit{1 CLOSE CORPORATIONS, supra note 17, § 1.08, at 31–32} ("Providing for employment may have been the principal reason why the shareholder participated in organizing the corporation."); \textit{see also} Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) ("A guaranty of employment with the corporation may have been one of the basic reason(s) why a minority owner has invested capital in the firm.") (internal quotation omitted); \textit{In re Wiedy's Furniture Clearance Ctr. Co.}, 487 N.Y.S.2d 901, 903 (App. Div. 1985) ("Although the exact amount of the capital contribution is disputed, petitioner utilized his own funds in getting this new venture underway, not simply as an investment, but to provide employment and a future for himself."); Alyse J. Ferraro, Note, \textit{Ingle v. Glamore Motor Sales, Inc.: The Battle Between Ownership and Employment in the Close Corporation}, 8 HOFSTRA LAB. L.J. 193, 215 (1990) ("Ingle was compensated for the sale of his shares, but to believe that the dollar amount received met his expectations would be to dismiss his purpose in acquiring those shares. Ingle had reasonably expected his employment to continue until he chose to retire or to acquire his own Ford dealership ...." (footnotes omitted)); Murdock, \textit{supra note 31, at 468} ("That people often invest in a closely-held corporation to provide a job is almost self-evident ...."); \textit{id.} ("To deny a minority shareholder employment when a job was part of his rationale in investing is oppressive, as is the failure to pay dividends to nonemployee shareholders when employed shareholders are receiving \textit{de facto} dividends through salaries." (emphasis added) (footnote omitted)); \textit{id.} at 472 ("[W]hat is at stake in the 'oppression' cases is often a job—a very attractive job."); Ragazzo, \textit{supra note 80, at 1110} (noting that a close corporation shareholder "often invests for the purpose of having a job").

\textsuperscript{92} This assertion, of course, assumes a comparison between similar jobs in businesses at similar stages of development. See \textit{infra} note 207 (discussing the higher salaries frequently associated with close corporation positions).

\textsuperscript{93} See \textit{1 OPPRESSION, supra note 22, § 3:07, at 54} (referring to the "prestige, privileges, and patronage that come from controlling a corporation and occupying its principal offices"); \textit{id.} § 3:06, at 38 ("[L]osing the prestige of a directorship may be of considerable consequence to the shareholder."); \textit{infra note 208} (discussing disparities in chief executive officer positions); \textit{cf. KLEIN & COFFEE, supra note 65, at 174} ([T]here is obvious psychic income associated with being a senior manager of a 'Fortune 500' firm or other well known corporation.").

\textsuperscript{94} See \textit{Ingle v. Glamore Motor Sales, Inc.}, 535 N.E.2d 1311, 1319 (N.Y. 1989) (Hancock, J., dissenting) (noting "the challenge, the independence, the prestige, the feeling of achievement, and the other intangible benefits of being part of the management of a successfully run small company"); Bahls, \textit{supra note 15, at 290–91} (noting that close corporation ownership includes "the social status and challenge of operating one's own company and the satisfaction of providing employment to one's children"); \textit{id.} at 319 n.212 (mentioning the "loss of satisfaction and other qualitative perks associated with operating a business"); \textit{O'Neill, supra note 61, at 668, 671} (describing the "psychological payoffs" that an "owner-manager" anticipates as a result of investing in a venture, including "the pleasure of being one's own boss, the feeling of satisfaction in creating a viable enterprise and even the excitement of taking a substantial risk"); Ragazzo, \textit{supra note 80, at 1110} ("Additionally, the employee may simply derive satisfaction from working in a business that he himself takes a substantial part in managing."); \textit{see also} Bonavita v. Corbo, 692 A.2d 119, 124 (N.J. Super. Ct. Ch. Div. 1996) ([A] job in the family
corporation employment, the majority’s decision to forego dividends may be
dictated by the majority’s personal desire to preserve and enhance its own
employment capital, rather than by an interest in maximizing shareholder value.
For example, the majority shareholder may retain profits and forego dividends
in order to fuel company growth, as growth often has the effect of increasing
the majority’s employment compensation. Even if this conflict is not as direct
as the law typically requires for rebutting the business judgment rule, its
presence casts at least some doubt on the wisdom of giving great deference to
the majority and of avoiding a deeper review of the majority’s decision.

2. The Thrust of the Shareholder Oppression Doctrine

The shareholder oppression doctrine is premised on the notion that
majority shareholder decisions in close corporations can disadvantage minority
shareholders in ways that would not be possible in a public corporation context.
The doctrine recognizes that matters traditionally entrusted to majority business
discretion—for example, employment, management, and dividend decisions—
can be manipulated to effectuate a minority shareholder freeze-out. More

95. See infra Part V.B (discussing conflicts of interest between minority and majority
shareholders).

96. See, e.g., Sinclair Oil Corp. v. Levien, 280 A.2d 717, 721–22 (Del. 1971). In Sinclair
Oil, the Delaware Supreme Court concluded that because a decision to pay dividends affected
all shares equally, there was no self-dealing by the controlling shareholder to rebut the business
judgment rule. Id. Following the logic of Sinclair Oil, a decision to forego paying dividends
presumably affects all shares equally as well. See supra notes 62–67 and accompanying text
(discussing the dividend irrelevance theory). Such a decision, therefore, is unlikely to rebut the
business judgment rule under traditional public corporation doctrine. But see Smith v. Atl.
shareholder of a close corporation who refused to pay dividends, and stating that “[t]he
judgment necessarily disregards the general judicial reluctance to interfere with a
corporation’s dividend policy ordinarily based upon the business judgment of its directors”).

97. As one commentator observed:

A better solution to unwarranted retention would be to delimit the parameters of the
business judgment rule as it applies to the declaration of corporate dividends,
thereby minimizing management’s potential for abuse of its powers. This departure
from the historic application of the business judgment rule to dividends would be in
conformity with the traditional legal approach to a conflict of interest between
management and shareholder.

Israel, supra note 66, at 98.

98. See, e.g., Hollis v. Hill, 232 F.3d 460, 467 (5th Cir. 2000) ("In the context of a closely
held corporation, many classic business judgment decisions can also have a substantial and
specifically, one of the lessons conveyed by the shareholder oppression doctrine is that the majority’s control over the firm’s dividend policy can be devastating to a minority investor in a close corporation.

Because employment discharges, management removals, and dividend denials can severely harm the value of a close corporation shareholder’s investment, the oppression doctrine calls for legitimate scrutiny of a majority’s decision to take one or more of such actions. The doctrine conveys, in other words, that such decisions require a more probing judicial review than the conventional business judgment rule allows. Thus, the thrust of the shareholder oppression doctrine is at odds with a judicial approach that gives great deference to the majority’s actions. Because the traditional right to compel dividends operates with such a "majority-deference" view, that law is a poor choice for close corporation disputes. In contrast, by inquiring into whether the majority’s actions have frustrated the minority’s investment expectations, the reasonable expectations approach requires more than a mere

adverse affect on the ‘minority’s’ interest as shareholder.”).


100. See supra notes 28–32, 57–58, 67–73 and accompanying text (discussing the effect of freeze-out tactics).

101. See, e.g., Smith, 422 N.E.2d at 801, 804 (stating, in a close corporation dispute, that "[t]he judgment . . . necessarily disregards the general judicial reluctance to interfere with a corporation’s dividend policy ordinarily based upon the business judgment of its directors"); Fox v. 7L Bar Ranch, 645 P.2d 929, 935 (Mont. 1982) ("When it is also considered that in close corporations dividend withholding may be used by controlling shareholders to force out minority shareholders, the traditional judicial restraint in interfering with corporate dividend policy cannot be justified." (citation omitted)); Grato v. Grato, 639 A.2d 390, 396 (N.J. Super. Ct. App. Div. 1994) ("[J]udicial consideration of a claim of majority oppression or freeze-out in a closely held corporation is guided by considerations broader than those espoused in defendants' version of the 'business judgment rule.'"); Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979) ("[T]he statutory language embodies a legislative determination that freeze-out maneuvers in close corporations constitute an abuse of corporate power. Traditional principles of corporate law, such as the business judgment rule, have failed to curb this abuse. Consequently, actions of close corporations that conform with these principles cannot be immune from scrutiny."); O’Neill, supra note 61, at 692 ("The burden-shifting scheme devised in Wilkes [a close corporation oppression decision] effectively deprives majority shareholders of the protection of the business judgment rule by requiring close judicial scrutiny of the majority’s action whenever the minority is harmed."); id. at 690 n.155 ("Courts in some jurisdictions have refused to apply the business judgment rule to close corporations in an effort to correct the squeeze out problem."). But see Brenner v. Berkowitz, 634 A.2d 1019, 1033 (N.J. 1993) (noting, in a close corporation dispute, that "the court is hesitant to overturn the corporation’s valued exercise of its business judgment," and observing that "[t]he Chancery Division properly concluded that it could not second-guess the corporation’s exercise of its business-judgment").

102. See supra Part III.A (discussing the traditional approach to compelling dividends).
surface inquiry into the majority's conduct. As such, it is a more appropriate standard. In jurisdictions that have adopted the shareholder oppression doctrine, it should be deemed that such adoption has, in the close corporation context, displaced the case law representing the traditional approach.

3. Summary

Because the reasonable expectations standard avoids reliance on the business judgment rule, it is a more appropriate standard for a close corporation context where the discipline of a market is absent and where the majority is tainted by self-interest. Similarly, because the reasonable expectations approach involves a deeper inquiry into the majority's employment,

103. The reasonable expectations approach is also a more appropriate standard for shareholder oppression disputes—including disputes over dividends—because it views oppression from a minority perspective rather than from a majority perspective. See generally Moll, Shareholder Oppression, supra note 60, at 789–809 (arguing that a "modified" minority perspective of oppression is superior to a majority perspective of oppression). In other words, the traditional right to dividends focuses on the propriety of the majority's conduct. If the majority's conduct is sufficiently improper to be characterized as "fraud" or "bad faith," liability is found. See supra Part III.A (describing the traditional judicial approach to compelling dividends). The reasonable expectations approach, however, moves away from an emphasis on the majority's conduct. Instead, it focuses primarily on the effect that such majority conduct has on the minority shareholder. If the majority's actions frustrate a reasonable expectation of the minority, oppression liability is found, even if the majority's actions would not typically be characterized as improper. See, e.g., Peeples, supra note 55, at 504 (observing that the reasonable expectations analysis "channel[s] the inquiry away from assessing fault"); Thompson, supra note 21, at 219–20 ("The increasing use of the reasonable expectations standard reflects a move away from an exclusive search for egregious conduct by those in control of the enterprise and toward greater consideration of the effect of conduct on the complaining shareholder, even if no egregious conduct by controllers can be shown."); id. at 210 ("The increasing legislative and judicial tendency to define oppression by reference to the reasonable expectations of shareholders . . . [has] pushed the focus of the dissolution remedy beyond fault of the controlling shareholders."); see also Brenner v. Berkowitz, 634 A.2d 1019, 1029 (N.J. 1993) ("Focusing on the harm to the minority shareholder reflects a departure from the traditional focus, which was solely on the wrongdoing by those in control, and reflects the current trend of recognizing the special nature of close corporations." (citations omitted)).

104. Many oppression decisions suggest that this "displacement" of the traditional view has, in fact, occurred. Rather than inquiring into whether the majority shareholder committed fraud or bad faith in choosing not to declare dividends, many courts are instead asking whether the majority has frustrated the minority's reasonable expectation of sharing in the profits of the company. See, e.g., In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179–81 (N.Y. 1984) (examining whether majority actions frustrated the minority's reasonable expectations). Even where courts still articulate the traditional "abuse of discretion" standard as discussed in Part III.A, it is often employed with a broader, more minority-friendly view of what constitutes abuse. See, e.g., Little v. Waters, No. 12155, 1992 WL 25758, at *6–9 (Del. Ch. Feb. 11, 1992) (finding a claim where plaintiff alleged a squeeze-out).
management, and dividend decisions, the approach is consistent with the underlying premises of the shareholder oppression doctrine. For these reasons, courts should view the shareholder oppression doctrine as having superseded the traditional approach to compelling dividends.

C. The Limits of the Reasonable Expectations Standard

As previously discussed, close corporation shareholders, at a minimum, possess a general expectation that their status as "stockholders" entitles them to a proportionate share of the company's profits.\(^{105}\) Because close corporations lack a market that reflects capital appreciation, the investor usually receives its share of the profits through dividends (either as "true" declarations or as "de facto" distributions through, typically, employment compensation).\(^{106}\) In a sense, therefore, one can view the general expectation of sharing proportionately in the company's profits as a general expectation of dividends.

The mere fact that a general expectation of dividends is possessed, however, does not mean that a minority shareholder can demand its proportionate share of the profits—that is, can demand a dividend—at any time. The oppression doctrine only enforces "reasonable" expectations and, depending on the particular circumstances before the court, a demand for dividends may not be reasonable. For example, where the majority chooses not to declare a dividend in an effort to retain profits for company expansion, or for an investment opportunity, or for any other legitimate business purpose, premising oppression liability on the frustration of the minority's general expectation may be inappropriate.\(^{107}\) In such circumstances, a minority's

\(^{105}\) See supra notes 56–57 and accompanying text (discussing the "general" reasonable expectation).

\(^{106}\) See supra notes 67–73 and accompanying text (discussing the significance of dividends in the close corporation).

\(^{107}\) As the Supreme Judicial Court of Massachusetts observed: [W]hen minority stockholders in a close corporation bring suit against the majority alleging a breach of the strict good faith duty owed to them by the majority, we must carefully analyze the action taken by the controlling stockholders in the individual case. It must be asked whether the controlling group can demonstrate a legitimate business purpose for its action.

Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 663 (Mass. 1976); see, e.g., Gay v. Gay's Super Markets, Inc., 343 A.2d 577, 580 (Me. 1975) ("If there are plausible business reasons supportive of the [dividend] decision of the board of directors, and such reasons can be given credence, a Court will not interfere with a corporate board's right to make that decision."); Crosby v. Beam, 548 N.E.2d 217, 221 (Ohio 1989) ("Where majority or controlling shareholders in a close corporation breach their heightened fiduciary duty to minority shareholders by utilizing their majority control of the corporation to their own advantage,
general expectation of dividends is arguably unreasonable, and the majority's "frustration" of that unreasonable expectation should not give rise to oppression liability.\textsuperscript{108} Simply put, the minority's interest in dividends has to be balanced against the majority's legitimate right to make business decisions for the company.\textsuperscript{109} Although it is fair to say that all close corporation shareholders possess a general expectation of profit participation, a court cannot give effect to that expectation—that is, a court cannot deem that expectation to be reasonable—in all circumstances.

Obviously, if explicit evidence exists indicating that the majority and minority shareholders agreed to defer dividends in particular circumstances,\textsuperscript{110} a court should rely on that evidence in assessing the reasonableness of a minority investor's assertion that the majority's conduct has frustrated its general expectation.\textsuperscript{111} For example, if the evidence indicated that all of the investors without providing minority shareholders with an equal opportunity to benefit, such breach, absent a legitimate business purpose, is actionable." (emphasis added)); Zidell v. Zidell, Inc., 560 P.2d 1086, 1089 (Or. 1977) ("[T]hose in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the minority shareholders . . . [T]hat duty is discharged if the decision is made in good faith and reflects legitimate business purposes rather than the private interests of those in control.").

\textsuperscript{108} See supra note 107 (discussing whether an expectation of dividends is reasonable in the circumstances).

\textsuperscript{109} See, e.g., Wilkes, 353 N.E.2d at 663 ("The majority . . . have certain rights to what has been termed 'selfish ownership' in the corporation which should be balanced against the concept of their fiduciary obligation to the minority."); Muellenberg v. Bikon Corp., 669 A.2d 1382, 1387 (N.J. 1996) ("[M]inority shareholders' expectations must . . . be balanced against the corporation's ability to exercise its business judgment and run its business efficiently."); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, petition denied) ("The minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently."); Hillman, supra note 59, at 60 (suggesting that an oppression standard should "develop a satisfactory method for balancing the competing interests and expectations of majority and minority shareholders"); Sandra K. Miller, Should the Definition of Oppressive Conduct by Majority Shareholders Exclude a Consideration of Ethical Conduct and Business Purpose?, 97 DICK. L. REV. 227, 258 (1993) ("The courts must balance the interests of minority shareholders against the majority's interest in making business decisions and limiting the minority shareholder's power."); see also Meiselman v. Meiselman, 307 S.E.2d 551, 572 (N.C. 1983) (Martin, J., concurring) (observing that the oppression inquiry requires "a consideration and balancing of all the circumstances of the case in determining whether relief should be granted and, if so, the extent, nature and method of such relief").

\textsuperscript{110} See, e.g., Fix v. Fix Material Co., 538 S.W.2d 351, 355 (Mo. Ct. App. 1976) ("In conjunction with this expansion, the shareholders, including plaintiff, signed a buy-sale agreement as to corporate stock, which among other things, prohibited payment of cash dividends during the ten-year term of the loan.").

\textsuperscript{111} See MICH. STAT. ANN. § 450.1489(3) (Michie 2002) (noting that oppressive conduct "does not include conduct or actions that are permitted by an agreement"); In re Topper, 433 N.Y.S.2d 359, 366 (Sup. Ct. 1980) ("The Court may determine the understanding of the parties
reached an understanding that the corporation would not pay dividends during a period of corporate growth, that evidence should, in most instances, lead a court to reject a claim of oppression liability during that period, at least a claim that is based upon an alleged frustrated general expectation. 2

Unfortunately, in most close corporation disputes, such explicit understandings or agreements are absent. A court has only the outer parameters of the general expectation to go on—the basic notion that all shareholders reasonably expect that they are entitled to participation in the company's profits. In many respects, it is analogous to a court attempting to interpret a skeletal agreement between the shareholders. It is clear that the majority and minority participants have reached an understanding that all stockholders are entitled to a proportionate share of the company's profits, as to the role the complaining shareholder is expected to play from agreements and evidence submitted.); see also MINN. STAT. ANN. § 302A.751(3a) (West 1992) ([A]ny written agreements . . . between or among shareholders or between or among one or more shareholders and the corporation are presumed to reflect the parties' reasonable expectations concerning matters dealt with in the agreements.); Hillman, supra note 59, at 78 ("The clearest type of expectation is one which is set forth in a shareholder's agreement signed by all of the parties."); cf. In re Apple, 637 N.Y.S.2d 534, 535 (App. Div. 1996) (noting that a buyout agreement explicitly bound each shareholder to sell "after ceasing for any reason, either voluntarily or involuntarily, to be in the employ of the corporation," and stating that, as a result, the terminated close corporation minority shareholder "cannot be heard to argue that he had a reasonable expectation that he would be employed and would be a shareholder for life"); Woodard v. Southwest States, Inc., 384 S.W.2d 674, 674 (Tex. 1964) ("Where there exists a valid express contract covering the subject matter, there can be no implied contract.").

