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NOTES AND COMMENTS

Close Corporations—Bad Faith of Majority

"It must be conceded that closely held corporations are easily subject to abuse on the part of dominant stockholders, particularly in the direction of action designed to compel minority stockholders to sell their interest at a sacrifice."[1] Frequently these dominant stockholders are also corporation officers and directors in the close corporation and thus are in an even better position to take unfair advantage of the minority.[2] The older cases have seemingly ignored this fact,[3] but it has been recognized as important in more recent cases.[4] In line with the informal way that close corporations are run, courts tend to ignore the differing fiduciary obligations of directors, officers, or stockholders, and business men themselves do not worry about the capacity in which they make a transaction.[5] Analysis is often best made in terms of the interests of the "majority" and the "minority," and many courts rule that the "majority," when actually controlling the corporation, has a fiduciary relation to the "minority."[6] No fiduciary relation arises from the mere fact of owner-

[1] Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692, 695-696 (Sup. Ct. 1947); See Note, 35 N. C. L. REV. — (1957) for a discussion of derivative suits and other remedies available to injured stockholders.

[2] See Bellows v. Porter, 201 F. 2d 429 (8th Cir. 1953); Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); McCarthy v. Osborn, 223 La. 305, 65 So. 2d 776 (1953); Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1953); Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919); Schramme v. Cowin, 205 App. Div. 520, 199 N. Y. Supp. 98 (1st Dep't 1923); Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692 (Sup. Ct. 1947); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951); Thurmond v Paragon Colliery Co., 82 W. Va. 49, 95 S. E. 816 (1918).

[3] See Cross v. Farmers' Elevator Co., 31 N. D. 116, 153 N. W. 279 (1915); Schramme v. Cowin, *supra* note 2; Thurmond v. Paragon Colliery Co., *supra* note 2.

[4] Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951); Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692, 695-696 (Sup. Ct. 1947) (dictum).

[5] *Cf.* Latty, *The Close Corporation and the New North Carolina Business Corporation Act*, 34 N. C. L. REV. 432, 453 (1956).

[6] Southern Pac. Co. v. Bogert, 250 U. S. 483 (1919); Lebold v. Inland S. S. Co., 82 F. 2d 351 (7th Cir. 1936); Hein v. Jobes, 14 F. 2d 29 (8th Cir. 1926); Consolidated Gold Mining & Milling Co. v. Gouthier, 22 Ariz. 67, 193 Pac. 1021 (1938); Thayer v. Valley Bank, 35 Ariz. 238, 276 Pac. 526 (1929); Garrett v. Reid-Cashion Land & Cattle Co., 34 Ariz. 245, 270 Pac. 1044 (1928); Red Bud Realty Co. v. South, 153 Ark. 380, 241 S. W. 21 (1922); Bodell v. General Gas & Elec. Corp., 15 Del. Ch. 119, 132 Atl. 442 (1926); Riley v. Callahan Mining Co., 28 Idaho 525, 155 Pac. 665 (1916); Veeser v. Robinson Hotel Co., 275 Mich. 133, 266 N. W. 54 (1936); Gaines v. Long Mfg. Co., *supra* note 4; Holub v. Jacobowitz, 123 N. J. Eq. 308, 197 Atl. 423 (1937); Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919); Heller v. Boylan, 29 N. Y. S. 2d 653 (Sup. Ct. 1941); Gerdes v. Reynolds, 28 N. Y. S. 2d 622 (Sup. Ct. 1941); Levy v. Feinberg, 29 N. Y. S. 2d 550 (Sup. Ct. 1941); Singer v. Carlisle, 26 N. Y. S. 2d 172 (Sup. Ct. 1940); Dodge v. Scripps, 179 Wash. 308, 37 P. 2d 896 (1934).

ship of a majority of the shares;[7] this fiduciary obligation is less than the trust relation of directors and in essence seems to be that this group not be guilty of bad faith in exercising its control of the corporation.[8] This Note is concerned with those acts of the majority towards the minority in certain corporate transactions which "freeze out" the minority and from which courts might find the evidence of bad faith required before interference in the internal affairs of the corporation.[9] To be distinguished are illegal acts or acts not within the corporate powers which this Note does not consider.[10]

Problems connected with the issuance of shares will be discussed in the text because the courts have apparently been reluctant to find bad faith in this area, although in some instances this device has proved to be more than ordinarily well adapted to "freezing out" the minority.[11] When a minority shareholder of a close corporation is unable or unwilling[12] to purchase his pro rata share of an issue of stock, pre-emptive rights would be inadequate to protect his interests from dilution, especially in the usual case where there is no adequate market for the sale of his rights in the stock issue.[13] Also in closely held corporations the majority

[7] Robb v. Eastgate Hotel, Inc., 347 Ill. App. 261, 166 N. E. 2d 848 (1952); Mairs v. Madden, 307 Mass. 378, 30 N. E. 2d 242 (1940); Levy v. American Beverage Corp., 265 App. Div. 208, 38 N. Y. S. 2d 517 (1st Dep't 1942).

