4-1-2011


N. Cameron Leishman

Follow this and additional works at: https://scholarsarchive.byu.edu/byuplr

BYU ScholarsArchive Citation
Available at: https://scholarsarchive.byu.edu/byuplr/vol25/iss1/10

This Article is brought to you for free and open access by the All Journals at BYU ScholarsArchive. It has been accepted for inclusion in Brigham Young University Prelaw Review by an authorized editor of BYU ScholarsArchive. For more information, please contact scholarsarchive@byu.edu, ellen_amatangelo@byu.edu.
MCLAUGHLIN V. SCHENCK, S.B. 179, AND THE FUTURE OF FIDUCIARY DUTIES IN UTAH CLOSE CORPORATIONS

by N. Cameron Leishman* & Shannon Sullivan**

I. INTRODUCTION

The closely held corporation model is utilized by most American businesses. Indeed, in 2008, 441 privately held companies in the United States employed 6.2 million people, and produced 1.8 trillion of all goods and services provided in the United States that year.1 Closely held corporations, whether in terms of the people they employ or the goods and services they produce, affect a substantial number of Americans. Despite the potentially large influence closely held corporations have on many Americans, conflict among shareholders causes failure among a significant number of these businesses, with 50% of new businesses failing within five years of start up.2

---

* N. Cameron Leishman is a sophomore majoring in finance. Through legal internships and BYU’s Capital Markets Club, Cameron has developed an interest in corporate governance. He will attend law school following graduation.

** Shannon Sullivan is a senior from Ventura, California, studying history and women’s studies. She will attend law school next fall.


Dissension among owners of a close corporation has led to an increased prevalence of legislation and jurisprudence oriented towards curbing this dissension. In many cases, dissension arises over some degree of control in the management of the business. Due to inherent vulnerabilities associated with a position as a minority owner in a closely held corporation, disputes often result in oppression or abuse by the majority shareholders. A majority owner’s control of the corporation’s board allows them not only to take actions that may be contrary to the interests of their minority counterparts, but to act maliciously with the intent to deprive minority shareholders of things they have reasonable expectation to as a shareholder. These expectations typically include some form of employment, a substantive role in the day-to-day management of the corporation, and a return on their investment.

Compounding these problematic actions is the fact that a minority interest in a corporation likely has little to no value once abusive actions are taken by a majority. Without external legislative protection guarding a minority’s rights, abuse by the majority is wholly permitted. Members who create a corporation may enter into agreements prior to incorporation that provide resolutions for disputes that may arise. Covenants that pre-date potential conflicts can provide an efficient and fair remedy to dissension within the corporation. Yet whether a result of naivety, the familial relationships of trust which corporations are often formed upon, or the wish to avoid additional legal fees, shareholders often neglect entering into these protection

6 Wells, supra note 3, at 297.
7 Id. at 275.
agreements. Indeed, as every possible conflict scenario cannot be anticipated, shareholder agreements without express legal protection for the minority seem incomplete. In recognition of the plight of minority shareholders, the Utah Supreme Court brought Utah’s corporate law in line with the majority of U.S. jurisdictions by holding in 2009’s *McLaughlin v. Schenck* that “shareholders in close corporations stand in fiduciary positions to one another and are required to act with the utmost good faith.”

However, shortly after *McLaughlin* was decided, the Utah Legislature passed Senate Bill 179 in the 2010 legislative session with essentially no debate and no meaningful committee review. S.B. 179 was subsequently signed into law by Governor Herbert. S.B. 179 directly attacked the *McLaughlin* decision and triggered amendments to Section 16-10a-622 of the Utah Revised Business Corporation Act, a step by step summary on how to legally incorporate a business in Utah, written by the Utah Division of Corporations and Commercial Code, to include a new sub-paragraph (3): “a shareholder of a corporation, when acting solely in the capacity of a shareholder, has no fiduciary duty or other similar duty to any other shareholder of the corporation, including not having a duty of care, loyalty, or utmost good faith.”