112. See supra note 111 and accompanying text (discussing the effect of agreements on reasonable expectations). If the majority is paying itself de facto dividends in violation of this understanding, of course, oppression liability should arise. See infra Part IV (discussing de facto dividend disputes).

113. See, e.g., Chittur, supra note 82, at 160 (noting that the expectations of a close corporation shareholder "may not be articulated with lawyerly precision"); O'Neal, supra note 88, at 883–84 ("A person taking a minority position in a close corporation often leaves himself vulnerable to squeeze-out or oppression by failing to insist upon a shareholders' agreement or appropriate charter or bylaw provisions . . . ."); id. at 886 ("The participants typically enter into 'agreements' among themselves, which sometimes are reduced to writing in the form of a formal preincorporation agreement or a shareholders' agreement, but which often are oral, perhaps just vague and half-articulated understandings."); see also Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979) ("The expectations of the parties in the instant suit with regard to their participation in corporate affairs are not established by any agreement."); Chittur, supra note 82, at 131 ("[P]eople generally avoid complex and expensive planning in small businesses."); id. at 139 (stating that "inadequately planned close corporations will always remain part of the picture," and noting that "[t]he most careful plan may fail to visualize some conflicts, even if it does not generate novel ones of its own").

114. See supra notes 56–57 and accompanying text (discussing the "general" reasonable expectation).
but it is unclear when a particular shareholder can demand distribution of its share through dividends.115

One way to resolve these uncertainties is to ask hypothetically what the shareholders would have agreed to had they contemplated the particular circumstances at issue.116 That is, what understandings would the shareholders

115. Similar problems arise in dealing with specific reasonable expectations. See supra notes 58–61 and accompanying text (discussing basic understandings that close corporation shareholders usually reach). At the inception of a close corporation venture, there is often sufficient circumstantial evidence to establish a basic understanding between the shareholders that investment in the company entitled a shareholder to employment or management participation. See Moll, supra note 56, at 1006–10 (discussing basic understandings that close corporation shareholders usually reach). Because reasonable expectations derive from such shared understandings between close corporation investors, that same evidence suffices to establish that the shareholders had specific reasonable expectations of employment or management. See, e.g., Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1019 (Sup. Ct. 1984) ("[T]he 'reasonable expectations' test is indeed an examination into the spoken and unspoken understanding upon which the founders relied when entering into the venture."); Hillman, supra note 59, at 78 ("[O]nly expectations embodied in understandings, express or implied, among the participants should be recognized."); Thompson, supra note 21, at 224 (observing that a reasonable expectations standard is based on the parties' understandings). There is generally no evidence, however, indicating whether the parties intended this basic understanding or expectation to persist in the post-inception circumstances before the court. For example, do the parties still share a basic understanding of employment after the venture's inception when the minority shareholder has engaged in misconduct, or when the minority shareholder's performance is inadequate? Put differently, is the basic expectation of employment still "reasonable" under these circumstances? As mentioned, there is usually no evidence indicating how the shareholders wanted these questions to be answered.

116. As Professor Farnsworth observes:

It is sometimes suggested that if a court cannot determine the actual expectations of the parties, it should implement the expectations that it thinks they would have had if they had considered the matter, thereby remedying the shortsightedness of individuals, by doing for them what they would have done for themselves if their imagination had anticipated the march of nature.'

E. ALLAN FARNSWORTH, CONTRACTS § 7.16, at 500 (3d ed. 1999); see, e.g., Gunderson v. Alliance of Computer Prof'ls, Inc., 628 N.W.2d 173, 185 (Minn. Ct. App. 2001) ("In the absence of specific agreements, reasonable expectations may be determined by reference to the understandings that would normally be expected to result from associative bargaining.""). John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 83 (1986) ("Under the standard theory, when a contractual term is missing, the court may insert that term which it believes rational parties would have agreed upon had they focused on it."); Easterbrook & Fischel, supra note 88, at 293 ("If a court is unavoidably entwined in a dispute, it must decide what the parties would have bargained for had they written a completely contingent contract."); id. at 291 ("Properly interpreted, fiduciary duties should approximate the bargain the parties themselves would have reached had they been able to negotiate at low cost."); id. at 298 ("The right inquiry is always what the parties would have contracted for had transaction costs been zero."); Ragazzo, supra note 80, at 1131 (noting, in a shareholder oppression context, that "[i]t would seem to be the courts' job to either enforce the spirit of the deal between the parties, even in cases where no formal contract exists, or to ask what protections the parties would have contracted for had they considered a particular question
likely have reached if, at the outset of the venture, they had bargained over the possibility of the majority refusing to declare dividends for business reasons, personal reasons, or for no reasons at all?117 Put differently, to convince the objectively reasonable investor to commit a substantial part of his savings to a close corporation,118 what understandings would the shareholders likely have to reach regarding the distribution of dividends?

This Article contends that the understandings resulting from these hypothetical bargains should be accepted as valid and accurate statements about the rationale of shareholders that invest in close corporations. More precisely, this Article asserts that the understandings should be accepted as the presumptive terms of the dividend "deal" that typical close corporation shareholders strike. In the absence of evidence indicating that the parties actually reached a consensus contrary to these understandings,119 the majority's violation of the hypothetical understandings should give rise to oppression liability. As this Article discusses the basic types of dividend disputes in close corporations, this hypothetical bargaining model will be employed to provide guidance for resolving the disputes.

IV. The Problem of De Facto Dividends

Perhaps the clearest case for judicial intervention into a close corporation's dividend policy involves the majority shareholder's receipt of "de facto" dividends to the exclusion of the minority shareholder. A dividend is merely a distribution of corporate profit to shareholders.120 As mentioned, a close corporation often chooses vehicles other than traditional dividend declarations to distribute its profits to investors. For example, salary and other employment-related compensation are typically used as mechanisms for

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117. See supra note 116 and accompanying text (discussing hypothetical bargains).
118. See infra note 222 (noting that close corporation shareholders often commit a large portion of their personal wealth to the venture).
119. See supra notes 111–12 and accompanying text (discussing the significance of explicit evidence).
120. See BLACK'S LAW DICTIONARY 478 (6th ed. 1990) (defining a dividend as "[t]he distribution of current or accumulated earnings to the shareholders of a corporation pro rata based on the number of shares owned").
distributing close corporation profit because the company can deduct reasonable employee compensation, but not reasonable dividend payments, from its taxable income. A "de facto" dividend, therefore, is simply a distribution of corporate profit to shareholders that a company disguises, often for tax reasons, as some other form of compensation or perquisite.

Because close corporations often distribute their business returns in the form of de facto dividends, declarations of "true" dividends are rare. So long as all of the investors are receiving their proportionate share of the de facto dividends, this absence of true dividends is generally unobjectionable as a corporate matter. In such circumstances, the investors are receiving their proportionate share of the company’s profits and, consequently, their general reasonable expectations are met. When the majority receives de facto dividends but excludes the minority from them, however, the absence of true dividends becomes problematic. Without true or de facto dividends, the minority has been effectively excluded from its proportionate share of the company’s profits. Such situations likely frustrate the minority’s general reasonable expectation and warrant judicial intervention.

In de facto dividend cases, however, some important distinctions could be drawn. In many of the published oppression decisions that address the issue, the minority’s exclusion from de facto dividends results from "majority fault":

121. See supra note 29 and accompanying text (discussing the tax implications of salary and dividends).

122. See, e.g., Alaska Plastics v. Coppock, 621 P.2d 270, 277 (Alaska 1980) ("Regardless of how the corporation labels these [salary and compensation] expenditures, if they were not made for the reasonable value of services rendered to the corporation, some portion of these payments might be characterized as constructive dividends."); Hirschkom v. Severson, 319 N.W.2d 475, 477 (N.D. 1982) ("[T]he corporation paid no dividends . . . . Rather, the corporate directors distributed the profits via salary increases, bonuses, and benefits . . . .").


that is, the majority shareholder takes some sort of unjustified action, such as a wrongful termination of the minority’s employment, that creates the exclusion. In such cases, the equities favor the aggrieved minority shareholder and the need for judicial intervention seems clear. Significantly, however, the minority’s exclusion from de facto dividends can also result from "minority fault"—that is, the minority’s misconduct or incompetence can prompt a justified majority action, such as the termination of the minority’s employment. The judiciary has rarely confronted these cases, and the propriety of judicial intervention is less clear. Finally, some disputes involve a "no fault" exclusion from de facto dividends, such as when a minority shareholder has been passive since the inception of the venture. Each of these scenarios will be discussed in turn.

A. Exclusion from De Facto Dividends: Majority Fault

As mentioned, many of the published oppression decisions involve a classic freeze-out where the majority shareholder unjustifiably terminates the minority shareholder’s employment. As a result, the minority is no longer entitled to salary and other employment-related compensation. The majority, however, will typically maintain its employment with the company and will continue to receive a salary and bonuses. When a company is paying de facto dividends through employment rather than declaring true dividends, this state of affairs is obviously detrimental to the minority. The amounts received as salary and bonuses constitute not only compensation for the value of the actual labor services performed for the company, but also a distribution of


126. See, e.g., Gimpel, 477 N.Y.S.2d at 1020–22 (involving a minority shareholder who embezzled funds from the company).

127. A "no fault" exclusion from de facto dividends might also involve a shareholder who quits or resigns from its position of employment with the corporation. See, e.g., Erdman v. Yolles, 233 N.W.2d 667, 668–69 (Mich. Ct. App. 1975) (involving a shareholder who was excluded from de facto dividends after he resigned from the company); In re Kemp, 473 N.E.2d at 1176, 1180–81 (same); Zidell v. Zidell, 560 P.2d 1086, 1090 (Or. 1977) (same).

128. See Landstrom v. Shaver, 561 N.W.2d 1, 10 (S.D. 1997) (describing freeze-out situations as "typical of oppression cases"); supra note 125 and accompanying text (describing majority fault situations).

129. See, e.g., Leslie, 2002 WL 532605, at *8–9 (involving de facto dividends); In re Kemp, 473 N.E.2d at 1176, 1180–81 (same).
profit to the shareholder.\footnote{130} By terminating the minority's employment and maintaining its own job, therefore, the majority has created a situation where it continues to receive a return on its investment while the minority shareholder does not.\footnote{131} It is the functional equivalent of the majority shareholder choosing to declare a dividend only for itself. Such a non-uniform declaration is impermissible under general corporate law principles.\footnote{132}

Moreover, from a hypothetical bargaining standpoint, the investors surely would not have agreed to an arrangement where the majority, solely at its whim and without any valid reason, could exclude a minority shareholder from distributions of profit that other shareholders (including the majority) are continuing to receive.\footnote{133} Such an arrangement would give the majority the

\footnote{130} See, e.g., Leslie, 2002 WL 532605, at *9 ("[T]his Court concludes that the $45,000 'employee bonus' payments that [the controlling shareholders] awarded themselves ... are nothing more than distributions or dividends of the kind previously made to shareholders."); Ferber v. Am. Lamp Corp., 469 A.2d 1046, 1049 (Pa. 1983) (distinguishing between salary payments that reflected "reasonable compensation," and "excess" salary payments that "shall be treated as profits"); Murdock, supra note 31, at 468 ("The courts have recognized the reality that compensation paid to those in control has a two-fold function: to recompense services and to provide a return on investment."); supra note 71 and accompanying text (discussing compensation in close corporations).

\footnote{131} See, e.g., Nagy v. Riblet Prods. Corp., 79 F.3d 572, 577 (7th Cir. 1996) ("Many closely held firms endeavor to show no profits (to minimize their taxes) and to distribute the real economic returns of the business to the investors as salary. When firms are organized in this way, firing an employee is little different from canceling his shares." (emphasis added)); Landorf v. Glottstein, 500 N.Y.S.2d 494, 499 (Sup. Ct. 1986) ("In a close corporation, since dividends are often provided by means of salaries to shareholders, loss of salary may be the functional equivalent of the denial of participation in dividends."); see also Bonavita v. Corbo, 692 A.2d 119, 128 (N.J. Super. Ct. Ch. Div. 1996) ("When defendants terminated the salary payments that had been made to Gerald Bonavita, they had an obligation to provide, or at least try to provide, some alternative benefit to the holder of Bonavita stock. They were not free simply to ignore those interests and operate the corporation for the sole benefit of [the controlling shareholder]."); In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1176, 1180 (N.Y. 1984) (involving a close corporation that, after two shareholders ceased working for the company, oppressively changed its policy of distributing earnings from one based on share ownership to one based on services rendered to the corporation: "It was not unreasonable for the fact finder to have determined that this change in policy amounted to nothing less than an attempt to exclude petitioners from gaining any return on their investment through the mere recharacterization of distributions of corporate income.").

\footnote{132} See Manne, supra note 88, at 274 ("[T]he directors may not declare a dividend to some holders of a class of shares but not to others holding shares of the same class."); see also Cratty v. Peoria Law Library Ass'n, 76 N.E. 707, 708 (Ill. 1906) ("Dividends among stockholders of the same class must always be equal and without discrimination ... ."); Leslie v. Boston Software Collaborative, Inc., No. 010268BLS, 2002 WL 532605, at *8-9 (Mass. Super. Feb. 12, 2002) ("What must not be done is to make payments only to the majority shareholders, payments having different names or styles but being in reality dividends.").

\footnote{133} See Edwin J. Bradley, An Analysis of the Model Close Corporation Act and a Proposed Legislative Strategy, 10 J. Corp. L. 817, 840 (1985) ("Never should the minority
unfettered right to freeze a minority investor out of the company's business returns for so long as the majority desires. Given the absence of bargaining power disparities at the inception of a close corporation venture, it seems likely that minority investors would have refused to invest in the company if the majority had insisted on such unfettered discretion. Put differently, to induce minority investors to commit capital to the venture, the majority shareholder would likely have to agree that it would not pay dividends ("true" or "de facto") in a disproportionate manner.

In majority fault disputes, therefore, judicial intervention into a close corporation's dividend policy is clearly warranted. By and large, the courts have agreed, presumably because frustration of the minority's general reasonable expectation is so clear where the majority wrongfully excludes the minority from de facto dividends but continues to receive those dividends itself.

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134. See Moll, supra note 56, at 1074–75. Indeed, the author has previously stated the following:

[T]he close corporation investor, *ex ante*, has the bargaining leverage to demand [protective] terms. After all, a prospective shareholder-employee of a close corporation has viable alternative options if the majority shareholder refuses to enter into a protective bargain. For example, the prospective shareholder-employee can invest her capital in other close corporations willing to provide more favorable terms, or the shareholder-employee can avoid close corporations all together by simply entrusting her capital to the stock or bond markets. In addition, given that the pool of potential investors for a particular close corporation (with its own particular line of business) is, presumably, relatively small, the majority shareholder has an incentive to make concessions to secure the potential investor's much-needed capital, as another prospective investor for that particular venture may not come along for quite some time (if ever). Simply put, because the bargaining leverage at the outset favors the prospective shareholder-employee, nothing compels the shareholder-employee to invest on unfavorable terms.

Id.; see also O'Neill, supra note 61, at 663 ("At the outset, the shareholder faces an extremely diverse array of other . . . investment opportunities encompassing not only stock in other . . . corporations, but also interests in mutual funds and debt securities of corporations, financial institutions and governmental authorities."); Ragazzo, supra note 80, at 1109 (noting that close corporation investors "would seem well advised to trust their capital to diversified mutual funds rather than a small corporation").

B. Exclusion from De Facto Dividends: Minority Fault

Where the minority's own misconduct or incompetence has led to its exclusion from de facto dividends, more difficult questions arise. On the one hand, although a termination of the minority's employment or a removal of the minority from management is likely justifiable when the majority can establish the minority's misconduct or incompetence, unfairness to the minority may

136. See, e.g., Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561-62 (N.J. Super. Ct. Law Div. 1979) ("Plaintiff's discharge from employment with the corporation . . . was because of his unsatisfactory performance. The circumstances under which the parties' expectations in these areas were disappointed do not establish oppressive action toward plaintiff by the controlling shareholders."); Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1020 (Sup. Ct. 1984) ("[The minority shareholder’s] discharge, as well as his subsequent exclusion from corporate management, were not oppressive. It was clearly not wrongful for the corporate victim of a theft to exclude the thief from the councils of power."); Meiselman v. Meiselman, 307 S.E.2d 551, 564 (N.C. 1983) ("For plaintiff to obtain relief under the expectations analysis, he must prove that . . . the expectation has been frustrated [and] the frustration was without fault of plaintiff and was in large part beyond his control."); id. at 572 (Martin, J., concurring) ("If it is determined that plaintiff's rights or interests require protection because of plaintiff's own conduct, it would be improper to grant equitable relief. He who seeks equity must do equity."); Naito v. Naito, 35 P.3d 1068, 1079 (Or. Ct. App. 2001) ("[The minority's] resignation was the result of his deteriorating relationship with [the majority] and of his own action in responding to a bank request in a way that . . . harmed the corporation. We are not persuaded that [the majority’s] actions in those regards are the kind of conduct that the law treats as oppressive conduct against minority interests."); see also Brenner v. Berkowitz, 634 A.2d 1019, 1029 (N.J. 1993) ("A court could reasonably determine that unfairness would result if a minority shareholder were permitted to seek judicial intervention after years of acquiescence or participation in the alleged misconduct."); 1 OPPRESSION, supra note 22, § 1:01, at 2 ("Minority shareholders may be so uncooperative and act so unreasonably and improperly that controlling shareholders are justified in moving to eliminate them from the enterprise . . ."); 2 OPPRESSION, supra note 22, § 7:15, at 94 n.15 ("As a practical matter, there is something anomalous about permitting a shareholder's laziness, absenteeism and/or inefficiency to confront the controlling shareholders with a Hobson's choice of retaining him at full pay or risking dissolution and all the adverse financial and tax consequences that come in its wake . . ." (internal quotation omitted)); Easterbrook & Fischel, supra note 88, at 295 ("It is hard to imagine . . . how closely held corporations could function under a requirement that all shareholders have an ‘equal opportunity’ to receive salary increases and continue in office regardless of their conduct." (emphasis added)); Hillman, supra note 59, at 55 (noting the "allocation of adverse economic consequences on the basis of fault" as a possible policy objective); id. at 77 (noting that a prerequisite for relief under an expectations-based analysis should be that "the failure to achieve the expectation was in large part beyond the control of the participant"); id. at 80 ("Requiring that the dissatisfied shareholder not be responsible for the failure to achieve his or her own expectations may appear to be one of the more arguable of the prerequisites for relief. The absence of such a condition, however, would enable a dissatisfied shareholder to obtain relief by simply sabotaging the expectations."); Miller, Should the Definition, supra note 109, at 233–34 ("[R]elief may be denied to minority shareholders whose behavior justifies the majority’s conduct."); Sandra K. Miller, How Can the Reasonable Expectations Standard be Reasonably Applied in Pennsylvania?, 12 J.L. & Com. 51, 68 (1992) ("The minority’s expectations may be frustrated where his misconduct is perceived as being the cause leading up to the frustration of
still arise if the actions result in the minority ceasing to receive its share of the company profits. After all, while misconduct or incompetence directly relates to one's ability to serve as an effective manager or employee, such "unfitness" has nothing to do with one's right to a financial return on a previously-made investment in the business. On such a view, a company that distributed profits solely as salary might have to declare "true" dividends in order to provide a return to a shareholder who was terminated, even justifiably, from its employment position. On the other hand, the shareholders may have had legitimate business reasons for structuring the company as one that distributed profits via de facto dividends rather than true dividends. Should the company have to change that profit-distribution scheme—that is, declare true dividends—simply because of a blameworthy shareholder whose own actions caused the original de facto dividend scheme to become inequitable?