[8] See cases cited note 2 *supra.*

[9] See Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953); Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1939); Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919).

[10] See Macon Gas Co. v. Richter, 143 Ga. 397, 85 S. E. 112 (1915) (increase of capital stock in excess of amount provided by charter); Woodruff v. Columbus Inv. Co., 135 Ga. 215, 68 S. E. 1103 (1910) (unauthorized amendment of the charter); Edward v. Peabody Coal Co., 9 Ill. App. 2d 234, 132 N. E. 2d 549 (1956) (denial of pre-emptive rights); Amick v. Coble, 222 N. C. 484, 23 S. E. 2d 854 (1943) (withholding of dividends in violation of a statute providing for the payment of dividends from accumulated profits).

[11] *Cf.* S. B. No. 49, N. C. Gen. Assembly, Sess. 1955 § 55-46, Comment C: "It has been too often assumed that denial of pre-emptive rights is bad and that, on the other hand, the giving of a pre-emptive offer to shareholders puts the treatment of shareholders beyond attack. Actually, perhaps more 'squeezes' of shareholders (particularly the family of deceased substantial shareholder) have been engineered by use of pre-emptive rights, at far below value, than by their denial."

[12] See Bennett v. Breuil Petroleum Corp., 99 A. 2d 236, 240 (Del. Ch. 1953): "But defendants say plaintiff has not been injured, even assuming that the price is grossly inadequate, because he is being offered his pro rata share of the additional shares. This argument is wide of the mark. I say this because plaintiff has the right not to purchase as well as the right to purchase. But his right not to purchase is seriously impaired if the stock is worth substantially more than its issuing price. Any other purchase at that price obviously dilutes his interest and impairs the value of his original holdings."

[13] See Bellows v. Porter, 201 F. 2d 429 (8th Cir. 1953); Bennett v. Breuil Petroleum Corp., *supra* note 12; Jones v. Concord & M. R. R., 67 N. H. 234, 30 Atl. 614 (1892); Schramme v. Cowin, 205 App. Div. 520, 199 N. Y. Supp. 98 (1st Dep't 1923); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951); Cross v. Farmers' Elevator Co., 31 N. D. 116, 153 N. W. 279 (1915); Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S. E. 816 (1918).

A majority conceivably might attempt to prove that a share issuance would not injure a minority by showing the presence of an adequate market for the sale of the minority's rights in the issue. If this were permitted by the court, perhaps the can effectively deprive the minority of the profits of the corporation by withholding dividends and paying themselves excessive salaries.[14] Corporate dissolution, reorganization, and other transactions which have been used as "freeze out" devices will not be treated at length because they are often complicated by detailed statutory regulation and dissimilar fact situations.[15] The cases selected have been picked mainly because it is thought they could be more readily compared with each other and perhaps would reveal some of the basic anatomy of bad faith.

The control of the corporation by the majority in a manner which injures the minority interest is not alone enough for the courts to find a bad faith motive in the absence of other specific evidentiary facts tending to show bad faith.[16] Thus it becomes important to examine the cases in this area to determine what actual factors present led to the decision that bad faith was or was not present.

The sufficiency of the business reason for the majority action may well be a determining factor.[17] If it is shown that a transaction causing gain to majority and loss to minority did not realize any substantial advantage for the corporation itself, the lack of a sound business reason may be fairly apparent.[18] And even when there is an actual or colorable gain to the corporation on the transaction, the fact that the same benefit could have been achieved by a means fairer to the minority makes the propriety of the majority's motive at least questionable.[19] This may have

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majority could cloud the issue sufficiently for a finding of an adequate market to be made even when there is not one. In such an event, there would seem to be little recourse for a plaintiff.

[14] See Tower Hill-Connellsville Coke Co. v. Piedmont Coal Co., 64 F. 2d 817 (4th Cir. 1933); Whittemore v. Continental Mills, 98 F. Supp. 387 (S. D. Me. 1951); W. Q. O'Neall Co. v. O'Neall, 108 Ind. App. 116, 25 N. E. 2d 656 (1940); Flemming v. Heffner & Flemming, 263 Mich. 561, 248 N. W. 900 (1933); Miner v. Belle Isle Ice Co., 93 Mich. 97, 53 N. W. 218 (1892); Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1939); Anderson v. W. J. Dyer & Bro., 94 Minn. 30, 101 N. W. 1061 (1904); Jones v. Van Heusen Charles Co., 230 App. Div. 694, 246 N. Y. Supp. 204 (3d Dep't 1930); Nebel v. Nebel, 241 N. C. 491, 85 S. E. 2d 876 (1955); Gaines v. Long Mfg. Co., 234 N. C. 331, 67 S. E. 2d 355 (1951); Patton v. Nicholas, 154 Tex. 385, 279 S. W. 2d 848 (1955); Nichols v. Olympia Veneer Co., 139 Wash. 305, 246 Pac. 941 (1926).