If interpreted as broadly as it is written, S.B. 179 suggests that shareholders in Utah close corporations owe absolutely no duties to each other, even though a majority shareholder can use otherwise legal corporate maneuvering to oppress and abuse minority owners through exercise of numerical voting advantage, a troubling development.

This paper argues that the nature of closely held corporations necessitates laws to impose fiduciary duties on shareholders to act with care, loyalty, and the utmost good faith. S.B. 179 effectively revokes any statutory obligation of such fiduciary duties to minor-

---

8 *Id.* at 314.
9 *Meinhardt*, *supra* note 5, at 289.
11 S.B. 179, 2010 Leg., 44th Sess. (Utah 2010).
ity shareholders in Utah. Due to the potentially detrimental effects of S.B. 179, the necessary steps must be taken to reverse this bill. Reversal of S.B. 179 would provide greater statutory protections for minority shareholders through the imposition of fiduciary duties on all shareholders in closely held corporations.

Part II of this article provides an overview of the development of fiduciary duties of shareholders in closely held corporations, and certain exceptions to these widely accepted protections. Part III outlines the need for protection of minority shareholders because of the unique disadvantage of minority status. Finally, Part IV examines and addresses the most common arguments against imposing fiduciary duties on controlling shareholders.

II. BACKGROUND

Donahue v. Rodd Electrotype

McLaughlin cited the landmark 1975 Massachusetts Supreme Court decision in Donahue v. Rodd Electrotype Co. Over the last 35 years, Donahue has become the majority rule in U.S. corporate law in defining the duties owed by owners of close corporations.

Donahue recognizes a closely held corporation is distinctly different from its public corporation counterpart. In the closely held corporation, there exists a day-to-day working relationship among owners and management. Stockholders participate in the management, operation, and direction of the company. There are a small (a number or range remains undefined by Donahue)\(^{12}\) number of shareholders, and there is no ready market for liquidity of the corporate stock. These factors contribute to a unique (and often tenuous) working relationship between owners that makes statutory or judicial protection of minority owners essential.

The facts of Donahue are as follows: a minority shareholder of Rodd Electrotype Co. sued the majority shareholder for abusing his majority control and causing the company to repurchase forty-five shares of his stock at a price of $800 per share. In contrast, the mi-

---

12 Wells, supra note 3, at 313. Some states have established numbers, e.g. Delaware: 30.
ority shareholder had not ratified the transaction and was denied a similar opportunity to sell some of her shares purchased at the same price.

The Massachusetts Supreme Court held that a controlling shareholders of close corporations owe a fiduciary duty to the other shareholders of the company when causing the corporation to repurchase their shares, which requires them to give all minority shareholders the same opportunity. This seminal decision further held that stockholders in close corporations have a duty of loyalty to all stockholders in the corporation, and must act according to this duty, even if such actions go contrary to self-interest or expediency.

In adopting the Donahue principles as Utah law, the McLaughlin court did not act as an activist court, nor was it setting rogue precedent. It simply formalized as Utah law widely accepted principles recognized in other states including New York, Pennsylvania, New Jersey, Texas, and North Dakota.  

McLaughlin v. Schenck: Utah's Application of Donahue

In McLaughlin, plaintiff Sam McLaughlin was hired as an employee of Cookietree, Inc., a closely held Utah corporation, and quickly rose to the position of vice president of operations. He was a party to an employment agreement that specified his employment was at-will, meaning either party could terminate his employment for any reason or no reason, as long as six months’ notice was given. McLaughlin was granted options to acquire common stock of Cookietree, which he exercised, thus becoming a minority shareholder of the corporation. Boyd Schenck, founder and majority stockholder of Cookietree, Inc., made a transfer of 818,000 shares of Cookietree immediately preceding his death to his son Greg Schenck. Additionally, the late Boyd Schenck’s widow, Anna, sold Greg 545,200 shares of the company in a transaction that was not recorded in the

corporation’s records or minutes. This sale contravened rights of first refusal set forth in a shareholders agreement to which McLaughlin and Schenck were both parties, an agreement that could only be waived through the consent of the board of directors, or holders of two-thirds of the outstanding shares. This transaction of shares to Greg Schenck by his parents shifted substantial majority ownership of Cookietree, Inc., to him.