If explicit agreements or understandings between the shareholders speak to this problem, they should clearly govern the situation. As mentioned, however, explicit agreements or understandings are absent in most close corporations and, as a consequence, one can only make hypothetical inquiries. That is, what understandings would the shareholders likely have reached if, at the outset of the venture, they had contemplated the possibility of a justifiable exclusion from the company's method of distributing profits?

Unless very special circumstances are present, it is hard to imagine close corporation shareholders agreeing that a complete freeze-out is permissible under any set of facts. After all, when the majority justifiably terminates a minority shareholder from employment and consequently cuts the minority shareholder out of the company's earnings distribution scheme, the net effect is the same as a malicious freeze-out. The majority denies the minority its

his expectations."); D. Prentice, Protection of Minority Shareholders, 1972 CURRENT LEGAL PROBS. 124, 145 (1972) ("Prima facie exclusion from corporate affairs should give rise to a remedy.... Circumstances might exist, however, justifying such exclusion. For example, where it can be proven that the excluded member was the author of his own fate then he should not be afforded any relief.").

137. See infra notes 158–60 and accompanying text (discussing the distinction between shareholder rights and employee rights).

138. See infra note 147 and accompanying text (describing when the declaration of true dividends may be required).

139. See, e.g., Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1020 (Sup. Ct. 1984) (observing that a de facto dividend policy "was basic to the financial structure of the business," and stating that paying true dividends would run "clearly against the original intent of the shareholders" because it would provide a disproportionate share of the income to some of the stockholders); see supra note 29 (discussing the tax implications of "true" dividends and "de facto" dividends).

140. See supra note 113 and accompanying text (noting that explicit agreements are typically absent in close corporations).
proportionate share of the business returns for an indefinite period of time, and there is no market available for the minority to exit the situation.\footnote{141} Most likely, an understanding that the majority could render a shareholder's investment worthless for an indeterminate period of time is not one that close corporation shareholders would reach, even if the minority shareholder's misconduct or incompetence precipitated the situation.\footnote{142} Perhaps another way of articulating the same idea is to assert that close corporation shareholders would likely reach an understanding that the punishment needs to fit the crime. As mentioned, while misconduct or incompetence may be grounds for the forfeiture of a specific reasonable expectation of employment or management,\footnote{143} such notions of unfitness are unrelated to the general reasonable expectation of sharing in the business returns.\footnote{144} It is the making of the financial investment itself—not any notion of satisfactory performance in an employment or management position—that gives rise to the general expectation of sharing proportionately in the company's profits.\footnote{145} Simply put, misconduct or incompetence in an active participation role (employment, management) should forfeit the shareholder's right to that active participation in the company. Allowing that same conduct to forfeit the shareholder's right to passive participation in the company (profit-sharing), however, goes too far.\footnote{146} Either a buyout of the shareholder's interests should occur, or a court should force the company to declare true dividends.\footnote{147} Although the company may be compelled to change its profit-

\footnote{141} See supra notes 28–34 and accompanying text (discussing freeze-out techniques).
\footnote{142} Cf. Bradley, supra note 133, at 840 ("Never should the minority participant be understood as assenting to the effective confiscation of his or her investment . . . ."). At best, one could imagine the shareholders agreeing to a temporary (and brief) exclusion from dividends, either as additional punishment or because the company needs some time to implement changes to its profit-distribution scheme so as to include the now-passive shareholder. See infra notes 147–48, 162 and accompanying text (discussing minority fault and its effect on hypothetical bargains).
\footnote{143} See supra note 136 and accompanying text (discussing minority fault).
\footnote{144} See, e.g., Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561–62 (N.J. Super. Ct. Law Div. 1979) (concluding that a minority shareholder's termination was not oppressive in light of the minority's "unsatisfactory performance," but noting that the minority's expectation of dividends was a separate issue that could potentially establish an independent oppression claim); infra notes 150–62 and accompanying text (discussing Gimpel).
\footnote{145} See supra notes 56–57 and accompanying text (discussing the "general" reasonable expectation).
\footnote{146} See, e.g., Exadaktilos, 400 A.2d at 561–62 (discussing the effect of minority fault); Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1021–22 (Sup. Ct. 1984) (same).
distribution mechanism as a result of the minority shareholder’s fault (that is, from "de facto" to "true" dividends), such a forced change is one that the shareholders would likely have agreed to had they discussed the alternative of a wholesale exclusion from the profits of the company. It bears repeating that the company can avoid this change in structure if it (or the majority shareholder) is willing to buy out the minority’s holdings at "fair value." terminate the employment of a moving shareholder, a good faith effort must be made to buy-out the shareholder at a fair price or [to] adjust the income distribution mechanism to insure the shareholder an equitable investment return."); Gimpel, 477 N.Y.S.2d at 1022 ("[T]he majority must make an election: they must either alter the corporate financial structure so as to commence payment of dividends, or else make a reasonable offer to buy out [the minority's] interest.").

148. In most cases, the change will require a company that relied exclusively on de facto dividends to become a company that incorporates, at least in part, the distribution of true dividends. In theory, however, a company could still avoid the declaration of true dividends so long as it altered the de facto dividends scheme to include the justifiably-terminated shareholder. A company that distributed profit as salary and other employment-related benefits, for example, could continue to distribute such de facto dividends to the working shareholders so long as a proportionate de facto dividend was given to the terminated shareholder—perhaps in the form of services or consulting fees. See, e.g., Gimpel, 477 N.Y.S.2d at 1017 n.3 (observing that a terminated minority shareholder was still allowed the use of a company car). Alternatively, a company could declare true dividends on a limited basis by issuing a special class of stock solely to the terminated shareholder and by declaring a dividend only for that class. The amount of the dividend would equal what the investor would have otherwise received as its proportionate share of the de facto dividends. Finally, the company does not have to change its profit-distribution scheme at all if it (or the majority shareholder) is willing to buy out the holdings of the excluded minority shareholder at fair value. See infra note 149 and accompanying text (discussing buyouts).

149. As mentioned, the prevalent remedy for shareholder oppression is a buyout of the oppressed investor’s holdings. See supra note 38 and accompanying text (discussing the prevalence of the buyout). Support for the buyout remedy exists in half the states, although the relevant statutes and judicial decisions differ in their operation. See Thompson, supra note 19, at 718 (discussing remedies for oppression). In some states, statutes permit the corporation or the shareholders to purchase the shares of a minority shareholder seeking involuntary dissolution. See, e.g., ALASKA STAT. § 10.06.630 (1989) (allowing purchase to avoid dissolution); CAL. CORP. CODE § 2000 (West 1990) (same); MICH. COMP. LAWS ANN. § 450.1189 (West 1990) (same); MINN. STAT. ANN. § 302A.751 (subd. 2) (West Supp. 2003) (same); N.J. STAT. ANN. § 14A:12-7(8) (West Supp. 2003) (same); N.Y. BUS. CORP. LAW § 1104-a, 1118 (McKinney Supp. 2003) (same); N.D. CENT. CODE § 10-19.1-115 (2001) (same); RMBCA § 14.34(a) (1993) (same). In other states, statutes authorize a court to order a buyout as one of several possible remedies in dissolution proceedings or in other litigation between shareholders. See, e.g., ARIZ. REV. STAT. ANN. § 10-1816 (1996) (listing possible remedies); ME. REV. STAT. ANN. tit. 13-C, § 1434 (West Supp. 2002) (same); S.C. CODE ANN. § 33-14-310(d)(4) (Law. Co-op. 1994) (same); MODEL STAT. close corp. CORP. § 41, 42 (1993) (same). Courts have also ordered buyouts as part of their general equitable authority. See, e.g., Orchard v. Covelli, 590 F. Supp. 1548, 1560 (W.D. Pa. 1984) (ordering a buyout); Davis v. Sheerin, 754 S.W.2d 375, 380, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (affirming a buyout); Thompson, supra note 19, at 720–21 ("Courts increasingly have ordered buyouts of a shareholder's interest by the corporation or the other shareholders even in the
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Gimpel v. Bolstein is a rare precedent that confronts the issue of a minority shareholder’s exclusion from a company’s profit-distribution scheme as a result of the minority’s own fault. In Gimpel, the close corporation at issue had declared no true dividends since its inception. Instead, the corporation distributed profits to the shareholders via de facto dividends, as there was a "policy of distributing profits in the form of salaries, benefits and perquisites, without declaring dividends." According to the court, this de facto dividend policy "was basic to the financial structure of the business, and for years it was carried out "apparently by consent of all shareholders, but in any event without objection from anybody."

Robert Gimpel, a minority shareholder in the company, was terminated from his employment position as a result of his embezzlement of $85,000 from the business. The company continued to adhere to its policy of not declaring

absence of specific statutory authorization.

A buyout remedy provides a shareholder with the "fair value" of its investment. See id. at 718 ("Several of the largest commercial states permit a corporation or its majority shareholders to avoid involuntary dissolution by purchasing the shares of the petitioning shareholders at their "fair value. "); see also RMBCA § 14.34(a) (1993) ("In a proceeding under 14.30(2) to dissolve a corporation . . . the corporation may elect or, if it fails to elect, one or more shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares." (emphasis added)); Davis, 754 S.W.2d at 381 ("An ordered "buy-out" of stock at its fair value is an especially appropriate remedy in a closely-held corporation . . . ."). In a sense, therefore, the majority has to change the company’s profit-distribution scheme only to the extent that it is unwilling to bear the expense of a fair value buyout. See 2 OPPRESSION, supra note 22, § 10:09, at 60 ("The buy-out feature in these statutes is desirable because it permits shareholders who want to preserve the enterprise as a going concern to buy out dissenters, and at the same time it provides an oppressed shareholder a fair price for his holdings."); see also supra note 148 (discussing other ways to avoid changing the company’s profit-distribution mechanism). But see Hillman, supra note 59, at 70-75 (stating that "[t]he assumption that those who desire to avoid a dissolution of the corporate enterprise may easily do so by purchasing the interest of a dissatisfied minority shareholder ignores a number of problems which may be encountered by those who wish to continue the venture," and discussing those problems).

151. See id. at 1020 (discussing the effect of minority fault).
152. Id. at 1017, 1020.
153. Id. at 1023; see also id. at 1020 ("All concerned received all income from the corporation in the form of salary for their corporate positions."); id. at 1022 ("To the extent that the salaries paid to majority shareholders have been fixed so as to include amounts in lieu of dividends, the salaries must be adjusted downward.").
154. Id. at 1020; see id. (noting the founding shareholders’ "reliance upon a no-dividend policy").
155. Id.
156. See id. at 1017 ("[T]he court deems it established that in 1975 Robert was, in fact, a
dividends, and Robert eventually sued. He alleged, in relevant part, that the "profits of the corporation are distributed to the majority interests in the form of salaries, benefits and perquisites, with no dividends being declared," and that, as a result of his termination, he "derives no benefit whatsoever from his ownership interest."\(^{157}\)

The *Gimpel* court recognized that Robert's misconduct justified his termination from company employment.\(^{158}\) Significantly, however, the court realized that Robert's general reasonable expectation still deserved protection:

> [T]he court is nonetheless constrained to recognize that Robert cannot be forever compelled to remain an outcast . . . . While his past misdeeds provided sufficient justification for the majority's acts to date, there is a limit to what he can be forced to bear, and that limit has been reached. *The other shareholders need not allow him to return to employment with the corporation, but they must by some means allow him to share in the profits.*\(^{159}\)

The court concluded that the company "must either alter the corporate financial structure so as to commence payment of dividends, or else make a reasonable offer to buy out Robert's interest."\(^{160}\)

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\(^{157}\) *Id.* at 1018; see also *id.* at 1017 ("Since [his termination], Robert has received no benefits from his ownership position with this obviously profitable company. The company has continued to adhere to its policy of not paying dividends and, while the other shareholders have received substantial sums as salary, benefits and perquisites, Robert has received not a penny.").

\(^{158}\) *See id.* at 1018 ("Clearly it was proper to dismiss a thief."); *id.* at 1020 ("[T]he only expectations he could reasonably entertain were those of a discovered thief: ostracism and prosecution."); *id.* ("Robert's discharge, as well as his subsequent exclusion from corporate management, were not oppressive. It was clearly not wrongful for the corporate victim of a theft to exclude the thief from the councils of power.").

\(^{159}\) *Id.* at 1021 (emphais added).

\(^{160}\) *Id.* at 1022; see also *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554, 561–62 (N.J. Super. Ct. Law Div. 1979) (concluding that a minority shareholder's termination was not oppressive in light of the minority's "unsatisfactory performance," but noting that the minority's expectation of dividends was a separate issue that could potentially establish an independent oppression claim); *In re O'Neill*, 626 N.Y.S.2d 813, 814 (App. Div. 1995) (laying out lower court conclusion regarding minority shareholder employment).

The [lower] court concluded . . . that while [the minority shareholder] could not expect to participate in the day-to-day operations of the corporation [after the minority's employment was terminated for a criminal conviction], he was entitled to his rights as a shareholder, and the court directed [the majority shareholder] to either alter the corporation's financial structure to commence the payment of dividends, or offer to purchase [the minority shareholder's] interest in the corporation.

*Id.*
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Gimpel is a noteworthy opinion to the extent that the court explicitly acknowledged the competing concerns of the terminated shareholder’s general reasonable expectation and the company’s pre-existing de facto dividend scheme. Even though the shareholder’s own misconduct caused his exclusion from this pre-existing scheme, the court recognized that such fault could not justify the wholesale defeat of his general reasonable expectation of sharing proportionately in the venture’s profits. In short, the Gimpel analysis properly captures the notion that a minority shareholder’s misconduct or incompetence can serve to "forfeit" the minority’s specific expectation of an employment or management position, but that such minority fault should not permanently alter the minority’s basic rights as a shareholder of the company. If a court

161. It is important to note that the Gimpel court seems to have considered the minority shareholder’s fault to be relevant to the general expectation inquiry. Robert, the minority shareholder, was discharged from his employment with the company in 1974 because of his alleged embezzlement of $85,000 of company funds. Gimpel, 477 N.Y.S.2d at 1017. He received no judicial relief until the Gimpel decision in 1984. Id. at 1021–22. In that decision, the court explicitly noted that Robert, since his termination, “ha[d] received no benefits from his ownership position with this obviously profitable company.” Id. at 1017. Thus, Robert had been excluded from ten years of de facto dividends by the time the Gimpel opinion was rendered. Nevertheless, the court provided no compensation for these past dividends, and the court’s language suggests that this remedial omission was intentional. Indeed, the court stated that Robert’s "past misdeeds provided sufficient justification for the majority’s acts to date," id. at 1021 (emphasis added), and the relief awarded was entirely forward-looking. Id. (providing the majority with six months to elect between "alter[ing] the corporate financial structure so as to commence payment of dividends," or "mak[ing] a reasonable offer to buy out Robert’s interest").

The Gimpel court, therefore, arguably adopted a punitive approach towards Robert’s misconduct that affected more than just his specific expectation of employment. Although the court ultimately recognized that the minority shareholder’s misconduct could not justify an indefinite exclusion from the returns of the business, the court did seem to believe that Robert’s fault was relevant to his general expectation claim—relevant to the extent that Robert’s misconduct justified a ten-year time period of exclusion from dividends.

As an alternative to this "punitive" theory, perhaps the court allowed this ten-year exclusion because the value of Robert’s proportionate share of those dividends was approximately equal to the $85,000 that Robert embezzled. Viewed in this manner, the court’s failure to provide Robert compensation for the ten years of missed dividends was not because it felt that minority fault should affect the shareholder’s general expectation. Instead, the remedial omission should be viewed as a quick and dirty accounting convention that recognized that Robert had already been "advanced" $85,000 in dividends. See id. at 1017 ("[F]or the purposes of this motion the court deems it established that in 1975 Robert was, in fact, a thief who stole from the family company."). Admittedly, this alternative explanation is a stretch, particularly because it is unclear whether Robert was permitted to actually keep the $85,000 in embezzled funds. See id. (noting that Robert’s father allegedly “adjusted any disputed financial transaction”). Moreover, the court never quantifies the total amount of de facto dividends paid by the company over the ten-year period, and it never mentions what Robert’s proportional share of that total sum would be.
nonetheless believes that minority fault should have some effect, it could account for such fault in ways that are less harsh than a complete denial of relief.162

162. For example, a "blameworthy" minority shareholder who asserts a de facto dividend claim could be required to carry the burden of proof. The typical de facto dividend claim involves the contention that a majority shareholder has received de facto dividends through excessive employment compensation. In many of these cases, the majority shareholder was actually involved in determining the amount of its compensation—a classic conflict of interest. See, e.g., Cole Real Estate Corp. v. Peoples Bank and Trust Co., 310 N.E.2d 275, 277–78 (Ind. Ct. App. 1974) (noting that the majority shareholder "set her own salary level ... without consultation with the board of directors"). Because of this conflict, the law would generally place the burden of proof on the majority to demonstrate that its compensation was not excessive—i.e., to demonstrate that it did not receive any de facto dividends. See, e.g., Crowley v. Communications for Hosps., Inc., 573 N.E.2d 996, 999–1000 (Mass. App. Ct. 1991). When minority fault is involved, a court could conceivably alter this traditional corporate law principle and place the burden of proof on the minority.

A court could also account for minority fault in the way that relief is structured. See supra note 161 (discussing the relief provided in the Gimpel case). Perhaps some combination of minority and marketability discounts could be employed to reduce the amount owed to the minority shareholder in a buyout award. See, e.g., 2 OPPRESSION, supra note 22, § 7.21, at 115–16 (discussing discounts); Bahls, supra note 15, at 301–04 (same); see also N.J. STAT. ANN. § 14A:12-7 (West Supp. 1999) (stating that the court may award fair value "plus or minus any adjustment deemed equitable by the court"). Alternatively, perhaps the terms of a buyout could be manipulated to prevent the possibility of a corporation facing a significant cash drain. As one judge stated:

If it is determined that the granting of relief will be unduly burdensome to the corporation or other shareholders, the trial court should consider this in determining whether to grant relief and, if so, whether this should affect the purchase price or value attached to plaintiff's shares or the method of payment.

