*Galler v. Galler* – **(agreement ok even though has dividend layout),**

**Shareholders Agreement:** Vote so that the 4 person board will be each of the brothers and their wives are members of the board, provide for a dividend if certain minimum earnings requirements are met. If either brother dies his wife gets twice the brother’s annual salary paid over five years.

**Facts**

Two brothers each own 47.5% of the stock. There is one very small minority shareholders. They sign an agreement (above) in which they agree to pay certain dividends each year ($50,000) and pay specified pension to widow in event that one should die. One brother dies and the other sues to enforce the agreement.

Ben dies and Isadore and his son try to take over the company. Ben’s wife sues. Isadore buys out Roseberg’s shares. Isadore argues that the agreement is unenforceable, as it is void against public policy.

**RB: Make some arguments why this should be void:**

1. It predetermines certain decisions that is usually left up to the board to determine by commanding the directors to vote a certain way, such as:
	1. Director’s salaries
	2. Decision to pay dividends (we are going to let shareholder decide this!? Crazy!?

**Holding**

Shareholders Agreement is enforceable (though agreement deviates from typical business practices) b/c

1. **No public Policy Concerns Here**
	1. Nearly all of the shareholders sign off on the contract
		1. This was a closely held corporation; not exactly everyone was a party to the agreement, but the sole minority shareholder (Rosenberg) did not complain and was gone by the time this suit was brought.
	2. No injury to public or creditors.
2. **Specific terms are reasonable:**
	* + Payment of dividend is contingent on minimum earnings.
		+ Salary continuation agreement is common.
		+ Court reads a general limitation into the duration of the agreement – lives of these four people. Therefore, it is not for an undue duration because it will expire upon their deaths.

(more extreme terms = might lead to a problem)

* + **Jurisdiction specific.** Court is more favorably inclined.

**Remedy:** Specific performance 🡪 get past payments and is put back on board of directors.

However, this leads to disagreement and deadlock with the surviving brother.

**RB:** Unlike partnerships, the default rules for corporations do not give shareholders dissolution/buy out rights that they can invoke whenever they want to.

Therefore, need to think of this stuff up front.

*Ramos v. Estrada* –

**Broadcast Group Voting Agreement That Existed Here:**

(1) Vote shares in a matter determined by a majority. (2) Restricts the transfer of shares. (3) If any member fails to abide by the voting decision, that member’s shares will be sold to the other group memebers at cost plus 8% a year.

**Facts:**

Broadcast Group and Ventura 21 each have 50% of the shares of TV, Inc. Each of those two elect 4 members to the board of directors. Soon after, Broadcast Group gets a few extra shares, and they then elect a 5th member to the board (new Board = 9 members.)

Estrada decides to defect from the Broadcast Group shareholders and gets rid of Ramos (from the Broadcast Group) as president. Broadcast Group holds their shareholders meeting to decide how to vote their shares at the next general election. Estrada refuses to recognize the Voting Agreement and does not vote her shares at the next general election. Broadcast Group sues for breach of the Shareholders Agreement, they have a right to buy her out.

**Holding:**

Shareholder Agreement and the buy-out provision are enforceable because…

**(1)** legitimate purpose to enter into agreement; parties wanted to ensure power to control corp through voting.

**(2)** Though new corp is not technically a closely held corporation, court will still treat it as such.

**(3)** Forced sale provision of shares is not unconscionable; parties negotiated for the deal on equal terms with seasoned counsel.

**Estrada 1s Argument**

Shareholder Agreement is void because it is a revocable proxy and Estrada has a right to revoke which she did. Estrada is trying to make the agreement look like something more problematic.

* + - **Court rejects.** This is not a proxy – no one gave anyone else the power to vote. It was a vote pooling agreement.

**Estrada’s Second Argument**

The buy out provision (the remedy, see below) is void because it is unconscionable.

* + - **Court rejects.** No evidence that she was tricked into this.
		- **Buy out provisions** are valid, favored by courts, and enforceable by specific performance.

**RB:** Estrada’s vote as a shareholder was a breach of the agreement. Her vote as a director was fine, because the agreement did not touch on what she had to do as a director. But the vote as a shareholder was the issue here that triggered the automatic sale of her shares to the other members.

* + No Clark and Dodge rationale possible here – here, there are minority interests that are not party to the agreement (Ventura Group).

**RB:** Broadcast Group is effectively tying the hands of the directors by punishing them if they do not vote they want they want them to when it comes to picking officers. They are able to effectuate what they formally cannot do, because can punish you if you step out of line.