When disputes emerged between McLaughlin and Greg Schenck, the latter unilaterally terminated McLaughlin’s at will employment, and excluded him from further involvement in Cookietree. Though his compensation continued, he was functionally denied a return on his investment, a meaningful role in management, and employment.

The Utah Supreme Court held that (i) shareholders in Utah closely held corporations owe each other fiduciary duties as per Donahue,\(^{14}\) (ii) such duties were not, however, violated by the termination of McLaughlin’s employment because he had no reasonable expectation of continued employment as a stockholder, and (iii) the case would be remanded to ascertain the fairness of the board’s waiver of the first right of refusal restrictions given the conflicting interests of the Schenck board members. Chief Justice Durham explained the key holding regarding the fiduciary duties owed by shareholders in closely held corporations:

The Massachusetts approach [in Donahue] of recognizing broader fiduciary duties in closely held corporations better achieves the goals of the Act [the Utah Revised Business Corporation Act] by stemming shareholder oppression and is the appropriate standard for evaluating fiduciary relationships among shareholders in a closely held corporation. Our adoption of the Massachusetts standard is a logical extension of our existing case law regarding close corporations, which acknowledges the unique nature of such corporations and seeks to protect their shareholders by interpreting the

\(^{14}\) And, in fact, used the same language to describe such fiduciary duties
Corporation Act with different corporate circumstances in mind.\textsuperscript{15}

This ruling effectively placed Utah in line with other U.S. jurisdictions that have adopted, either judicially or legislatively, the reasoning of the \textit{Donahue} decision as being not only of logically valid and in accord with precedent, but also one of important pragmatic value.

\textit{Senate Bill 179}

Shortly after the \textit{McLaughlin} decision was handed down by the Utah Supreme Court, Senate Bill 179 was passed with no meaningful committee or floor debate. S.B. 179 effectively nullifies the fiduciary duties imposed on shareholders of close corporations by the \textit{McLaughlin} decision and clarifies that owners of a close corporation owe each other no duties in their capacities as shareholders. Instead of simply being benignly misguided, S.B. 179 will have lasting and harmful effects on minority shareholders in close corporations, which will, in turn, adversely affect the small business community and Utah’s economy. As there were an estimated 203,468 small businesses in Utah in 2004—with that number expected to have since grown—Utah’s economy is dependent in material part on small businesses.\textsuperscript{16}

\textbf{III. THE NEED FOR MINORITY SHAREHOLDER PROTECTIONS}

\textit{Abuses as a Result of Simple Majority Rule}

Conventional U.S. corporate law relies heavily on majority rule: a majority holder controls the election of the board of directors, which is the centralized location of most corporate power.\textsuperscript{17} Using this power, the majority shareholder is able to undertake actions that

\textsuperscript{15} \textit{McLaughlin}, 220 P.3d at 156.


\textsuperscript{17} Wells, \textit{supra} note 3, at 280-82.
can be harmful to a minority owner.\textsuperscript{18} Such actions are most often referred to as oppressive and can encompass a wide variety and degree of abuses.\textsuperscript{19} Because of the lack of exit ability, a minority shareholder is at the mercy of the majority shareholder’s rule.\textsuperscript{20} There are many specific scenarios in which the minority holder may be damaged. These include, but are by no means limited to the following:

- Terminating the employment of the minority holder notwithstanding the expectation of both parties that employment by the entity they co-own is a fundamental part of their business arrangement
- Increasing the salary and bonus compensation of the majority owner, which reduces the amount of net income distributable as profits from the business thereby depriving the minority owner of the economic benefit of the business
- Withholding distributions or dividends of earnings arbitrarily and in order to pressure the minority owner into leaving the company or selling out at an unfairly low price
- Depriving the minority of meaningful involvement in the operation of the business when such involvement was the expectation of both parties at the outset of the venture
- Withholding tax distributions and dividends necessary to cover (at least in the case of Subchapter S corporations) the income allocated to the minority member thereby creating a material tax liability but not providing any cash to pay the tax liability
- Compelling the minority to be subject to a variety of corporate transactions such as freeze-out mergers and asset sales where the minority’s remedies of appraisal or dissenter’s rights are not robust enough to afford meaningful


\textsuperscript{19} \textit{Id.} at 286.

\textsuperscript{20} Kline, \textit{supra} note 4, at 4.
• Unilaterally issuing new shares at low prices that disproportionately dilute the minority’s ownership and participation

Indeed, minority shareholders in close corporations are in a precarious and often helpless situation. Due to the voting control of majority shareholders, absent enforceable covenants between owners, minority owners are subject to a multitude of abuses and methods of coercion from majority owners, as outlined above. A shareholder of a public corporation that objects to management’s decisions can sell his stock, recoup all or some portion of his invested capital, and find a new investment. In contrast, shareholders in closely held corporations are incapable of controlling the corporation’s direction and in most cases will have no ability to liquidate their investment because of contractual transfer restrictions, the lack of any market for the corporation’s securities, and a lack of understanding of the fair market value of such shares. As shareholders in privately held corporations have little control in the direction their corporation or investment in that corporation takes, exit strategies for shareholders in which they can withdraw their investment in the corporation are necessary.

No Exit

The ability of a stockholder to exit a corporation for any reason is an important protection for several reasons. First, the option to sell shares allows for the ability of a minority owner to recover the amount of their invested capital, independent of the objections of other shareholders with potentially competing interests. Second, the threat of capital depletion is an extremely important leverage point when dealing with majority shareholders (who are often officers of the corporation). The following lists a few of the barriers minority

---

21 Wells, supra note 3, at 275.
22 Meinhardt, supra note 5, at 288.
23 Wells, supra note 3, at 286.
24 Illig, supra note 18, at 288.
shareholders in close corporations may encounter when seeking an exit strategy.

i. Lack of Contractual Protections

Because close corporations are often founded on the basis of personal and familial relationships,\textsuperscript{25} oftentimes no covenants exist regarding dissolution, buy/sell agreements, or other methods for minority owners to maintain any degree of liquidity of their investment.\textsuperscript{26} While dissolution has traditionally been the courts’ most explicitly defined remedy for minority shareholders, it is often far from the most desirable option for either partner, and wholly unnecessary. Additionally, it frequently involves lengthy and extremely costly litigation for an already cash-poor or even insolvent minority owner. Dissolution, while traditionally the most explicitly defined legal option for a wronged minority shareholder, is often the least beneficial solution.\textsuperscript{27}

ii. Value of Minority Stock

Another substantial barrier to the successful liquidation of the minority’s interest in a close corporation is the fact that their stock is effectively meaningless in the operation of the company.\textsuperscript{28} Potential investors seeking to engage in buyout or merger negotiations have little desire to own a non-controlling minority portion of a corporation’s stock without paying a steep discount. The minority position lacks enough voting power to have final decision-making ability in the corporation. In addition, a corporation with majority owners engaging in abusive conduct towards minority holders does not increase the attractiveness of a minority holder’s proposal to a potential purchaser of shares. These deterrents can inequitably decrease the price of a minority holder’s interest in the corporation.

\textsuperscript{25} Id. at 275.
\textsuperscript{26} Id. at 314.
\textsuperscript{27} Id. at 275.
\textsuperscript{28} Id. at 286.
iii. No Competitive Market for Shares

By definition, there is no ready market available for the selling shares of a closely held corporation. Donahue notes that one of the defining characteristics of a closely held corporation is “no ready market for the corporate stock.” 29 Because of this, there is not a connected network of potential buyers of a minority holder’s stock. Most potential investors who are interested at all in maintaining any degree of liquidity in their investment seek publicly traded shares.