Meiselman v. Meiselman, 307 S.E.2d 551, 572–73 (N.C. 1983) (Martin, J., concurring); see also Bahls, supra note 15, at 328 n.258 ("Several state statutes permit the courts to order installment payments."); Hillman, supra note 59, at 83 (discussing the possibility of "structuring installment payments with a commercially reasonable rate of interest over an extended period of time"); cf. Bonavita v. Corbo, 692 A.2d 119, 130 (N.J. Super. Ct. Ch. Div. 1996) (appointing a "special fiscal agent" to consider the appropriate terms and conditions for a court-ordered buyout, including the interest rate, the payment schedule, and the need for any security).

When a buyout is awarded in a majority fault context, however, it is calculated as the fair value of the minority's shares. See supra note 149 and accompanying text (discussing buyouts). No additional "penalty" sum is added to the award to account for the majority's wrongdoing. If majority fault is typically ignored in the damages phase of an oppression dispute, perhaps minority fault should be ignored as well. But see Bahls, supra note 15, at 302 (arguing that a minority discount to a buyout award is inappropriate in part because the lower buyout price would benefit a majority shareholder whose fault led to the oppression finding).
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C. Exclusion from De Facto Dividends: No Fault

Even if no majority or minority "fault" is involved, de facto dividends are still problematic when the minority investor is not receiving its proportionate share. Typically, a "no fault" exclusion from de facto dividends arises when a minority shareholder has quit or retired from its former employment position with the company, although it could also arise when a minority shareholder has been passive since the inception of the venture. Where a majority shareholder receives de facto dividends but fails to pay the minority investor its proportionate share, the majority is paying a dividend only to itself. As mentioned, such a non-uniform declaration is impermissible under general corporate law principles. Passive minority shareholders—investors who depend solely on dividends for their investment return—would not have assented to such an arrangement. Simply put, if such a disproportionate dividend is oppressive where the minority has acted with misconduct or incompetence, it is certainly oppressive where the minority's actions are free of such fault.

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163. See supra note 127 and accompanying text (describing a "no fault" exclusion from de facto dividends).

164. A "passive from inception" shareholder is not the norm in the close corporation setting. See, e.g., Pedro v. Pedro, 463 N.W.2d 285, 289 (Minn. Ct. App. 1990) ("[T]he primary expectations of minority shareholders [in close corporations] include an active voice in management of the corporation and input as an employee."); supra notes 19-20 and accompanying text (explaining that close corporation shareholders typically participate in employment and management).

165. See supra note 132 and accompanying text (noting that non-uniform dividend declarations are improper).

166. See supra Part IV.B (discussing minority fault).

167. See, e.g., Erdman v. Yolles, 233 N.W.2d 667, 668-69 (Mich. Ct. App. 1975) (concluding, in a dispute involving a minority shareholder who quit his employment with the company, that "profits of the corporation were distributed through salary increases and that plaintiff was improperly denied his 1/4 share").

The Oregon decision of Zidell v. Zidell arguably reaches the wrong result in a "no fault" de facto dividends dispute. Zidell v. Zidell, 560 P.2d 1086 (Or. 1977). In Zidell, the corporation's "customary practice [was] to retain all earnings in the business rather than to distribute profits as dividends." Id. at 1088. While working for the company, the plaintiff minority shareholder had agreed with this policy. Id. After the minority resigned from his employment position, however, he demanded that dividends be declared. Id. Dividends were paid, but in an amount that the minority characterized as "unreasonably small," and that the court referred to as "modest when viewed as a rate of return on [the minority's] investment." Id. at 1088, 1090.

The court stated that the minority had shown that "those stockholders who are working for the corporations are receiving generous salaries and bonuses, and that there is hostility between [the minority] and the other major stockholders." Id. at 1089. Despite this apparent showing of de facto dividends, the court refused to order additional dividends beyond the minimal amounts that had previously been paid. Id. at 1090. The court apparently found it significant that the
D. Remedying an Exclusion from De Facto Dividends

When a shareholder is excluded from de facto dividends, the shareholder effectively misses profit distributions that it is entitled to receive. Proper judicial relief should, therefore, provide compensation for these missed distributions and prohibit such exclusions in the future. For example, a court’s award should encompass (1) a damages award equal to the past de facto dividends that the excluded shareholder did not receive (plus interest), and (2) an order that future dividends (true or de facto) shall be paid to the excluded shareholder in the same proportional amount that other shareholders receive.

Significantly, this remedial structure should not change even if a court awards a buyout of the minority’s holdings. A buyout of the minority will remove the aggrieved shareholder from the company. Thus, it is certainly true that the need for a court order of future dividends to the excluded minority shareholder is obviated. A buyout award, however, does not provide the aggrieved minority shareholder with compensation for the past de facto dividends that it failed to receive. Although a proper company valuation for buyout purposes adds the de facto dividend amounts back into the corporation’s income, that adjustment is because the valuation is typically based upon the

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minority had resigned, as it specifically noted that the minority "left his corporate employment voluntarily" and "was not forced out." Id.

Although the case appears to be a classic example of the controlling shareholders impermissibly paying de facto dividends to themselves, it may be unfair to criticize the court’s conclusion. The opinion states that the minority "[did] not contend that these salaries [paid to the working shareholders] are excessive in his briefs on appeal." Id. at 1088. The minority, therefore, arguably did not sufficiently place the de facto dividends issue before the court.

168. As the Supreme Court of Pennsylvania explained:

When the trial court has determined an amount that would have been reasonable compensation for Harry, Isadore, and Joseph’s services to the corporations, if amounts in excess of that amount, either in salaries or other benefits were paid, those excess amounts shall be treated as profits which were distributed to the three brothers and shall be used, along with other excess payments (i.e., auto, boat and entertainment payments which have already been determined to be non-business related), to calculate the amount which is to be distributed to Ms. Ferber as her share of profits.

Ferber v. Am. Lamp Corp., 469 A.2d 1046, 1049 (Pa. 1983); see, e.g., Erdman v. Yolles, 233 N.W.2d 667, 669 (Mich. Ct. App. 1975) (stating that "profits of the corporation were distributed through salary increases and that . . . plaintiff was improperly denied his 1/4 share," and awarding damages for that amount).

169. See infra note 172 and accompanying text (discussing the need for an earnings adjustment).
company’s earnings. In other words, de facto dividends are profits that have not been recorded as such on the company’s books, typically for tax reasons. Before performing a valuation that is based on the amount of profits that a company generates, the company’s books must be adjusted to account for these mischaracterized profits (that is, the de facto dividends must be added back into earnings).

It is critical to recognize, however, that this is truly a "paper" adjustment to the company’s stated profit figures. That is, the shareholders who received their proportionate share of the de facto dividends do not actually return those sums. Thus, this well-accepted

170. As mentioned, a buyout remedy provides the shareholder with the "fair value" of his investment. See supra note 149 and accompanying text (discussing buyouts). For buyout purposes, the "fair value" of a close corporation is most commonly derived by calculating investment value—a calculation that is usually based upon the earnings of a corporation. See Thompson, supra note 21, at 233 ("The most common method for determining fair value is to calculate investment value, usually based on the company’s earnings."); id. ("[T]he most commonly utilized formula [for calculating investment value] treats company earnings as determinant of investment value."); see also SHANNON P. PRATT ET AL., VALUING A BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES 40 (3d ed. 1996) [hereinafter VALUING A BUSINESS] ("Generally, earning power is the important internal variable affecting the going-concern value of the business.").

De facto dividends are usually recorded as expenses (e.g., salary or other employee compensation payments) rather than profits. See supra note 29 and accompanying text (discussing the tax consequences of dividends).

171. As one court observed:

The term 'adjusted pretax income' is arrived at by adding to pretax income for the most recent fiscal year of the company... all compensation paid to Dick Hendley... during that year. Dick Hendley’s salary is added back to income because Mr. Hendley performed no services for the company during that year; his compensation was more in the nature of a distribution of profits.

Hendley v. Lee, 676 F. Supp. 1317, 1327 (D.S.C. 1987); see, e.g., In re Raskin v. Walter Karl, Inc., 514 N.Y.S.2d 120, 121 (App. Div. 1987) (noting that in calculating the earnings of an enterprise, any excess compensation that has been paid to shareholder-employees and corporate officers should be added to reported corporate earnings to determine the company’s real earning power); infra note 174 and accompanying text (describing the need to restate earnings).

Professor Murdock similarly observes:

[I]f the majority is taking excessive salaries to the exclusion of the minority, the earnings of the corporation will be thereby reduced and any valuation technique predicated upon earnings, such as capitalized earnings or discounted cash flow, will be 'unfair' unless earnings and cash flow are adjusted to reflect the situation that would exist absent the oppressive conduct.

Murdock, supra note 31, at 428; see id. at 477 ("[T]o truly reflect the companies' earning power, the net income is adjusted by eliminating from the corporate expenses a portion of the officer-shareholders' salaries that is considered excess compensation." (internal quotation omitted)).

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173. See, e.g., Hendley, 676 F. Supp. at 1327 (performing calculations); In re Raskin, 514
valuation adjustment does not provide the minority shareholder with compensation for the value of the de facto dividends that it missed; instead, it simply restates the company's earnings to insure the accuracy of an earnings-based company valuation. 1

Perhaps another way to see this point is to imagine that the majority has excluded the minority shareholder from true dividend payments that the other shareholders have received. A buyout award would not require any adjustment to the company's stated earnings figures because sums distributed as true dividends are profits of the company that have already been recorded as profits on the company's books. If the buyout was of a shareholder who had received the dividend payments, the shareholder would keep those sums and would receive its proportionate share of the company's earnings-based value. The minority shareholder excluded from the dividend payments should receive no less—that is, it should receive its portion of the prior dividend payments and its share of the company's value. Nothing changes when de facto dividends are involved other than a bookkeeping adjustment to correct the stated profit figures so

N.Y.S.2d at 121 (same).

174. See Murdock, supra note 31, at 477; id. at 488–89 (noting that courts have seen "the need to adjust income and assets for nonfunctional compensation in valuing the shares of the minority for buy-out purposes"); supra note 172 and accompanying text. One noted valuation authority has stated the following:

In closely held companies, compensation and perquisites to owners and managers may be based on the owners' personal desires and the company's ability to pay—rather than on the value of services these individuals perform. How much to adjust the earnings base to reflect discrepancies between compensation paid and value of service performed depends, in part, upon the purpose and objective of the appraisal. Owners of successful closely held businesses may distribute what normally would be considered profits in the form of compensation and discretionary expenses. This practice may be an effort to avoid the double taxation that arises from paying a corporate income tax and then paying a personal income tax on what the closely held business pays to the owner in the form of dividends. It is not uncommon to find an owner/manager of a successful closely held company earning a greater amount in annual compensation than the amount an equivalent nonowner employee would earn as compensation.

Valuing a Business, supra note 170, at 121. Similarly, as commentators have explained:

The item that most often begs adjustment on the income statements of a privately held entity is the compensation to the owners. Actual compensation tends to be based on what the entity can afford or how the owners desire to be compensated, and may bear little or no relationship to the economic value of the services actually performed by the owners.

that a profit-driven valuation is accurate. Thus, the mere award of a buyout in the context of an exclusion from de facto dividends is incomplete. A court's relief should encompass (1) a damages award equal to the past de facto dividends that the excluded shareholder did not receive (plus interest), and (2) a buyout via a company valuation that adds the de facto dividend amounts back into income to reflect the company's real earning power. Unfortunately, many courts have failed to recognize the need to award both of the relevant components.

V. The Problem of Dividend Suppression: Forcing Distributions in the Absence of De Facto Dividends

At some level, disputes involving de facto dividends are relatively easy to resolve. After all, these disputes typically involve a majority shareholder who takes a disproportionate amount of the company's profit. Such conduct, simply put, is clearly unlawful, and one can characterize it as unlawful in a number of different ways—for example, fraud on the minority investors, bad faith to the minority investors, an illegal dividend to the majority, or plain and simple theft by the majority. Where de facto dividends are not involved, however, dividend disputes are much more complicated. For example, where a company has earned profits for a period of time without distributing them to anyone, when, if ever, should a minority shareholder be able to force a dividend? Put differently, if all shareholders are treated equally—that is, if no one receives a disproportionate amount of the company's profits—is it ever reasonable for the minority shareholder to expect a dividend?

175. See supra notes 172, 174 and accompanying text (discussing the need for an earnings adjustment).

176. See supra note 168 and accompanying text (discussing damage awards).

177. See, e.g., Hendley, 676 F. Supp. at 1327 (performing calculations); In re Raskin, 514 N.Y.S.2d at 121 (same).

178. See, e.g., Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1017–18, 1022 (Sup. Ct. 1984) (ordering the payment of true dividends in the future or a buyout of the minority's holdings, but providing no damages award to the minority for the prior de facto dividends that the minority was excluded from); supra note 161 and accompanying text (discussing Gimpel). But see Davis v. Sheerin, 754 S.W.2d 375, 378, 382–83 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (upholding a trial court award of damages for "informal dividends" that the majority received to the exclusion of the minority, and affirming the trial court's additional order for a fair value buyout of the minority's holdings).

179. This Article assumes that an active shareholder (i.e., a shareholder who is also a company employee) is not receiving a "disproportionate amount of the company's profits" if it is paid a reasonable salary by the company, even if the company also has passive shareholders (who, by definition, are not paid a salary by the company). In other words, this Article defines a
A. The Cost of Capital Inquiry

Modern economic theory provides a conceptual answer to this question. A company’s board of directors should reinvest profits in a new project (and therefore forego dividends) only when the expected returns from the project equal or exceed the firm’s cost of capital.\(^\text{180}\) That is, a company should pursue

"reasonable" salary as fair compensation for the value of the labor services that an active shareholder performs for the company. When this Article refers to the receipt of a "disproportionate amount of the company’s profits," it is referring to de facto dividends—i.e., sums over and above reasonable compensation for the value of the labor services performed.

This assumption, however, could be challenged. For example, imagine that a company, over a period of years, only earns enough to pay the reasonable salaries of its active shareholders. After paying these reasonable salaries, there are little to no additional sums remaining to pay out as dividends. From the standpoint of a passive investor, the active shareholders are receiving a disproportionate amount of the company’s "profits," at least to the extent that the active shareholders are the only investors who are financially benefiting from the company. A passive investor might take this position even if the amount of the active shareholders’ compensation could otherwise be described as "reasonable" based on the value of the contributed labor. See Miller v. Magline, Inc., 256 N.W.2d 761, 763, 767-68, 770 (Mich. Ct. App. 1977) (affirming the chancellor’s conclusion that a profit-sharing compensation arrangement was "within the outer limits of reasonable compensation," but noting the chancellor’s suggestion that the arrangement should be modified if it precluded the ability to pay a dividend); id. at 770 ("[W]e deem it an untenable position to argue that non payment of dividends is justified on the basis that such a concept of profit distribution would imperil the continued well being of the corporation. If such retention of profits were indicated they should have been more diligent in seeing that [salary] distributions based upon percentage of profits should also be curtailed."); cf. Bonavita v. Corbo, 692 A.2d 119, 124-26, 128 (N.J. Super. Ct. Ch. Div. 1996) (noting, in a dispute involving a corporation with substantial retained earnings, that there was no claim that the salaries paid to the controlling shareholder and his family were excessive, but finding oppression because the "operation of the corporation benefits only [the controlling shareholder]” and "provides no benefit of any kind to [the minority shareholder]").

At some level, this difference in characterization stems from what one means by "reasonable" compensation. Should reasonable compensation be an amount derived solely from the value of the labor services that a shareholder performs for the company—i.e., what the company would have to pay someone to do the tasks? Or should reasonable compensation be derived (1) from the value of the labor services performed for the company, and (2) from the need to leave the company with the financial ability to provide a minimal return to passive shareholders? Under this latter conceptualization, compensation would not be "reasonable" if it left the company with little to nothing to pay as a return to the passive investors, even if it would otherwise be an appropriate sum based on the value of the labor contributed to the company.\(^\text{180}\)

As Professor Brudney observes:

Under the irrelevance proposition if management has investment opportunities that offer the equivalent of the firm’s current rate of return, it is free to retain or distribute earnings indifferently. If management has projects that offer more than the current rate of return, then its duty is to reinvest earnings in those projects to maximize shareholder wealth. If, however, management has no investment project that offers prospects as good as those in which it has invested already, then it should distribute the earnings as dividends.
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an investment only if the investment’s return justifies its risk. Otherwise, "shareholders are unfairly compensated for the risk of the investments and are better off receiving dividends and choosing their own investment vehicles."\textsuperscript{181}
The theory suggests, therefore, that even a profitable investment (an investment with a positive rate of return) should not be pursued unless the expected return is high enough to compensate for the risk.\textsuperscript{182}

A simple example helps to convey this point. Suppose that a person wishes to invest $100 and is considering two investment options. The money

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\textsuperscript{181} Ragazzo, supra note 80, at 1112.

\textsuperscript{182} Id. at 1112 n.63. The net present value rule and the internal rate of return rule are two important capital budgeting techniques that are based on the cost of capital notion and the "risk/return" relationship. As Professor Ragazzo has observed:

To apply the net present value method, one determines the expected returns of a potential investment and discounts those returns to present value using a discount rate that appropriately measures the corporation's level of risk. As a result, expected returns in riskier corporations have lower present values than expected returns in less risky corporations. Investments are justified when the present value of the investment exceeds the present cost of the investment.

In contrast, the internal rate of return method asks at what discount rate the net present value of the expected returns of an investment is zero. Only if the internal rate of return generated by the project is higher than the rate of return normally required for corporate investments (which should equal or exceed the corporation's actual discount rate) should the project be undertaken. These capital budgeting methods are similar, and both reflect the concept that an investment that is likely to produce positive future returns can still be unwise unless those returns are sufficient to justify the risk of the investment.

\textsuperscript{180} (emphasis added); see also BREALEY & MYERS, supra note 180, at 20, 89 (describing the net present value and internal rate of return rules).
could be invested in relatively safe U.S. government securities, or the money could be invested in a company that sells widgits (Widgits, Inc.). Assume that the government securities are expected to pay a five percent return, Widgits, Inc. is expected to pay a ten percent return, and that all transaction costs are ignored. Even though the expected return from investing in Widgits, Inc. is twice as much as the expected return from investing in government securities, the investment may still be unwise. Indeed, an investment in Widgits, Inc. presumably carries more risk, as the company is exposed to the general risks of competition and business failure. A rational investor would commit capital to Widgits, Inc. only if the investor believed that the expected five percent additional return sufficiently compensated it for the greater risk of such an investment.