* Remedy is punitive – if you fail to vote the way you agree to vote, you must sale your stock. The shares were worth more than cost plus 8% per year at this point.
	+ If going to walk out on the agreement, try to negotiate buy out agreement so that get fair market value.
	+ If not going to walk out, cost is good. Bring down the hammer.
	+ Trust is undermined if try to bargain more for shares.

**Remedy**: D must sell shares and is no longer part of the board; this is good b/c avoids more conflict.

**Problem** Courts may order specific performance but sometimes that doesn’t solve anything. Courts cannot order parties to engage in a buyout agreement.

* **Do not need to elect close corporation status:**
	+ Some states have statutes that allow you to elect close corporation status. If you do elect close corporation status within the articles of incorporation, then you can cut through a lot of the red tape that has to do with maintaining **corporate formalities.**
	+ However, a lot of corporations **do not** elect close corporation status because:
		- Want corporate formalities for own protection. With formalities, there is more certainty. With close corporations, do not know what is really going to happen because not as much interpretation of the business code with respect to close corporations (i.e. piercing the corporate veil laws)
		- Also, many of these closely-held corporations might be looking to expand.

**RB:**  Courts recognize importance of such deals in closely held corporation and will not invalidate it where it is reasonable to protect interests of shareholders.

**General Rule: one may make agreement to become directors but not on how they will vote as directors, unless all shareholders agree to it!!!**

**E. ABUSE OF CONTROL**

* **General rule:** Shareholders do not owe each other fiduciary duties.
* **Exception:**
	+ **Controlling shareholders (Sinclair):** A controlling shareholder in a public corporation might be found to owe fiduciary duties to the minority shareholders and may be found to breach those fiduciary duties if they exercise control in a certain way (give themselves a benefit to the exclusion of the minority shareholders).
	+ **Closely held corporation:** Because closely held corporations are small, it is common for people to have controlling blocks/alliances. It is common for people to use that control to directly further their own personal interests.

🡪 Courts have come up with special rules in the closely held context.

*Wilkes v. Springside Nursing Home, Inc.*  ***=* test for freezeout**

**Facts:**

Four investors form a corporation to operate a nursing home – a closely held corporation. They have an understanding (not a formal agreement though) that they are all going to work for the corporation – members of the board, officers with different responsibilities, etc. They will each draw an equal salary if conditions permit. Corporation does not pay dividends.

Wilkes and Quinn have a falling out about the sale of some corporate property. Wilkes gave notice of his intention to sell his shares. Quinn and the others stop paying Wilkes a salary, do not re-elect him to the board, and fire him without cause (he had been performing his duties competentnly). Quinn and the others keep drawing salaries. They did not want to buy his shares off him.

Wiles sues the other 3 shareholders for damages, arguing that they breached their fiduciary duties owed to him as the minority shareholder.

**RB:** Normally, shareholders do not owe each other a fiduciary duty. But… **Rule:** In a closely held corporation, the majority stockholders have a fiduciary duty to the minority shareholders.

* + **Why special duty for shareholders in closely held corporation?**
		- Danger that a minority shareholder will be frozen out of all economic benefit (no dividends being paid here, no salary to him, cannot sell shares and cash out like you can in a public corp because there is no secondary market for it).
			* In other words, a danger of oppression to minority shareholders
		- Analogize to partnership law, but do not adopt partnership standards entirely (duty of the utmost loyalty).
			* After all, they chose a corporation, not a partnership.
			* Do not want to impose undue limitations on the legitimate action by the controlling group of shareholders
			* **RB:** Had this been a partnership, we would look to the partnership agreement or to the UPA to determine what each partner is entitled to (default = equal share).
				+ Then, if Wilkes just quit, the partnership would end absent an agreement, and the partnership would have to then divvy up the assets. Easy way out.

**Holding**

Breach of fiduciary duty. Remand for damages.

**Wilkes Rule: To determine whether a majority block of shareholders have frozen out a minority shareholder in a closely held corporation, thus breaching their fiduciary duty:**

1. If the action of the majority is challenged by the minority shareholder for breach of fiduciary duty like this, the majority shareholder has the burden of showing some **legitimate business purpose** for the challenged action. [This is what was applied here; see below].
2. Even if majority satisfies that standard, the minority shareholder can come back and say that the majority could have achieved that purpose in a **manner less harmful/restrictive to the minority interest.**
3. The court will then weigh the **totality of the circumstances** to decide if there was a breach.