IV. Common Arguments Against Statutory Protection of Minority Shareholders

Despite the copious abuses minority shareholders in closely held corporations might experience, arguments against the right of minority shareholders to legal protection have been proposed. This section addresses three of the most commonly used arguments against of minority shareholders’ rights.

A Passive Shareholder is Responsible to Make an Unrelated and Wronged Shareholder Whole

One common argument in response to mandated fiduciary duties among shareholders in a close corporation is that it makes a shareholder who has engaged in no oppressive conduct liable to make a wronged shareholder whole. 30 In other words, a shareholder who has not acted out of self-interest or avarice may in some way be held accountable for the damages a wronged shareholder experiences at the hands of another shareholder who has acted out of self-interest or avarice. This argument proves faulty however, for as McLaughlin outlines, so long as passive shareholders do not act “in derogation of their duty of loyalty to the other stockholders and corporation,” they are not liable for another plaintiff’s damages. 31 It is also important to note here that

31 McLaughlin, 220 P.3d at 18.
protections of minority holders do not remove or mitigate the existing fiduciary duties of directors and management of the corporation; they still possess intrinsic obligations to act on behalf of the corporation's best interest, and cannot act in derogation of these obligations, nor out of avarice, expediency, or in their own personal interest.\textsuperscript{32}

\textit{Capital Flight}

Perhaps the most compelling argument against the statutory protection of minority holders is the threat that large financiers (e.g. large venture capital and private equity firms) and affluent private individuals may forgo investing in a corporation because of minority protections.\textsuperscript{33} Deals involving this type of financing from large financiers and affluent individuals are often economically significant, and these liquidity events often are directly related to the corporation making an initial public offering and changing its status permanently.

Furthermore, these large deals are tremendously attractive to state lawmakers seeking to bring additional revenue to their state. To this end, there are several notable U.S. jurisdictions that have not only avoided adopting some form of the \textit{Donahue} language regarding fiduciary duties among close corporation owners, but have rejected it explicitly and have further strengthened the position of majority shareholders. Delaware provides a notable example of this.\textsuperscript{34} Because it provides protections favorable to majority holders, it attracts many corporations incorporating or reincorporating.\textsuperscript{35} In fact, many of the large capital sources outlined above require and/or strongly encourage a reincorporation or incorporation in one of these jurisdictions.

However, because far more corporations incorporate in these states than operate in them, a robust system to remedy ownership, operating, and other disputes among shareholders exists.\textsuperscript{36} Relying

\begin{flushright}
\textsuperscript{32} \textit{Donahue}, 367 Mass. at 593. \\
\textsuperscript{33} \textit{Illig}, supra note 18, at 279. \\
\textsuperscript{34} \textit{Id.} at 279. \\
\textsuperscript{35} \textit{Meinhardt}, supra note 5, at 290. \\
\textsuperscript{36} \textit{See Kline}, supra note 4, at 250.
\end{flushright}
on a large body of precedent, Delaware has developed a dense and specialized code pertaining to the treatment of corporations and other business entities. In particular, Delaware allows the speedy and efficient escalation to the state’s Chancery Court to resolve any disputes that may arise among shareholders. While this extremely robust system is an incentive to incorporate in Delaware, it highlights Utah and other jurisdictions who traditionally set forth protections for minority holders as less than feasible alternatives, whose courts do not have the same body of precedent and statutory code on which they can draw. Indeed, the dependable and established nature of Delaware law makes the behavior of courts vis-à-vis shareholders predictable and preferable for majority shareholders.