When a rational shareholder commits capital to a company, therefore, the investment is premised on the notion that the expected returns from the company will, when factoring in the risk of the company's business, equal or exceed the expected returns from other investment possibilities when their risks are considered. More succinctly, when investing in a company, the rational shareholder believes that the risk-adjusted expected returns from the company

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183. See VALUING A BUSINESS, supra note 170, at 163 (describing United States Treasury obligations as "instruments considered to have virtually no possibility of default").

184. See id. at 166 ("Company [risk] characteristics could include, for example, management's ability to weather economic conditions, relations between labor and management, the possibility of strikes, the success or failure of a particular marketing program, or any other factor specific to the company.").

185. See id. at 163 ("Over and above a risk-free return, investors must expect some additional rate of return to induce them to invest in non-Treasury bonds, in equities, or in similar securities—to compensate them for the additional risk incurred in such an investment.").

In the real world, of course, there are an endless number of investment choices, and the relationship between the risk and return of different securities is more complex than the overly-simplified example. The Capital Asset Pricing Model (CAPM) is the most widely-accepted explanation of the risk-return relationship. According to the model, "the expected return of an investment portfolio (ERP) is equal to the risk-free rate of return (RF) plus the beta (which is a measure of the systematic or market-based risk of the portfolio and excludes company- and industry-specific risk) of the portfolio (βp) multiplied by the difference between the expected rate of return on the market portfolio (ERm) and the risk-free rate of return." Ragazzo, supra note 80, at 1108 n.45; see BREALEY & MYERS, supra note 180, at 161–64 (discussing CAPM); VALUING A BUSINESS, supra note 170, at 164–68 (discussing the relationship between risk and return). As a formula, the CAPM is expressed as ERP = RF + βp(ERm - RF). Despite its complexity, the CAPM conveys (among other things) the basic proposition that investors require additional return for taking on additional risk. See id. at 166 ("A fundamental assumption of the capital asset pricing model is that the risk premium portion of the expected return of a security is a function of that security's systematic risk."); BREALEY & MYERS, supra note 180, at 162 ("The expected risk premium on an investment with a beta of 0.5 is, therefore, half the expected risk premium on the market [beta of 1.0]; and the expected risk premium on an investment with a beta of 2.0 is twice the expected risk premium on the market.").
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will equal or exceed the risk-adjusted expected returns from other possible investments. A particular company's "cost of capital" is a reflection of this idea—it signifies the minimum return on financial capital that shareholders demand for the risk of investing in that company's line of business.  

Put differently, it is the return that shareholders could get themselves, on a risk-adjusted basis, by investing elsewhere. In our example, if Widgits, Inc. had a cost of capital of ten percent, and if it was approximately twice as risky as an investment in government securities, the ten percent cost of capital signifies that shareholders could get a similar risk-adjusted return on their financial capital by investing elsewhere, namely in "safer" government securities paying a rate of return of five percent.

Conceptually, therefore, there is an answer to the question of whether it is reasonable for a shareholder to expect dividends in the absence of de facto distributions. When the expected returns from possible investments fall short of the company's cost of capital, the majority should declare dividends rather than retain profits, as the shareholders are better off making their own investment choices. Conversely, when the expected returns from investment

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186. See Valuing a Business, supra note 170, at 40 (defining "cost of capital" as the amount of expected return that is required to attract investment, and stating that "[t]he cost of capital depends on the general level of interest rates and the amount of premium for risk (above the return available on a safe, fixed-income investment) that the market demands, as well as the risks attributable to the subject business"); id. at 153 (defining "cost of capital" as "the expected rate of return available in the market for other investments of comparable risk and other investment characteristics"); Brealey & Myers, supra note 180, at 13 (noting that the "opportunity cost of capital" is "the rate of return offered by comparable investment alternatives"); id. at 74–75 ("The opportunity cost of taking the project is the return shareholders could have earned had they invested the funds on their own . . . . The opportunity-cost concept makes sense only if assets of equivalent risk are compared."). In this context, a company's "cost of capital" is also referred to as its "discount rate." See Valuing a Business, supra note 170, at 153 (indicating that "cost of capital" and "discount rate" are synonymous); id. at 196 (observing that "[t]he discount rate is the cost of capital and applies to all prospective economic income"); id. at 157–58 (defining a "discount rate" as an "opportunity cost," that is, the expected rate of return (or yield) that an investor would have to give up by investing in the subject investment instead of in available alternative investments that are comparable in terms of risk and other investment characteristics"); id. ("The discount rate is the cost of capital for that particular category of investment. The discount rate is determined by market conditions as of the valuation date as they apply to the specific characteristics of the subject contemplated investment."); id. at 161 (stating that the discount rate represents the rate of return "necessary to induce investors to commit available funds to the subject investment, given its level of risk").

187. See supra note 186 and accompanying text (defining "cost of capital").

188. See supra notes 185–86 and accompanying text (discussing cost of capital).

189. See, e.g., Israel, supra note 66, at 89 ("When corporate managers are faced with the alternative of either declaring a dividend or retaining earnings . . . the investor is deprived of a part of his profit if the return on ploughback is less than the corporation's overall return on its capital . . . .") supra notes 180–81 and accompanying text (discussing cost of capital); infra
projects equal or exceed the company's cost of capital, the majority should retain profits to commit to those projects rather than pay dividends.\footnote{239} By doing so, shareholders are earning more on their financial capital than they could in their own investment vehicles.\footnote{239}

Articulated from a hypothetical bargaining perspective, these are the understandings that the shareholders would likely have reached if they had discussed when, in the absence of de facto distributions, actual dividends should be declared.\footnote{239} Simply put, when the company can reinvest its profits at a risk-adjusted rate greater than the shareholders could earn elsewhere, the majority and minority shareholders would probably concede that reinvestment is superior to dividends, particularly because these circumstances should translate to more valuable dividends down the road.\footnote{239} If a majority shareholder insisted on greater flexibility in making dividend decisions than

\footnote{239}{See supra notes 180–81 and accompanying text (discussing a company’s risk-return calculus); infra note 239 (explaining company cost of capital and project cost of capital).}

\footnote{190}{See supra notes 180–81 and accompanying text (discussing a company’s risk-return calculus); infra note 239 (explaining company cost of capital and project cost of capital).}

\footnote{191}{In the context of public corporations, Professor Brudney has characterized the cost of capital inquiry as a method where “dividends become a mere residual of investment policy.” Brudney, supra note 2, at 97. He then argues that such an inquiry may not make sense if dividend decisions have an independent impact on market price. Id. at 99 n.43. In the close corporation, of course, there is no market to independently react to a dividend decision. A cost of capital inquiry, therefore, is an appropriate theoretical framework: “[I]n the interest of maximizing shareholder wealth, legal norms would restrict management to making investment decisions and leaving dividends to be determined as a mere residual of investment policy, and concomitantly management would be forbidden from making dividend decisions on any other grounds. [S]uch regulation would require judicial or administrative assessment of managerial judgments about expected returns and risks involved in proposed investment opportunities . . . . Difficult as judicial review of such decisions might be, it could at least be conducted within a theoretical framework for assessing the propriety of the behavior.” Id. at 99–100 n.43 (emphasis added). Professor Israel similarly notes:

If corporate earnings can be efficiently employed internally, the value of the shareholder’s earnings are maximized. If the corporation can earn only a low rate of return, however, the stockholder himself should be free to determine where those funds, paid to him as a dividend, should be deployed. In addition to increasing the shareholder’s return on his investment, this would facilitate the efficient distribution of capital within the economy.

Israel, supra note 66, at 97.}

\footnote{192}{See supra notes 113–18 and accompanying text (discussing hypothetical bargains).}

\footnote{193}{See, e.g., BREALEY & MYERS, supra note 180, at 60 (“Investors are willing to forego cash dividends today in exchange for higher earnings and the expectation of high dividends sometime in the future.”). The text reference to “more valuable dividends down the road” refers to future dividends with a present value that exceeds the present value of the dividend that is currently being contemplated.}
these understandings would provide, it is fair to assert that a reasonable minority shareholder would have refused to invest in the company.\textsuperscript{194}

B. Corruption of the Cost of Capital Inquiry: Conflicts of Interest Between the Majority and Minority

In the abstract, one would assume that the interests of both the majority and minority shareholders are served by investing only in projects with an expected return that exceeds the firm's cost of capital. If the return on investment for both the majority and the minority depends solely on the corporation's expected returns—that is, if return on financial capital is the investors' only concern—the shareholders' incentives are aligned. If expected returns from the company's new projects exceed the firm's cost of capital, it is in the majority and minority's mutual interest to reinvest in the company. If such expected returns fall short of the company's cost of capital, it is in their mutual interest to declare a dividend so that they can more profitably invest their money elsewhere.\textsuperscript{192} Simply put, where the shareholders' incentives are aligned, there is little need for a rigorous judicial inquiry. The majority's self-interest can be relied upon to protect the minority's interests as well.\textsuperscript{196}

The problem, however, is that return on investment in the typical close corporation is not solely based on the corporation's expected returns. Instead, return on investment in a close corporation is usually a combination of return on financial capital and return on human capital.\textsuperscript{197} Close corporation

\textsuperscript{194} See supra text accompanying notes 189--91 (discussing cost of capital).
\textsuperscript{195} See supra notes 189--91 and accompanying text (discussing cost of capital).
\textsuperscript{196} See, e.g., Brudney, supra note 2, at 102 ("If each shareholder's wealth is seen as maximized by the same dividend policy that maximizes other shareholders' wealth, management's dividend decisions become matters of business judgment (except as management itself has interests that diverge from shareholders' interests) that affect all shareholders equally."); infra notes 227--29 and accompanying text (discussing the interests of majority and minority shareholders). Of course, judicial review would still be required for dividend decisions which amount to fraud or bad faith. See, e.g., Gay v. Gay's Super Markets, Inc., 343 A.2d 577, 581 (Me. 1975) (describing, as an example of bad faith, "the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible" (citing Gottfried v. Gottfried, 73 N.Y.S.2d 692, 695 (1947)); Fisher v. Steelville Cmty. Banc-Shares, Inc., 713 S.W.2d 850, 853 (Mo. App. Ct. 1986) ("[A]llegations that a majority shareholder, who controlled the corporate directors, caused dividends to be withheld and depressed the value of the stock of a minority shareholder for the purpose of acquiring that stock state a cause of action against the majority shareholder."); supra note 76 and accompanying text (discussing judicial review of dividend decisions).

\textsuperscript{197} See, e.g., Bahls, supra note 15, at 330 ("Shareholders in close corporations expect proportional distribution of the earnings of the corporation while it is operating."); Hillman, supra note 59, at 79 n.248 ("Obviously, an individual commits capital to a venture with the
employment, in other words, is valuable, and it is often the largest component of the shareholder's overall return on investment. As a consequence, it is often rational for a majority shareholder to care more about increasing the return on its human capital than increasing the return on its financial capital. Put differently, because the lion's share of the majority's investment return likely derives from the benefits of employment, the majority will have an incentive to act in ways that preserve and enhance those benefits. At times, however, those actions are not ones that the majority would

expectation that a return will be forthcoming, either through an appreciation in the value of his holdings or, more typically for a close corporation, through a distribution of corporate earnings."); supra note 57 and accompanying text (discussing the "general" reasonable expectation); see also Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 662 (Mass. 1976) ("The minority stockholder typically depends on his salary as the principal return on his investment."); Bonavita v. Corbo, 692 A.2d 119, 124 (N.J. Super. Ct. Ch. Div. 1996) ("[E]mployment is, of course, a frequent and perfectly proper benefit of stockholders in a close corporation."); id. at 126 ("[T]he primary benefit that [the defendant close corporation shareholder] receives from the corporation is continued employment for himself and his family."); Exadaktilos v. Cinnaminson Realty Co., 400 A.2d 554, 561 (N.J. Super. Ct. Law Div. 1979) ("[T]here generally is an expectation on the part of some [close corporation] participants that their interest is to be recognized in the form of a salary derived from employment with the corporation."); supra note 31, at 468 ("The courts have recognized the reality that compensation paid to those in control has a two fold function: to recompense services and to provide a return on investment."); Ragazzo, supra note 80, at 1109 (noting that a close corporation shareholder "often invests for the purpose of having a job, and the salary and other benefits he receives is conceived to be part of the return on his investment"); id. at 1109 ("In a closely held corporation, a shareholder-employee has interests in his job and stock that are often economically intertwined."); id. at 1110 ("[T]he discharge of an employee in a closely held corporation usually involves appropriation of a portion of his investment by the remaining shareholders.").

198. See supra notes 91–94 and accompanying text (discussing the benefits of close corporation employment).

199. See, e.g., Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 514 (Mass. 1975) ("Typically, the minority shareholder in a close corporation has a substantial percentage of his personal assets invested in the corporation. The stockholder may have anticipated that his salary from his position with the company would be his livelihood."); supra note 57 and accompanying text (discussing the "general" reasonable expectation); Muellenberg v. Bikon Corp., 669 A.2d 1382, 1385 (N.J. 1996) (noting that participation in the business is the "principal source of employment and income" for many close corporation shareholders); In re Kemp & Beatty, Inc., 473 N.E.2d 1173, 1178 (N.Y. 1984) (noting that a shareholder's "participation in [a] close corporation is often his principal or sole source of income"); Oppression, supra note 22, § 1:03, at 4 (stating that a close corporation shareholder "may put practically everything he owns into the business and expect to support himself from the salary he receives as a key employee of the company. Whenever a shareholder is deprived of employment by the corporation... he may be in effect deprived of his principal means of livelihood"); cf. Coffee, supra note 116, at 17 ("[T]he manager's most important asset is his or her job.").

200. See supra note 199 and accompanying text (discussing the importance of close corporation employment).
take if return on financial capital were the only concern, as the actions often take the form of below cost of capital investments. Of course, when a passive minority shareholder is present (either a true passive shareholder or a formerly active shareholder whose employment with the company has ended), return on financial capital is the only concern. Thus, for passive shareholders whose return on investment does not include an employment component, below cost of capital investments are problematic. When the majority works for the company and the minority does not, therefore, the interests of the shareholders skew. An understanding of this divergence is necessary to appreciate the utility of the cost of capital inquiry.

1. The Desire for Growth

Reasonable compensation for an employment position in a business is, at some level, related to the size of the company. In general, as a company grows larger, both the upper and lower limits of a reasonable salary for a particular position increase. Intuitively, the president of a company with $100 million in annual sales can earn more than the president of a comparable company with $10 million in annual sales without exceeding the constraint of "reasonable" compensation.

Given this relationship between company size and managerial compensation, it may be in a majority shareholder's interest to grow the firm—not because growth is necessarily profit-maximizing for shareholders, but

201. See infra notes 205–12 and accompanying text (discussing the desire for growth).

202. The reference to "passive" shareholders is used to distinguish those shareholders who are employed by the company from those shareholders who are not. See supra note 179 (discussing passive shareholders). A shareholder's "passivity" can result from never working for the company, see supra text accompanying note 127 (discussing passive shareholders), or from a voluntary or involuntary termination of employment from the company. See, e.g., In re Kemp & Beatley, Inc., 473 N.E.2d 1173, 1176 (N.Y. 1984) (involving a shareholder who resigned from employment, and a shareholder who was terminated from employment).

203. See, e.g., KLEIN & COFFEE, supra note 65, at 174 ("[L]evels of compensation are positively correlated with firm size."); see also Brenner v. Berkowitz, 634 A.2d 1019, 1024 (N.J. 1993) (observing that the trial court found that the majority shareholder's salary—which had increased from $125,000 to $474,206—"was reasonable in light of the company's impressive growth"); Raynolds v. Diamond Mills Paper Co., 60 A. 941, 947 (N.J. Ct. Ch. 1905) (noting the idea that a corporation's "business had expanded, and that therefore the services of this . . . manager . . . now might receive . . . a higher rate of compensation because of the greater success or increase of the business—the growth of the assets of the corporation"); see infra note 205 and accompanying text (discussing company growth).

204. See supra note 203 and accompanying text (discussing the relationship between company size and compensation levels).
because growth increases the perquisites and prestige associated with management positions. Indeed, the increased return on employment capital provided by growth can outweigh any relative losses that result from investing at less than the company's cost of capital.

For example, imagine a close corporation that operates a restaurant. The majority shareholder works full-time for the business as the chief executive officer and draws a $50,000 salary. (Assume that this salary does not include any de facto dividends—i.e., it is reasonable in light of the value of the labor services that the majority performs for the company). Assume further that the majority could earn only $40,000 in comparable employment outside of the close corporation. The corporation is considering whether to distribute

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205. See, e.g., Brudney, supra note 2, at 95 ("It has also been suggested that management prefers retention over distribution as a concomitant of its preference for growth in sales and size (and associated managerial perquisites) over growth in profits."); Coffee, supra note 116, at 29 ("Why is growth maximization the goal of managers?... [G]rowth provides managers with greater compensation, greater psychic income, and greater security."); Israel, supra note 66, at 93 ("It has been widely noted that executive compensation is more often related to corporate size than to profitability... Therefore, corporate growth is management’s uppermost priority and maximum profitability tends to be relegated to secondary importance."); id. at 94 ("Management’s desire for growth is often adverse to the shareholder’s quest for profit. Management strives toward maximum retention of corporate earnings despite low profitability... "); supra note 203 (discussing the relationship between company size and compensation levels); infra note 222 and accompanying text (discussing management’s desire for growth); see also Coffee, supra note 116, at 8 (observing "a long-standing managerial bias in favor of corporate growth"); id. at 20 ("Empire building may be rational for managers but inefficient for shareholders."); id. 22 (suggesting that "managers are overly biased toward earnings retention (possibly because they wish to maximize growth")"); id. at 30 ("[T]here is, if anything, additional reason today to believe that they correctly describe the manager’s own preferences as biased in favor of growth over profitability."). But see Fischel, supra note 2, at 712–14 (rejecting the significance of the "managerialist" hypothesis that managers prefer growth over profitability in part because of the market constraints on public corporation management).

This self-interested view of management’s preferences is typically referred to as the "managerialist" theory. See, e.g., Klein & Coffee, supra note 65, at 174 (discussing managerialists). The theory focuses on the behavior of managers in publicly-held corporations. See id. (describing the "managerialists" as a "school of economics" that argues that, "in the case of the publicly held corporation, corporate managers tend not to pursue profit maximization, but rather size or growth maximization"). Nevertheless, as this Article attempts to demonstrate, the theory’s insights are directly relevant to the closely-held corporation as well.