**Application to this case:** Breach of fiduciary duty because majority cannot show a legitimate business purpose (if they could have, this would not have been a breach). The only purpose was that they were trying to freeze him out. The Court stopped the test at part 1 here and did not do any weighing b/c majority had no valid purpose.)

**Remedy**

Damages from the other shareholders – what he expected to receive (salary, for ex.) In a close corporation, the other shareholders took the excess money that would have gone to P. Therefore, the damages come from them.

* + But if the money was being kept in the corporation, the damages should come from the corporation. It’s all about where the money went.
* D should argue that back pay is improper because P should have mitigated damages.

**Alternative Potential Court Reasoning:**

Implied contract (that he would receive a salary) breached by the other three shareholders.

**Alternate Theory: Possible Dominant Shareholder Sinclair type argument**

D was dominant shareholder and conferred benefit upon himself to the exclusion of minority shareholders. You benefitted yourself at the exclusion of the minority shareholder.

-Defenses of the other three would be that:

 (a) D was not a majority/dominant shareholder, and

 (b) not to the exclusion of minority shareholders, because the minority shareholder is not entitled to a job, or a salary, etc.

**Alternate Theory: Effective Breach of Duty of Loyalty argument**

Claim that the other three people breached their duty of loyalty as directors to him, a shareholder. (Instead of arguing that they breached their duty as shareholders to him).

Wilkes could argue, as a shareholder, that you, directors, are attempting to profit individually at the corporation’s expense. And, the board would not be able to sanitize it because all directors are interested. Thus, BJR wouldn’t apply, so board would have to prove the transactions are fair.

Analysis Q7, p. 613) This should have been avoided by making up front decisions – employment contract, shareholder agreement, buy-out agreement (have remaining shareholders buy back his shares) – basically, just provide for what to do at the outset and sign an agreement as a planning technique.

**Criticisms of the Wilkes Test:**

* + - Muddying expectations, making it harder for people to decide in advance what will be the rules that govern their business relationship. People are choosing a corporation, and expect fiduciary duties under corporation law. However, under this test, they get strange duties.
		- Not deferring to business judgment. The directors have fiduciary duties. If sue them in their capacity as shareholders, will have to get beyond business judgment rule protection. Therefore, minority shareholder may not have a remedy.
		- Court is upset about what happened and that’s why it stepped in.
		- Not clear that this intermediate rules adds value.

*Ingle v. Glamore Motor Sales, Inc****. =* (employment contract vs stock contract)**

**Facts:**

Ingle is hired by Glamore as a sales manager. Over time, Glamore sells Ingle 40 of his 100 shares.

They sign a Shareholders Agreement – Glamore will be entitled to buy back any stockholder’s shares if his employment ends for any reason.

Eventually, Glamore brings his sons into the agreement, fires Ingle, and buys Ingle’s shares back for $96,000. Ingle sues.

**Ingle’s Argument**

As a minority shareholder in a closely held corporation, I was owed a fiduciary duty by the other shareholders and that duty was breached when I was fired and my shares were bought back at this price.

Ingle argues that since he was a shareholder of a closely held corporation, he was more like a partner than a run of the mill employee.

**Holding**

Ingle Loses.

If a close corporation shareholder status dominates, there is a fiduciary duty and potential for a violation. But, if employment status dominates, then there is no fiduciary duty.

 **Here - No freeze out and no violation.** He was an employee, and the shareholders agreement made it clear that his shares could be repurchased. No expectation of partnership. **The employment status dominates over quasi-partner type status. Expectations matter.**

Differences between Ingle and Wilkes To Reconcile Them**:**

* + Ingle = **Not a total freeze out.** Ingle got money for his shares. Vs. Wilkes was totally locked out and did not get anything.
	+ **Different type of relationship at the outset.** Ingle was an employee when he started out; he did not expect a return as his compensation as being a shareholder because he was not a shareholder. Wilkes started out more like a partner and had the expectation of a salary.
	+ **Evidence of what they expect their rights as shareholders to be.** Contract evidence in Ingle that contemplated a buy out in the shareholders agreement.
	+ **Different jurisdiction.** Cases in this area are all over the place.

**Remedy**

If Ingle had been able to show a fiduciary duty violation and Ingle is allowed to get damages, he can double dip because he can get another job. (Of course, that might lead to a mitigation of his damages.)

**RB:** What should Ingle have done to protect himself? Read the contract closer, insist on a better buy-out provision, try to get an employment contract instead of just a shareholder agreement.

**Terminiello v. Chicago**

* F

**Cantwell v. Connecticut**

* F

**Feiner v. New York**

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**Chaplinsky v. New Hampshire**

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