Because smaller states seeking to attract big capital have removed minority protections—which is insufficient motivation to attract such investors—it puts states like Utah in a uniquely awkward predicament. Close corporations’ shareholders are vulnerable to the abuses outlined above, but instead of these crippling disputes being counter-balanced or even outweighed by the promise of new capital flow into the state, it suffers further from the lack of a tried, tested, and established set of statutory code with regard to corporations, as in Delaware.

In addition, close corporations already incorporated in Utah will not leave the state and take their taxable revenue with them, except in the statistically rare event of a liquidity event involving private equity, venture capital, or angel capital, as there is no incentive to incur the significant cost of doing so. There are thousands of closely held Utah corporations for whom a reincorporation is impractical. For many of these corporations, resolving operational disputes among owners is a much larger challenge to the viability of the business than financing. It is this type of business for which Utah (or the specific jurisdiction’s) corporate law is the most relevant, and it is these types of entities, specifically where there is no institutional investor presence, where having fiduciary standards owed by their owners makes the most sense. Thus, the argument of capital flight is inap-

37 Wells, supra note 3, at 282.
38 Id.
plicable to existing corporations. The risk/reward calculus makes independent reincorporation less than ideal.

Furthermore, the small number of economically significant incorporations that otherwise would have taken place in Utah (or another jurisdiction with minority owner protections) are far outweighed by the economically less significant but statistically far more numerous operation of small business financed by methods other than the large financiers outlined above. It is ill advised to promote public policy that will adversely affect a majority of smaller close corporations in favor of accommodating sophisticated financial investors who will take the profits from their equity in Utah corporations to be taxed in other jurisdictions. Alienating small business, much of which is made up by the close corporation model, will have lasting and harmful effects. An effective and efficient small business community can lay the groundwork for the development of a successful economy. A robust system of minority protection fosters this development in the most effective way possible.

Statutory Protections Infringe on Owners’ Rights to Pre-Incorporation Covenants

A common argument against incorporating protections of minority holders into statutory law stems from the notion that fellow shareholders of a corporation have a right to establish certain binding covenants. This is certainly a compelling and valid argument, as the flexibility and rights afforded by these contractual agreements are a tremendously important part of the American corporate model.

In reality, however, the vast majority of closely held corporations have no such agreements in the form of executed documents. Because such a large number of closely held corporations are founded on the basis of personal and familial relationships, there is an expectation that the minority shareholder can trust their majority owner counterpart to not engage in the above outlined abuses. In reality, however, it is this non-written trust based on personal relationships that often leads to irreconcilable disputes on the terms of their agree-

39 Hillman, supra note 30, at 62.
40 See Wells, supra note 3, at 276, 314.
ment at the time of incorporation. In the case of personal relationships being intertwined with business relationships, “good fences make good neighbors.”

Because so many close corporations have functionally no written agreement regarding stockholders’ duties to each other, the question of negating those rights via statutory protection is largely moot. However, the ideal piece of legislation would include language that would allow pre-existing contractual agreements that have been executed by all affected parties to supersede the statutory and judicial protections that would allow a baseline level of protection. It is a no risk proposition.

V. Conclusion

Removal of statutory protections of minority shareholders in close corporations alienates small businesses and is immensely dangerous for minority shareholders in closely held corporations. Senate Bill 179 is an extremely high-risk public policy with little potential for success vis-à-vis its original intent—to attract economically significant institutional venture capital deals. Rather, S.B. 179 may prolong and complicate litigation between shareholders of close corporations, and hinder the development of Utah’s small business community. As there are over 203,468 small businesses in Utah, S.B. 179, by hindering the growth of Utah’s small business community, will thus inhibit the growth of Utah’s economy as a whole. Indeed, this bill seems misguided, unwarranted, and dangerous. The necessary steps must be taken to rescind S.B. 179 and bring Utah’s corporate law back in line with the majority of U.S. jurisdictions and the seminal decision of *McLaughlin v. Schenck*. The protection of minority shareholders from potential abuses of the majority through imposition of fiduciary duties will see to the continued growth of Utah’s small businesses and economy.