206. See supra note 179 (discussing "reasonable" compensation).

207. This disparity in salary is due primarily to two factors. First, as the owner of a small business, the majority shareholder can set its own salary at the higher end of the range of reasonable compensation for that type of position. In another corporation where the shareholder lacks majority control, it is likely that the shareholder will also lack the power to set its own
salary. Instead, the shareholder will bargain with other actors for its salary and, as a result, the compensation paid may be lower in the range. See 1 OPPRESSION, supra note 22, § 3:07, at 57 n.5 ("[T]he special prerogatives enjoyed by a majority in a close corporation not infrequently block the sale of a close corporation because the majority has difficulty obtaining such lucrative employment elsewhere." (citing J.C. Hetherington, Special Characteristics, Problems, and Needs of the Close Corporation, 1969 ILL. L.F. 1, 20 n.72)); VALUING A BUSINESS, supra note 170, at 121 ("It is not uncommon to find an owner/manager of a successful closely held company earning a greater amount in annual compensation than the amount an equivalent nonowner employee would earn as compensation."); Ragazzo, supra note 80, at 1109–10 ("The shareholder may invest for the purpose of having a job that produces higher compensation than could be garnered through employment by third parties."); see also Bonavita v. Corbo, 692 A.2d 119, 124 (N.J. Super. Ct. Ch. Div. 1996) ("[W]here there is no claim that the [close corporation] salaries are excessive, neither was there a showing that if the ‘inside’ employment were terminated those family members could earn as much elsewhere."); Nelson v. Martin, 958 S.W.2d 643, 644 (Tenn. 1997) (noting that the annual compensation of a shareholder-employee of a commercial printing business "was in excess of $250,000"), overruled by Trace-Med of America, Inc. v. Allstate Ins. Co., 71 S.W.3d 691 (Tenn. 2002).

Second, the majority owner of a small business can use its control to obtain a high-level executive position that generally commands a greater salary. See, e.g., Coffee, supra note 116, at 17–18, 74 (suggesting that senior executive positions are limited and are associated with greater compensation); see also Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657, 659–60 & n.9 (Mass. 1976) (observing that all of the close corporation participants were directors of the company and that the offices of president, treasurer, and clerk were held by each of the participants over the years); Balvik v. Sylvester, 411 N.W.2d 383, 384 (N.D. 1987) (noting that both participants in a close corporation were directors of the company and observing that one shareholder-employee served as the president while the other served as the vice-president). In another corporation where the shareholder lacks majority control, there is no guarantee that such a high-level position could be obtained, even if the shareholder possessed the requisite skills. Indeed, within any given company, there may be several employees who are qualified to serve as the chief executive officer. Nevertheless, there is only one chief executive officer position. As Professor Coffee observes:

[Because lateral mobility among senior corporate executives is limited...the manager cannot assume the existence of an external market rate of return applicable to his or her labors, as the lower-echelon employee may be able to assume. Rather, the still prevailing pattern is one in which there are "ports of entry" within the corporate hierarchy, but little opportunity exists for lateral movement at an equivalent level.

Coffee, supra note 116, at 17–18; see also id. at 74 ("Although lateral mobility is today increasing, the still-prevailant pattern is one under which new managers enter the firm at relatively low-level 'ports of entry' and gradually move upward along steep seniority ladders."); id. at 38 n.102 ("To be sure, most executives are promoted from within, and the executive labor market is still largely an internal one."); infra note 208 (discussing lateral mobility among executive positions). Professor Coffee, however, has also stated the following:

[An active market for senior executive services exists, and many CEOs came to their present firm without prior service there. To be sure, internal promotion is the more common route, but the existence of a substantial rate of interfirm transfers is inconsistent with the claim that an executive must make substantial investments in firm-specific human capital to advance within the corporate hierarchy.

Coffee, supra note 116, at 38.
$100,000 in surplus as a dividend, or whether to invest that $100,000 in expansion of the existing restaurant (for example, larger seating area, larger kitchen). Expansion is projected to pay a return of $12,000 a year, and it is not expected to increase the number of hours worked by the majority to any significant degree. The corporation's cost of capital is 15%. For the moment, assume that expansion will not affect the majority's salary.

On these facts, the rational majority shareholder would choose to pay a dividend rather than to expand. On the assumption that the shareholders can earn the cost of capital themselves in other investment vehicles, the shareholders require at least a $15,000 return on a $100,000 investment. With expected returns of only $12,000, or 12% a year, the expansion project falls short by $3,000, or 3% a year. Foregoing expansion in favor of a dividend is in the interest of all shareholders—majority and minority—who care solely about their return on financial capital.

Now assume that expansion will allow the majority to increase its salary from $50,000 to $55,000. This increase includes no de facto dividends and is still considered reasonable compensation in light of the additional revenues and earnings generated from the expansion. Outside of the close corporation, assume that the majority could still earn only $40,000 in comparable employment, as chief executive officer positions are simply not available at other similar companies.\(^{208}\) Thus, without expansion, close corporation

\(^{208}\) In other words, while it may be true that chief executive officers of similar restaurants earn $55,000, there is only one chief executive officer position at each company. Such comparable positions, therefore, may be unavailable. See supra note 207 (discussing lateral mobility among executive positions). Put differently, part of the value of being a majority shareholder in a close corporation is that the majority can name itself to a high-level executive position that generally commands a greater salary. In another company, that position may already be held by someone else. See supra note 207 (discussing lateral mobility among executive positions).

Even if comparable positions are available at other firms, it is worth noting that the majority shareholder's skill set may not transfer well to these positions. As Professor Coffee observes:

Such [firm-specific] capital could arise either because of specific job training or technological skills the manager acquires, which are not equally valuable to other firms; it also may arise because of the significance of 'corporate cultures,' which necessitate that special interpersonal skills be acquired to function in individual corporate environments.

Coffee, supra note 116, at 17 n.42. Professor Coffee further states the following:

Firm-specific human capital consists not only of specialized training or knowledge, but also the ability to work within the existing corporate culture and organizational structure . . . . [I]t existence implies that the senior manager may be left in an exposed position, because to the extent he has invested heavily in firm-specific human capital, he typically has little lateral mobility.
employment is paying the majority shareholder $10,000 more than the shareholder could earn outside of the company ($50,000–$40,000). With expansion, the employment "spread" increases, as the majority is earning $15,000 more than it could earn outside of the company ($55,000–$40,000). Overall, expansion has increased the return on the majority's employment capital by $5,000—i.e., the majority's close corporation position now commands a $15,000 "market premium" rather than a $10,000 "market premium." 209

Given this additional information, notice how the majority's incentives change. Expansion now provides the majority shareholder with a $5,000 gain on its employment capital that more than offsets the $3,000 loss on its financial capital. On these numbers, a rational majority shareholder would choose expansion, even though expansion is still a poor investment choice from the standpoint of return on financial capital. 210 Stated more broadly, the majority will prefer expansion because its total return on investment (the aggregate of the return on its employment capital and the return on its financial capital) 211 increases as a result. Of course, passive minority shareholders will prefer dividends because expansion produces no gain on their employment capital (by definition) and generates an inferior return on their financial capital. Where such divergence between the majority and minority interests is present, the potential for conflicts over dividend policy is apparent. 212

2. The Desire for Surplus

Aside from the desire for growth, a close corporation majority shareholder also has a desire for surplus which may cause it to forego dividends in favor of

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209. See supra note 207 (discussing lateral mobility among executive positions).
210. In fact, on these numbers, expansion is in the majority's interest so long as expansion pays more than a 10% return on the $100,000 investment. That is, if the expected return from expansion was $10,000, or 10% a year, the investment falls $5,000 short of what the shareholders could earn elsewhere (the 15% cost of capital on the $100,000 investment in a close corporation). That $5,000 loss is offset by the $5,000 gain on the majority's employment capital. Anything more than a 10% return on the $100,000 expansion project, therefore, is in the majority's interest.
211. See supra note 197 and accompanying text (describing return on investment in a close corporation).
212. Cf. BREALEY & MYERS, supra note 180, at 64 ("Rapid growth is good news, not bad, so long as the business is earning more than the opportunity cost of capital.").
below cost of capital investments. This desire for surplus stems from two related incentives. First, the majority shareholder has a general incentive to insure that the company maintains sufficient resources to pay its employment compensation in future years.\(^{213}\) Second, a majority shareholder has a specific incentive to increase its salary to the upper limit of its reasonable compensation range.\(^{214}\) Because of the value of close corporation employment,\(^{215}\) in other words, a rational majority shareholder will desire a sizable company surplus to insure that the employment position and its perquisites are maintained, if not enhanced. Given this context, the majority will be wary of dividends.\(^{216}\)

At some level, this conservative dividend policy is appropriate. It is perfectly proper for the majority shareholder to care about the future viability of the enterprise and the enterprise’s ability to meet its obligations. Moreover, the majority’s own economic interests should, in theory, prevent it from following an overly conservative dividend policy. After all, the majority has an economic

\(^{213}\) See, e.g., Bonavita v. Corbo, 692 A.2d 119, 126 (N.J. Super. Ct. Ch. Div. 1996) ("Since the primary benefit that [the controlling shareholder] receives from the corporation is continued employment for himself and his family, the maintenance of a $5,000,000 earned surplus, large cash balances, and the non-payment of dividends is certainly in his best interest."); cf. Coffee, supra note 116, at 8 n.16 (referring to the manager’s "undiversifiable investment of human capital in the corporation"); id. at 78–79 ("The unique problem with human capital is that the usual market solutions for risky investments—i.e., insurance or diversification—simply are not feasible.").

\(^{214}\) Company growth allows the majority shareholder to shift the reasonable compensation range for its position into a higher "bracket." For example, assume that chief executive officers of manufacturing concerns with approximately $10 million in sales earn, on average, from $100,000-$500,000. It is fair to assert that the average compensation for chief executive officers of comparable businesses with $100 million in sales falls within a range whose lower and upper limits are higher (e.g., from $1,000,000-$5,000,000). See supra notes 203–04 and accompanying text (discussing the relationship between company size and compensation levels). Aside from efforts to shift the compensation bracket through growth, however, a majority shareholder has a separate incentive within its existing compensation bracket to increase its salary to the upper limit of that range. Using the prior example, if chief executive officers of manufacturing concerns with approximately $10 million in sales earn, on average, from $100,000-$500,000, the majority shareholder has an incentive to push its salary toward $500,000, even if the range itself stays constant.

\(^{215}\) See supra notes 91–94 and accompanying text (discussing the benefits of close corporation employment).

\(^{216}\) As Professor Coffee notes:

All this data comes into clearer focus once we begin from the premise that senior management, having a fixed investment in the firm, will act in a more risk-averse manner than the shareholders . . . . Thus, the less risk-averse shareholder wants a high payout, while the manager wants to hoard cash and assets to protect against future contingencies.

Coffee, supra note 116, at 22; see also infra note 219 and accompanying text (discussing the majority shareholder’s conservative tendencies regarding dividend and investment policy).
incentive to maximize its total return on investment—return on its employment capital as well as its financial capital. Where the company has no above cost of capital investment opportunities, this maximization is theoretically accomplished at the point where (1) the company has retained just enough funds to pay the majority's present and future employment compensation (and other fixed company obligations); and (2) the company has distributed the remaining funds as dividends such that the majority can invest its share in other vehicles paying at least the cost of capital. At this optimal point, the majority is maximizing its return on employment capital as well as its return on financial capital. That is, just enough funds are left in the company to accomplish the majority's compensation goals (and to pay fixed obligations), while the company distributes all other available funds so that the shareholders can earn cost of capital returns.

In actuality, however, there is good reason to believe that the typical majority shareholder will be overly conservative in its desire for surplus and its reluctance to pay dividends. Although in theory the above-described optimal point for retention and distribution may exist, in actuality such a point is difficult (if not impossible) to identify with any degree of accuracy. Simply put, the future is uncertain and, as a consequence, it is unclear how much surplus is required to insure that the majority's compensation goals are met. If the majority's return on employment capital were comparable to its return on financial capital, perhaps the effect of this uncertainty could be ignored. Because the return on employment capital is usually the far larger component of the majority's overall investment return, however, it is fair to assert that this uncertainty will cause the majority to err on the side of conservatism, most likely to an excessive degree.

Like the desire for growth, therefore, the

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217. See supra note 197 and accompanying text (discussing the components of investment return in a close corporation).

218. See supra note 199 and accompanying text (discussing return on employment capital in a close corporation).

219. As Professor Israel notes:

Management does not pursue a policy of maximization of profit as vigorously as might be expected. Rather than seeking out the most profitable investment opportunities, it tends to reinvest corporate earnings within the enterprise, either in expansion of existing enterprises or in diversification. Each management thereby maximizes the funds kept under its direct control.

Israel, supra note 66, at 88. Professor Israel further observes:

Should the corporate executive pursue an aggressive investment policy in an attempt to maximize the profitability of the firm, the stockholders will receive the profits which may result from taking [the] chance, while [the executive's] position in the firm may be jeopardized in the event of serious loss. Therefore, a conservative investment policy permeates the decision-making process . . . and the
desire for surplus is apt to push the majority away from dividends and towards the only profitable investment opportunities that the company has, even if those opportunities provide a below cost of capital return.\textsuperscript{220}

C. The Need for the Judiciary to Make the Cost of Capital Inquiry

As a result of these conflicts of interest, one cannot trust the close corporation majority shareholder to ask the right question when deciding whether to pay dividends. Rather than asking whether the financial return from a contemplated project exceeds the company's cost of capital, the majority is often asking whether the financial \textit{and employment} return from the project exceeds the company's cost of capital.\textsuperscript{221}

In some contexts, however, even this distrust might not call for judicial review. In the public corporation, for example, managers have similar desires to preserve and enhance their employment capital—desires that push them towards growth and below cost of capital investments.\textsuperscript{222} These desires, imprimatur of self-interest is impressed upon dividend and investment policy.

\textit{Id.} at 91 (internal quotation omitted) (footnote omitted); see \textit{id.} at 94–95 ("Management strives towards maximum retention of corporate earnings despite low profitability with the result that weak management [tends] to perpetuate itself...[in] its conservatism beyond what would be permitted by stockholder-oriented decision rules." (internal quotation omitted)).

\textsuperscript{220} See infra note 222 (discussing management's desire for growth); \textit{cf} Israel, \textit{supra} note 66, at 94 (noting that, in public corporations, "prevention of loss is of more vital concern than maximization of profit").

\textsuperscript{221} To be clear, it is likely that the majority is primarily (if not only) asking about the employment return that it, as opposed to the other shareholders, would receive from the project.

\textsuperscript{222} See, e.g., Coffee, \textit{supra} note 116, at 21, 28 n.76 (observing that public corporations' rate of return on retained earnings "was well below that on debt or equity," and noting that this suggests that "managements have tended to retain earnings when they should pay dividends"); Israel, \textit{supra} note 66, at 89 (commenting on data that indicated that "the rate of return on retained earnings was generally less than what the investor could have earned by simply placing his dividends in a risk-free savings account or government security"); \textit{supra} note 205 and accompanying text (discussing management's desire for growth); see also JAMES D. COX ET AL., \textsc{Teacher's Manual to Securities Regulation: Cases and Materials} 51 (3d ed. 2001) (mentioning findings that seasoned equity offering firms "that have rapid increases in sales and capital expenditures have lower subsequent stock returns," and observing that "this suggests that management is investing in less positive net present value projects"); Brudney, \textit{supra} note 2, at 95–96 ("[W]hen management invests retained earnings the investment tends to produce lower returns than does the investment of newly acquired funds."). Professor Coffee has also noted the following:

Professor Jensen has collected evidence that during the late 1970s the oil industry was earning low to negative returns on exploration and development expenditures and that the announcement of increased such expenditures elicited a negative stock market reaction. Yet, such expenditures advanced managerial interests and so were
however, are constrained by the market and the effect that the market price can have on the continuance of a managerial position. Systemic below cost of capital investments, in other words, fail to maximize shareholder value and ultimately translate into a lower stock price for the company. As mentioned, continued in the face of shareholder opposition, until the intervention of hostile bidders.

Coffee, supra note 116, at 55 n.163 (citation omitted).

In public companies, growth can also increase managerial security by diversifying the company's business. The idea is that losses in one business area will be offset by gains in another, thereby diminishing the risk of bankruptcy and the loss of managerial positions that usually accompany bankruptcy. As Professor Coffee observes:

Some economists... have argued that corporate managers maximize sales or growth, not profits. In part, such an empire-building policy is pursued, they claim, to increase the security of the corporation's managers, because the acquisition of additional divisions and product lines both reduces the risk of insolvency and provides opportunities for personal advancement.

Coffee, supra note 116, at 20; see Ragazzo, supra note 80, at 1112 n.64 (noting that diversification "help[s] reduce the corporation's level of risk, which in turn reduces the risk of bankruptcy and helps to safeguard the positions and substantial salaries of the corporation's key executives"; see also Israel, supra note 66, at 93 ("Managerial security is also served by a policy of corporate growth, even if the enterprise's profitability is only marginally enhanced.")

In the close corporation context, growth through diversification of business lines is infrequently observed. Economic theory would suggest, however, that diversification at the firm level might make sense in a close corporation. Because close corporation shareholders typically commit a large portion of their personal wealth to the venture, they have little remaining resources to sufficiently diversify their portfolio. See, e.g., Ragazzo, supra note 80, at 1109 ("[M]any investors in small businesses invest a significant portion of their life savings in the business. This practice defeats their ability to diversify their investment portfolios and exposes them to company- and industry-specific risk."); see also Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 514 (Mass. 1975) ("Typically, the minority shareholder in a close corporation has a substantial percentage of his personal assets invested in the corporation."); In re Topper, 433 N.Y.S.2d 359, 362 (Sup. Ct. 1980) (noting that a close corporation minority shareholder "put his life savings into the venture"); EASTERTROOK & FISCHEL, supra note 68, at 237 (observing that "[i]nvestors in close corporations often put a great deal of their wealth at stake"); 1 OPPRESSION, supra note 22, § 1:03, at 4 (noting that a close corporation investor "may put practically everything he owns into the business"); VALUING A BUSINESS, supra note 170, at 172 ("Most owners of closely held businesses or interests in closely held businesses do not diversify their investment portfolios nearly to the extent to which investors diversify their holdings of publicly traded securities."). Thus, the continued solvency of the close corporation is of great importance.

223. As Professor Fischel states:

An inefficient dividend decision is no different than any other suboptimal managerial decision. If managers adopt a lower (or higher) payout policy than shareholders desire, the price of the firm's stock will trade at a lower price than otherwise identical firms with different dividend policies.

Fischel, supra note 2, at 713; see supra note 83 and accompanying text (discussing the relationship between investor satisfaction and a company's stock price); see also KLEIN & COFFEE, supra note 65, at 372–73 (demonstrating how a below cost of capital investment
a decreased stock price gives rise to investor pressure for managerial replacements, and it makes the company more attractive as a takeover target (again threatening managerial positions). In a public corporation, therefore, a manager's self-interest in keeping its position may lead to some abuse of dividend policy, but not to excessive abuse. Even though public corporation management may not ask the right question in making a dividend decision, the presence of market constraints lessens the need for judicial scrutiny.

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224. See, e.g., Coffee, supra note 116, at 7 ("[S]ubstantial managerial layoffs are now likely after either a hostile takeover or a friendly 'white knight' transaction or restructuring."); Fischel, supra note 2, at 713 ("If a firm's share price falls far enough as a result of suboptimal dividend policy, the firm will become a likely candidate for a proxy fight or a tender offer."); supra notes 83–85 and accompanying text (discussing the relationship between investor satisfaction and dividend decisions).

225. That is, while some below cost of capital investments enhance a manager's employment capital, excessive below cost of capital investments threaten such employment capital by raising the risk of displacement. See supra notes 83–85, 223–24 and accompanying text (discussing the risk of displacement). As Professor Coffee has observed:

[T]he claim that managers want to pursue growth or other security-enhancing objectives within the boundaries established by external profit constraints on the firm is at least in part a statement that managers will seek to reduce risk up to that point where the shareholders may oust them if they pursue this objective further. Coffee, supra note 116, at 30. In a close corporation, this "point of ouster" for the majority shareholder does not exist, as there is no market for corporate control and no ability to outvote the true majority shareholder. See supra note 6 and accompanying text; infra note 226 (noting the significance of a market). Without judicial scrutiny, therefore, nothing constrains management's self-interest in growth and stability.

226. As Professor Fischel has stated:

Any systematic suboptimal dividend policy will have negative consequences in the managerial services market, the capital market, the product market, and, if prolonged, may trigger a proxy fight or a takeover. With such powerful market forces controlling management discretion, there will rarely, if ever, be a need for courts to entertain challenges to the dividend policy of a publicly held corporation's management. Fischel, supra note 2, at 715–16; see id. at 712–14 (rejecting the significance of the "managerialist" hypothesis that managers prefer growth over profitability in part because of the market constraints on public corporation management); supra note 86 and accompanying text (describing the effect of a market).

Moreover, there is at least some possibility of shareholder coordination in a public corporation that can block excessive managerial abuses. Although this constraint may be more theoretical than real, see, e.g., Israel, supra note 66, at 95, the absence of a true "majority" shareholder in the typical public corporation creates the possibility that a coordinated shareholder effort could exert control to stop a pattern of below cost of capital investments. By contrast, the shareholder with true majority control often carries out the abuses in a close corporation. No amount of coordination can prevent them. Thus, the presence of both "market" and "coordination" constraints in the public corporation context reduce the need for judicial scrutiny.
Even in close corporations, distrust of the majority may not call for judicial review. As mentioned, where the company employs all of the shareholders, the majority's selfish interests may wind up protecting the minority's interests as well.\(^{227}\) The majority will only decide to retain earnings for investment purposes if the total return on the investment (return on financial capital and return on the majority's human capital) exceeds the firm's cost of capital. So long as the investment affects the human capital of the majority and the minority by approximately the same amount, this calculus also serves the minority's interests.\(^{228}\) If the majority decides to retain and invest rather than to pay dividends, the minority will presumably have no problem with the decision, even if the investment's expected financial returns fall below the company's cost of capital.\(^{229}\) When the interests of the majority and minority are aligned, in other words, the need for judicial scrutiny is less pressing.

In most close corporation dividend disputes, however, the majority shareholder is employed by the company while the minority shareholder is not.\(^{230}\) Interests diverge in these situations, as the minority receives no benefit from majority decisions that favor employment capital. It is here where the inability to trust the majority to ask the right cost of capital question is problematic, as there are no market or other constraints to curb excessive majority abuses.\(^{231}\) In the typical close corporation dividend dispute, therefore, a rigorous judicial review is needed.\(^{232}\)

Obviously, this review must go beyond the superficial inquiry that is often associated with the business judgment rule.\(^{233}\) If the majority puts forth a...
legitimate business purpose for retention of funds (for example, need for expansion), most courts end the inquiry. It is these business purposes, however, that the courts must scrutinize to insure that their financial returns justify their risks. The courts, in other words, should resolve close corporation dividend disputes by making the cost of capital inquiry. Even when the majority proffers a business purpose for retention, a court should inquire into whether the expected financial returns from retention exceed the company's cost of capital. If the returns fall short, the majority's decision to retain and invest violates the understandings that the shareholders likely would have reached if they had discussed the issue. As a consequence, a court should deem the general reasonable expectation frustrated, and oppression liability should arise.

D. The Role of Time in the Cost of Capital Inquiry

In applying the cost of capital inquiry to close corporation dividend disputes, the length of time that a business has been operating will often be relevant. With high growth companies, for example, dividends are rarely paid

234. See, e.g., Gay v. Gay's Super Markets, Inc., 343 A.2d 577, 581–82 (Me. 1975) (accepting, without scrutiny, the majority shareholder's assertion that dividends could not be paid because of the need to expand the corporation's facilities); id. at 580 ("If there are plausible business reasons supportive of the decision of the board of directors, and such reasons can be given credence, a Court will not interfere with a corporate board's right to make that decision."); Zidell v. Zidell, 560 P.2d 1086, 1089 (Or. 1977) (citing Gay v. Gay's Super Markets, Inc., 343 A.2d 577, 581–82 (Me. 1975)) (same).

Conversely, if a majority shareholder is unable to put forth a legitimate need for the retention of funds, a minority shareholder has a chance of prevailing. See, e.g., Naito v. Naito, 35 P.3d 1068, 1080 (Or. Ct. App. 2001) (ordering dividends to be paid from a corporation with over $5 million in retained earnings after noting that "the corporation did not contemplate any new ventures that would call for extraordinary resources"); id. at 1082 (downplaying the controlling group's list of company projects—a list that was expanded "shortly before trial"—because it was "designed more to use up the available cash on paper than to be a realistic assessment of what the corporation intended to do").

235. See Israel, supra note 66, at 99 ("Good faith alone would not be sufficient to defend management's failure to declare dividends. Proof derived from examination of the corporation's expected rate of return on ploughback would be evaluated to determine whether the anticipated return on reinvested earnings is sufficient to compensate the investor for dividends not received."); see also Brudney, supra note 2, at 97–98 (characterizing the cost of capital inquiry as a method where "dividends become a mere residual of investment policy," and stating that "[t]o the extent that the law seeks to induce, if not compel, management to maximize shareholder wealth in circumstances where stockholders cannot persuade management to do so by market action or by votes, management should be penalized if it fails to make dividend policy a resultant of investment opportunities").

236. See supra notes 192–94 and accompanying text (discussing hypothetical bargains).
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in the early years of the business. In such companies, this emphasis on reinvestment of earnings is often consistent with the cost of capital inquiry, as attractive investment opportunities are generally more prevalent in the beginning stages of a company's life cycle, particularly where competitors have not yet entered the market. Moreover, in the early years of a company's development, retention of some earnings is prudent until a sufficient surplus is built up to handle contingencies. As long as surplus-building typically involves the reinvestment of company profits in vehicles with less risk than projects within the company's line of business (for example, placing company funds into a money market account), such activity can also satisfy the cost of capital inquiry. In the early years of a business, therefore, the absence of dividends may not run afoul of the cost of capital framework. This lack of dividends is consistent with the expectations of many shareholders at this stage in a company's existence, as reasonable investors understand (or certainly should

237. See, e.g., BREALEY & MYERS, supra note 180, at 60 ("Some companies have such extensive growth opportunities that they prefer to pay no dividends for long periods of time.").

238. See id. (discussing company growth).

239. A company cost of capital, in other words, is the relevant benchmark only for projects that fall within the company's line of business. After all, the cost of capital inquiry looks at both risk and return. See supra note 186 and accompanying text (defining cost of capital). Investment opportunities with less risk than the company's ordinary business (e.g., money market or other savings accounts) can still satisfy the cost of capital inquiry, even though they provide a correspondingly lesser return. See, e.g., BREALEY & MYERS, supra note 180, at 181 ("[T]he company cost of capital rule can also get a firm into trouble if the new projects are more or less risky than its existing business. Each project should be evaluated at its own opportunity cost of capital."); id. at 182 ("Many firms require different returns from different categories of investment."); id. at 183 ("The company cost of capital is the correct discount rate for projects that have the same risk as the company's existing business but not for those projects that are safer or riskier than the company's average."); see also JOHN D. AYER, GUIDE TO FINANCE FOR LAWYERS 291-92 (2001) (distinguishing company cost of capital from project cost of capital).

Presumably there is some limit on how long surplus-building activities can occur. The investment of company funds into a money market account, for example, would likely satisfy the cost of capital inquiry because of the low risk of the investment. Nevertheless, surely management cannot direct the bulk of a company's available investment capital to such low-risk investments forever. It is fair to say that a shareholder investing in a company is seeking returns that are consistent with the risk profile of that company's business. If a company continually deviates from that risk profile to any significant degree, a principal reason for the shareholder's investment is likely frustrated. The hard issue for a court, of course, is determining whether a company, given its peculiar characteristics and the nature of its business, has already built up an adequate surplus for its foreseeable needs. Although difficult, courts have made such determinations. See, e.g., Baron v. Allied Artists Pictures Corp., 337 A.2d 653, 660 (Del. Ch. 1975) (determining whether a corporation was financially able to pay a dividend); Cole Real Estate Corp. v. Peoples Bank and Trust Co., 310 N.E.2d 275, 282 (Ind. Ct. App. 1974) (same); Raynolds v. Diamond Mills Paper Co., 60 A. 941, 944-46 (N.J. Ct. Ch. 1905) (same); Naito v. Naito, 35 P.3d 1068, 1078, 1080, 1082 (Or. Ct. App. 2001) (same).
understand) that reinvestment of profits is necessary to help establish the business.\textsuperscript{240}

With the passage of time, however, the continuance of a no-dividend or low-dividend policy becomes increasingly more suspect. In a competitive business environment, high current rates of growth "can rarely be sustained indefinitely."\textsuperscript{241} Indeed, in the later stages of a company's development, above cost of capital investment opportunities tend to be few and far between.\textsuperscript{242} For many companies, therefore, these later stages are the time period when the cost of capital inquiry would indicate that dividends are appropriate.\textsuperscript{243}

\begin{itemize}
\item \textsuperscript{240} Cf. Hetherington & Dooley, supra note 7, at 51 (noting that a withdrawal of capital in the formative stages of a new business "might be particularly disruptive").
\item \textsuperscript{241} BREALEY & MYERS, supra note 180, at 54; see also id. at 60 (noting the "inevitable deceleration of rapid growth").
\item \textsuperscript{242} As Professors Klein & Coffee state:

Most mature firms have limited opportunities to earn acceptable returns by expansion of their existing business or by entering new businesses and are reluctant to invest in the securities of other firms. When such mature firms retain their spare cash rather than paying it out as dividends, they will therefore be likely to invest that cash in projects with low rates of return.

\textsuperscript{243} Under a cost of capital inquiry, a majority shareholder would be justified in retaining and reinvesting profits for a project so long as the project's expected returns equaled or exceeded the company's cost of capital. See supra notes 189-94 and accompanying text (discussing the cost of capital inquiry). Taken to its logical extreme, a majority shareholder would never have to pay a dividend under this inquiry as long as above cost of capital investments were perpetually available. If the shareholders had bargained over this possibility, however, they likely would have reached an understanding that a permanent avoidance of dividends was impermissible, even if such avoidance was due to an unending supply of above cost of capital opportunities. After all, reasonable minority shareholders do expect a return on their financial capital at some point. Without a market for capital appreciation, only dividends (true or de facto) provide that return. Thus, while above cost of capital investments will presumably increase the amount of earnings that are available for dividends in the future, the minority typically realizes no return on its invested capital until those dividends are actually declared. From a hypothetical bargaining standpoint, therefore, the cost of capital inquiry is acceptable to close corporation minority investors only because they assume that dividends will ultimately be paid.

Put differently, although minority investors may be willing to defer their receipt of dividends for some period of time, they are not willing to do so forever. At some point, minority investors must realize a return on financial capital. It is fair to assert that if the majority had not assented to an understanding that a permanent avoidance of dividends was impermissible, passive minority shareholders would have refused to invest in the company. Cf. Bonavita v. Corbo, 692 A.2d 119, 126, 130 (N.J. Super. Ct. Ch. Div. 1996) (ordering a buyout of a minority shareholder's interest where a refusal to pay dividends was a "policy from which [the controlling shareholder] does not intend to deviate"); Raynolds v. Diamond Mills Paper
Obviously, not every company is a growth company, and even growth businesses differ significantly. Depending on the particular firm, therefore, the cost of capital inquiry may indicate that dividends are proper at an earlier or later date than the above generalizations would suggest. Nevertheless, in conducting a cost of capital inquiry into a firm's dividend policy, the length of time that a business has been operating will often be a relevant consideration. As a general matter, it is fair to state that it becomes increasingly more difficult to justify the retention of profits and the absence of dividends as a company matures.

E. The Ability of the Judiciary to Make the Cost of Capital Inquiry

As this Article has explained, there are two general inquiries that courts need to make in close corporation dividend disputes. First, where a plaintiff alleges the payment of de facto dividends, a court needs to inquire into whether the majority shareholder has taken profits while excluding a minority investor from its proportional share. Second, where de facto dividends are not present but a shareholder still challenges a corporation's dividend policy, a court needs to inquire into whether the majority is making below cost of capital investments.

Even if one accepts that these are the two relevant inquiries, the judicial administrability of such inquiries is still in question. It is often stated that the judiciary lacks institutional competence to review a corporation's dividend decisions, as such decisions are shaped by factors that are peculiarly within the

Co., 60 A. 941, 945 (N.J. Ct. Ch. 1905) ("[A] time will come when it is not fair to the stockholders, even though the directors may be acting in good faith, to indefinitely extend the corporate business .... [T]he only sure benefit to stockholders to be derived from the successful prosecution of the corporate business must come from the distribution of dividends in cash ...."); id. at 948 ("The success of a great business ... is measured by what the stockholders get, and not by mere accumulation of assets.").

In a competitive business environment, of course, it would be highly unusual to find a company with an unending supply of above cost of capital investments. See supra notes 241-42 and accompanying text (noting that above cost of capital investment opportunities tend to become scarce as a company matures). Nevertheless, the conceptual possibility again demonstrates that there is a temporal component to the cost of capital inquiry. Simply put, when a company has been profitable for a number of years, an expectation of dividends may become reasonable, even if above cost of capital investments are still available.

244. See supra Part IV (discussing the problem of de facto dividends).

245. See supra Part V.A (discussing the cost of capital inquiry). Obviously, the courts should also continue to make the traditional inquiries into whether fraud, bad faith, or other abuse of discretion is present in the majority's dividend decision. See supra Part III.A (discussing the traditional approach to compelling dividends).
knowledge and experience of a company’s management. In disputes involving de facto dividends, this argument carries very little weight. Taking profits while excluding other investors from their share of those profits is plain and simple theft—self-dealing of the first order—that courts look for in both close and public corporation disputes (not to mention in a host of other non-corporate contexts). Spoting and rectifying theft is arguably a core function of courts in general, and it makes little sense to treat dividend disputes differently.

Where de facto dividends are not involved, however, the judicial incompetence argument has more force. Given that dividend decisions involve projections about the future affairs of a company, one could argue that courts have no superior information or judgment to second-guess the decisions of company insiders. Of course, where a market is involved to discipline overly conservative dividend policies, this argument for a "hands-off" judiciary is easier to accept. In the close corporation, a hands-off approach by the judiciary

246. As Professor Fischel notes:

Management may base the dividend decision on a variety of factors... [including] whether funds are needed for investment, payment of creditors, or maintenance and upkeep of existing facilities, and whether needed funds can be cheaply or readily obtained from the capital market.... Decisions based upon these factors are particularly within the competence of management.... Under these circumstances, any judicial second-guessing of the dividend decision is likely to reduce shareholder welfare.

Fischel, supra note 2, at 716–17; see, e.g., Brudney, supra note 2, at 99 n.43 ("Even upon the assumptions of the irrelevance proposition... such regulation would require judicial or administrative assessment of managerial judgments about expected returns and risks involved in proposed investment opportunities—matters within the special competence of management, but not of courts or administrative agencies."); Fischel, supra note 2, at 724 ("[J]udges are unable to evaluate the issues raised by management's decision whether and to what extent a dividend should be declared."); see also id. at 716 ("[M]anagers are better equipped to make business decisions than uninformed and inexperienced judges or shareholders."); Israel, supra note 66, at 76 ("[A]s an institution, the judiciary is fundamentally ill-equipped to make business decisions or to evaluate the wisdom of such decisions made by others."); cf. Raynolds v. Diamond Mills Paper Co., 60 A. 941, 944 (N.J. Ct. Ch. 1905) ("This work of examining the situation of a great business corporation owning large plants, mills, and machinery, and with large business transactions on its hands... in order to find out whether dividends are being unfairly and unjustly and unreasonably withheld from the stockholders, is an exceedingly difficult task.").

247. See, e.g., Ragazzo, supra note 80, at 1115 (stating that majority shareholder self-dealing—the majority’s effort to "appropriate to itself a disproportionate share of the corporation’s income stream"—is present in publicly-held and closely-held corporations); id. at 1136 (noting that Delaware courts "rigorously" apply an entire fairness test to self-dealing transactions); supra text accompanying note 179 (noting that disputes involving de facto dividends are clearly unlawful).

248. See supra note 246 and accompanying text (discussing the judiciary’s competence to review dividend decisions).
effectively grants the majority an unreviewable discretion, even though that authority can be used to the detriment of minority investors.²⁴⁹ Before accepting a judicial "punt" in disputes where de facto dividends are not involved, therefore, it is important to examine whether cost of capital inquiries are truly different from other financial issues that courts routinely handle in valuation and other "fair price" disputes.²⁵⁰

In the typical dividend lawsuit, the majority shareholder claims that dividends are inappropriate because the company's excess funds are to be used for a particular project that the majority favors.²⁵¹ For a court to assess whether the expected returns from that project exceed the company's cost of capital, it needs information on both of these variables. That is, the court must determine the company's cost of capital, and the court must assess the expected returns from the project. By no means are these inquiries simple, but it is fair to assert that they are routinely made in other valuation disputes. For example, cost of capital calculations are performed as a standard step in many valuations of closely-held businesses, whether for buyout or other purposes.²⁵² Granted, the court usually does not have the expertise to perform the cost of capital calculations itself; instead, the court relies on, and assesses the merits of, the calculations of the parties' expert witnesses.²⁵³ This reliance on expert testimony for knowledge that is beyond the ken of the average judge or juror is,

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²⁴⁹. See supra notes 25–32 and accompanying text (discussing freeze-out techniques in close corporations).

²⁵⁰. In statutory appraisal proceedings, for example, courts routinely assess whether dissenting shareholders received a "fair value" for their ownership stake. See, e.g., Cavalier Oil Corp. v. Harnett, 564 A.2d 1137, 1144 (Del. 1989) (analyzing "fair value" under the appraisal statute). Similarly, as part of an entire fairness review of a fiduciary's self-dealing conduct, courts examine whether the transaction at issue involved a "fair price." See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (examining a transaction by focusing on "two basic aspects" of fairness—fair dealing and fair price).


²⁵². See, e.g., VALUING A BUSINESS, supra note 170, at 163 ("[T]he cost of capital is one of the most important variables in the valuation of a business or a business interest."); id. at 153–58 (discussing the need to calculate the cost of capital in valuations using the income approach); id. at 162–64 (explaining how to calculate the cost of capital for a particular company or investment); id. at 175 (noting that there is a common procedure for developing discount rates for privately-held companies); see also id. at 153 (indicating that "cost of capital" and "discount rate" are synonymous).

of course, commonplace in litigation in general. In valuation disputes specifically, expert reports are ubiquitous. Determining a company's cost of capital, therefore, is no more beyond the competence of the judiciary than any other valuation issue that requires an assessment of expert opinion.

Assessing the expected return from a particular project is complicated by the fact that it is a future-oriented analysis. As a consequence, assessments of expected return are simply guesses—educated guesses to be sure, but still guesses—about the likely success or failure of a project. Nevertheless, as part of their capital budgeting strategy, companies routinely make such calculations before embarking on a project, and the concept of valuation itself is often viewed as a function of expected investment returns. Indeed, one valuation technique that is well-accepted in financial and legal circles is the discounted cash flow (DCF) model. In operation, the DCF analysis is premised on discounting a stream of estimated future cash flows from an investment back to the present at an appropriate "discount" rate (or cost of

254. See, e.g., Fed. R. Evid. 702 ("If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise . . . .").

255. See, e.g., Rapid-American Corp. v. Harris, 603 A.2d 796, 802 (Del. 1992) ("It is frequently the case in appraisal proceedings that valuation disputes become a battle of experts."); Balsamides v. Protameen Chems., Inc., 734 A.2d 721, 729 (N.J. 1999) (observing that valuation disputes "frequently become battles between experts").

256. See, e.g., VALUING A BUSINESS, supra note 170, at 37 ("[F]uture benefits and their predictability . . . are more difficult to establish.").

257. See ROBERT S. HARRIS & JOHN J. PRINGLE, INTRODUCTORY CORPORATE FINANCE 298-300 (1989) (examining the methods and the several main activities involved in the capital budgeting process). See generally BREALEY & MYERS, supra note 180, at 243-55 (discussing forecasting techniques); HARRIS & PRINGLE, supra, at 306-32 (discussing techniques for estimating future cash flows).

258. See VALUING A BUSINESS, supra note 170, at 197 ("All economic, financial, and regulatory literature makes it clear that valuation is a function of expected prospective economic income. The past history is relevant only to the extent that it may, in some cases, provide useful guidance in projecting future economic income.").

259. See, e.g., Weinberger v. UOP, Inc., 457 A.2d 701, 712-13 (Del. 1983) (allowing courts to use valuation techniques that "are generally considered acceptable in the financial community," and implicitly encouraging the use of the discounted cash flow model); In re Radiology Assocs., Inc. Litigation, 611 A.2d 485, 490 (Del. Ch. 1991) ("The Delaware courts have affirmed the validity of this [discounted cash flow] method of valuation repeatedly."); Joseph Calio, New Appraisals of Old Problems: Reflections on the Delaware Appraisal Proceeding, 32 AM. BUS. L.J. 1, 48-49 (1994) ("Consistent with its general acceptance and vast application in the financial community, the 'discounted cash flow' method has become the valuation 'methodology of choice' in Delaware appraisal proceedings.") (footnotes omitted). See generally VALUING A BUSINESS, supra note 170, at 149-98 (discussing discounted economic income valuation methods, including the discounted cash flow model).
A positive net present value (the present value of the investment’s expected cash flows minus the cost of the investment) indicates that the investment has a rate of return that exceeds the discount rate.

The DCF model is simply a subcategory of the broader discounted economic income method of valuation where some measurement of economic income anticipated from an investment (for example, cash flow, net income) is discounted back to present value at an appropriate rate. The cost of capital inquiry suggested by this Article is a subcategory of this broader method as well, as the projected income from an investment is discounted back to present value at the company’s cost of capital. If the net present value is positive, it indicates that the investment has a rate of return that exceeds the company’s cost of capital. To the extent that courts accept the DCF analysis as a legitimate valuation method, therefore, they have accepted the premise of the cost of capital inquiry as well. That is, the valuation of a stream of projected cash flows (the DCF model) is functionally identical to the valuation of a

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260. See, e.g., BREALEY & MYERS, supra note 180, at 52 (noting that the discounted cash flow method "discount[s] the cash flows . . . by the return that can be earned in the capital market on securities of comparable risk"); Calio, supra note 259, at 49 ("The basic premise of the discounted cash flow method is that the value of all assets is equal to the present value of the expected cash returns, or cash flows, from that asset while it is held."); id. ("This [discounted cash flow] method takes all future streams of potential benefits and converts them into a current value: a single number of current dollars that is equivalent to the stream of benefits over time."); see also VALUING A BUSINESS, supra note 170, at 153 (indicating that "cost of capital" and "discount rate" are synonymous); infra note 262 (discussing the discounted economic income method of valuation).

261. See, e.g., HARRIS & PRINGLE, supra note 257, at 283–85 (defining the net present value of an investment as "the present value of the inflows less (net of) the required outlay"); id. at 290 ("If the internal rate of return exceeds the required rate of return . . . net present value will be greater than zero, so both rules signal a decision to accept the investment."); supra note 182 (explaining the net present value and internal rate of return rules).

262. See VALUING A BUSINESS, supra note 170, at 152 ("[T]he basic concept of the income approach is to project the future economic income associated with the investment and to discount the projected income stream to a present value at a discount rate appropriate for the expected risk of the prospective economic income stream."); id. ("[I]n this approach, the value of the subject investment (i.e., the subject business interest) is the present value of the economic income expected to be generated by the investment . . . ."); id. ("[T]he investor ‘anticipates’ the ‘expected’ economic income to be earned from the investment. This expectation of prospective economic income is converted to a present worth—that is, the indicated value of the subject business interest."); see also id. (noting that cash flow, net income, net operating income, interest, and dividends are some of the measurements of economic income that are commonly analyzed in the discounted economic income method of valuation). See generally id. at 149–98 (discussing the discounted economic income method of valuation).

263. See supra note 261 and accompanying text (discussing the discounted cash flow analysis).
stream of projected investment returns (the cost of capital inquiry). If courts are sufficiently competent to assess valuations based on projections of future cash flow, they would seem to be sufficiently competent to assess valuations based on expected investment returns.

Despite the similarities between the DCF and cost of capital frameworks, it is important to note that courts typically use the DCF model to value companies rather than to value particular projects. Such an inquiry into a company's value may pose lesser administrative difficulties for courts than a cost of capital inquiry into a specific investment. Within any one particular company, for example, dividend disputes may occur on an ongoing basis. Each time the majority decides to retain funds for a particular project, there may be a question as to whether that project's expected returns exceed the firm's cost of capital. A court may find itself assessing future streams of income on multiple projects—a task that may be more difficult and ongoing than a one-time assessment of a firm's future stream of income in a company valuation. Nevertheless, given the importance of dividends to a close corporation minority shareholder and the great potential for majority abuse, such inquiries are necessary to protect the minority's rights. If a majority shareholder is found to have frustrated the minority's general expectation by investing in a below cost of capital project, a court fearful of recurring litigation between the parties over subsequent projects could simply order a fair value buyout of the complaining minority investor.

264. See Valuing a Business, supra note 170, at 152 (noting that cash flow and net income are some of the measurements of economic income that are commonly analyzed in the discounted economic income method of valuation).

265. As one commentator observed:

Quantitative methods permeate the discipline of business administration, and management... is becoming a science. Prior to this development of this kind of expertise, judicial hesitancy in reviewing business decisions was perhaps understandable. But it would seem that both legislature and court should now better than ever be able to define more precise legal standards for the protection of minority shareholders.


266. See Calio, supra note 259, at 48–54 (describing how the discounted cash flow method is used to calculate a corporation's value and noting that Delaware courts use this method).

267. Cf. Hetherington & Dooley, supra note 7, at 16 ("Neither the courts nor the minority shareholders have the resources for constant policing and challenging of majority management decisions.").

268. See supra Part II.D (discussing the importance of dividends to the close corporation minority investor).

Moreover, when a court is engaged in the task of valuing a company, it can avoid the DCF approach if the future cash flows for that particular company are too speculative to rely upon. If necessary, courts can turn to other valuation methods that focus more on a company’s historical data than on its projected numbers. At times, in other words, future numbers are too hard to predict, and courts cannot rely on future-oriented valuation methods to any credible degree. In such circumstances, it may not be possible to evaluate a.

concerns about continuing dissension between the shareholders). As Professor Murdock explains:

[I]f the problem is triggered by animosity among the shareholders, there may be an endless parade back to court to seek additional relief, should the animosity not be resolved. Therefore, in many instances, the only permanent resolution to the problem would be to eliminate the complaining minority interest by a repurchase of shares.

Murdock, supra note 31, at 428 (footnote omitted). In addition, the losing party in a dividends dispute over a particular project will likely be more reluctant to involve the courts in the next reinvestment versus dividends dispute. Given the cost of litigation and the potential for sanctions for frivolous pleadings, the prospect of a minority shareholder bringing project-by-project litigation over an extended period of time seems unlikely.

270. See VALUING A BUSINESS, supra note 170, at 159 (noting that "capitalizing" is "a process applied to an amount representing some measure of economic income for some single period to convert that economic income amount to an estimate of present value," and stating that "capitalization procedures can be used with expected, current, historical, or 'normalized' ... measures of economic income"); id. at 206 (explaining the guideline company method of valuation where "value measures" are developed "based on prices at which stocks of similar companies are trading in a public market," and those measures are then "applied to the subject company's fundamental data and correlated to reach an estimate of value for the subject company or its shares or other interests"). See generally id. at 203–38 (discussing the guideline company method of valuation); id. at 253–84 (discussing asset-based methods of valuation). But see id. at 197 ("All economic, financial, and regulatory literature makes it clear that valuation is a function of expected prospective economic income. The past history is relevant only to the extent that it may, in some cases, provide useful guidance in projecting future economic income.").

271. See, e.g., In re Radiology Assocs., Inc. Litigation, 611 A.2d 485, 490 (Del. Ch. 1991) ("The quality of the projection as to the future benefits over some period and the residual or terminal value is central to the reliability of the underlying methodology of the discount[ed] cash flow method."); id. ("In Harris, this Court declined to use the discounted cash flow method because the projections on which petitioners relied were too speculative." (citing Harris v. Rapid-American Corp., C.A. No. 6462, 1990 WL 146488, at 15 (Del. Ch. Oct. 2, 1990), rev'd in part, aff'd in part, Rapid-American Corp. v. Harris, 603 A.2d 796 (Del. 1992)); HARRIS & PRINGLE, supra note 257, at 84, 87 (noting that the discounted cash flow model "has its limitations, especially in situations involving uncertainty" as to the expected cash flows from a project); id. at 87 ("The numbers that go into a DCF analysis must be based on reasonable assumptions and a full assessment of the facts; otherwise, the numbers that come out will be unreliable."); id. at 300 (noting the "difficulty of applying" net present value rules "especially when very uncertain cash flows need to be projected"); VALUING A BUSINESS, supra note 170, at 153 ("The discounted economic income method is practical only to the extent that the projections used are reasonable to the decision maker for whom the valuation is being prepared."").
dividend dispute with a cost of capital inquiry that relies solely on projections of investment returns.\textsuperscript{272} Where the returns from a project are too speculative

Without supportable projections, the discounted economic income method can convey an aura of precision that is not justified.\textsuperscript{,} Calio, supra note 259, at 50–51 (explaining that courts will usually accept "reliable and accurate projects" of cash flows such as those "calculated by management, for its own use, or calculated by a disinterested third party," but noting that "estimated future cash flows calculated in preparation for litigation are generally dismissed as speculative and unreliable"); see also VALUING A BUSINESS, supra note 170, at 37 ("Historical facts are often considered more credible evidence in the eyes of the court than projections of what somebody thinks will happen . . . . The courts generally prefer provable historical results to unproven expectations of future results.").

\textsuperscript{272} One way to avoid some of the perceived difficulties in conducting the cost of capital inquiry is to statutorily require a close corporation to pay out a certain percentage of its net profits each year as dividends. See 2 OPPRESSION, supra note 22, § 10:08, at 47–48 ("A statute requiring directors to declare and pay dividends in a specified amount at periodic intervals if consistent with state law is an obvious way to combat squeeze-outs which utilize the dividend-withholding technique."). See generally id. at 47–52 (discussing mandatory dividend statutes). Although such statutes would help to alleviate many of the problems discussed in this Article, they are problematic in their "one size fits all" approach. A statute ordering a payout of 30\% of net profits each year, for example, may be too high for some companies (companies with several projects that return at or above the cost of capital) and too low for others (more mature companies with dwindling numbers of promising investments). The cost of capital inquiry proposed in this Article is a superior approach (albeit a more labor-intensive approach) because it tailors the dividend inquiry to the particular risk and return traits of the company and project at issue. Moreover, after paying out the required percentage, the statute would presumably allow a majority shareholder to invest the remaining profits in below cost of capital projects. The cost of capital inquiry proposed in this Article would prohibit such conduct. Finally, if a majority shareholder did not pay out the required statutory percentage, a court would still have to decide whether such excessive retention was justified. See, e.g., id. at 50–51 (proposing a statute where a close corporation could be required to pay out 30\% of its earnings "in the absence of a convincing showing by corporate management that the corporation needs to retain all of its earnings"); Israel, supra note 66, at 99 ("If the board of directors failed to declare a dividend or declared a dividend of less than 50\% of net earnings . . . . the burden of proof would be on management to prove the reasonableness of their policy."). That determination should involve a cost of capital inquiry. Even with a mandatory dividend statute, therefore, a potentially difficult and time-consuming cost of capital inquiry is likely involved.

Nevertheless, statutes requiring a fixed dividend payout could conserve judicial resources in some instances (e.g., where the majority does distribute the required percentage), and they are clearly more useful in combating dividend withholding than the overly deferential business judgment rule approach. See 2 OPPRESSION, supra note 22, § 10:08, at 50–51 ("These writers, however, are persuaded that solid policy considerations support a tightly drawn statute empowering holders of a substantial block of shares (say 20 or 25\% of a corporation's outstanding shares) to require the corporation to pay out as dividends a modest part of its annual earnings (perhaps up to 30 or 35\% . . . ."); Israel, supra note 66, at 99 n.108 ("Although retention of 50\% of earnings may be excessive in certain instances, it does strike a workable balance between avoidance of shareholder oppression and conservation of judicial resources."). But see Ernest L. Folk, III, Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered, 43 N.C. L. REV. 768, 842–45 (1964) (criticizing North Carolina's former mandatory dividend statute).
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for a court to evaluate, however, a majority shareholder would seem to have little justification for wanting to invest in that project. In fact, given the conflicts of interest that a majority shareholder often faces in making dividend decisions, the majority shareholder should have the burden of proof to demonstrate that the future returns from a proposed investment exceed the cost of capital. If the majority cannot meet that burden because the project's future returns are too speculative, the majority should not be able to retain funds for investment in that project.

VI. Conclusion

It is far from startling to observe that close corporations and public corporations are different. What is significant, however, is the recognition that these differences matter, particularly when dividend policy is at issue. Without a well-developed market, a close corporation shareholder has no ability to manufacture "homemade" dividends through sales of stock at an appreciated value. Moreover, without a market, perhaps the most critical constraint on self-interested managerial behavior is absent. In the close corporation context, therefore, the majority shareholder's dividend decisions should not escape legitimate judicial scrutiny. Instead of reflexively applying the deferential business judgment rule, courts should employ the oppression doctrine's more searching reasonable expectations framework.

A meaningful inquiry into close corporation dividend policy, however, requires more than merely recognizing that the reasonable expectations standard is a superior analytical framework. Indeed, this Article has pushed further by developing standards for determining when a close corporation's dividend policy warrants judicial intervention. With respect to disputes involving de facto dividends, a minority shareholder's expectation of dividends should be considered reasonable, and thus enforceable, whenever the majority shareholder receives a disproportionate amount of the company's profits. Regardless of whether such disputes arise from the fault of the majority, the fault of the minority, or from no fault at all, such a position mirrors the understandings that the shareholders themselves likely would have reached had they contemplated the possibility of an exclusion from de facto dividends.

273. See supra Parts III.B.1.b, V.B (describing conflicts of interest inherent in dividend decisions).

274. Cf. Manne, supra note 88, at 280 ("In fact, it would not be too extreme [in a close corporation] to put the burden of proving the propriety of its dividend policy on the controlling shareholders.").
In dividend controversies where de facto distributions are not at issue, basic principles of financial economics provide a useful standard for when judicial intervention is appropriate. When the majority shareholder seeks to reinvest company profits in a project expected to pay a below cost of capital return, the majority is committing the company’s funds to a project whose return is inadequate to compensate for its risk. From the standpoint of return on financial capital, such a below cost of capital investment is disadvantageous to all shareholders—majority and minority alike. As this Article has discussed, however, the majority shareholder’s desire to maximize its return on financial capital will frequently fail to curb this behavior, as below cost of capital investments can provide employment benefits to the majority—and often only to the majority—that more than offset the insufficient financial return.

To combat this majority incentive to make sub-optimal investment choices, judicial intervention is necessary. As a consequence, this Article has argued that judicial compulsion of a dividend is warranted when the majority seeks to retain profits for reinvestment in below cost of capital projects. A minority shareholder has a reasonable expectation of dividends, in other words, when the projected financial returns from the majority’s investment choices are inadequate to compensate for the risks of those choices. Once again, this is the understanding that all of the shareholders likely would have reached if they had bargained over the possibility of the majority refusing to declare dividends for reinvestment purposes.

In short, the close corporation is different, and it is those differences that make dividends critical to minority investors in such organizations. As a result, dividend policy in close corporations cannot be free from scrutiny. By attempting to channel that scrutiny into a principled framework, this Article takes a needed step in the right direction.