[15] N. C. GEN. STAT. § 55-113 (b) [eff. July 1, 1957] (Supp. 1955) may soon cover these types of situations.

[16] Bellows v. Porter, 201 F. 2d 429 (8th Cir. 1953); Jones v. Concord & M. R. R., 67 N. H. 234, 30 Atl. 614 (1892); Schramme v. Cowin, 205 App. Div. 520, 199 N. Y. Supp. 98 (1st Dep't 1923); Cross v. Farmers' Elevator Co., 31 N. D. 116, 153 N. W. 179 (1915); Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S. E. 816 (1918).

[17] See Atlantic Refining Co. v. Hodgman, 13 F. 2d 781 (3d Cir. 1926).

[18] See Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951) (the stock issuance would reduce the book value of plaintiff's stock from about $50,000 to about $800, and facts were alleged which tended to show that the stock issuance was unnecessary); Nichols v. Olympia Veneer Co., 139 Wash. 305, 246 Pac. 941 (1926) (loss of dividends to nonworking stockholders by paying working stockholders twice as much as working nonstockholders, although most of working stockholders did the same sort of routine work as working nonstockholders).

[19] See Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953). Plaintiff admitted that the corporation was not in good financial shape, but he

been a factor persuading the court to find in favor of the plaintiff in *Gaines v. Long Manufacturing Co.*[20] There, the majority, which had been withholding dividends, proposed to reduce the corporate debt in a fashion which "froze out" the plaintiff minority stockholder. The plaintiff countered with two alternative resolutions of his own. These set out detailed plans, consistant with sound business practice, for achieving the debt reduction in a manner which would preserve all of the stockholders' respective interests in the corporation and also allow a dividend to be paid.

When the motive for the issuance of stock is questioned the apparent necessity for new financing seems to be of primary importance. If some good business reason for new financing can be found, the court may be strongly influenced to say this falls within the business discretion of the majority and dismiss any injury suffered by the minority as an incidental hazard of business.[21] There must be more than a mere allegation of bad faith; facts tending to show bad faith must be alleged and proved. Nor is the fact that the necessity for refinancing arises out of a debt owed by the corporation to the majority, in itself, evidence of bad faith.[22] Of course if the issuance of shares which depletes plaintiff's interest is apparently unnecessary for new financing, this would seem to be strong evidence of bad faith.[23]

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contended that although he was not denied pre-emptive rights, the newly authorized stock was issued for the purpose of forcing him out. He sought cancellation of the stock. An amendment to the certificate of incorporation had lowered the par value of the stock and doubled the number of authorized shares. The defendant majority stockholders purchased the entire issue at par. Plaintiff claimed that the par value was less than one-sixth of its fair value. Defendant's motion to dismiss and for summary judgment was denied. It seems that the majority could have been fairer to the minority without damaging their own interests by purchasing the stock at a higher price.

[20] 234 N. C. 331, 67 S. E. 2d 355 (1951); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951) (connected case).

[21] See Bellows v. Porter, 201 F. 2d 429 (8th Cir. 1953). Here the corporation had operated at a net loss in two recent years. Defendant majority stockholder purchased the entire issue of new stock, in payment releasing a large debt owed to him by the corporation. Plaintiff minority stockholder was not denied pre-emptive rights, but alleged he was financially unable to purchase his pro rata share and that the purpose of the issuance was to deplete the book value of his stock. In Schramme v. Cowin, 205 App. Div. 520, 199 N. Y. Supp. 98 (1923) plaintiff was not denied pre-emptive rights. The corporate assets consisted of vacant lots, and the corporation was indebted to the majority stockholders. Plaintiff claimed the stock increase was for the purpose of depleting his interest in the corporation, and that it was known to defendants that he was unable to purchase his pro rata share. A directed verdict for the defendant was affirmed.

[22] Cases cited note 21 *supra*.

[23] See Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951). The majority stockholders passed a resolution authorizing the issuance of the unissued authorized capital stock for the purpose of paying a debt of Long Mfg. Co. to Long Supply Co., a corporation wholly owned and controlled by the individual defendants. Plaintiff minority stockholder alleged that the resolution was passed in bad faith to destroy the value of his shares. Also facts were alleged which tended to show that the assets of Long Mfg. Co. were sufficient to pay the indebtedness to Long Supply Co. and have sufficient working capital left. The court affirmed an

Where bad faith in the withholding of dividends is charged, the same business reason criterion can be applied; there is an examination of the corporation's financial structure to determine whether a surplus existed from which a dividend could be paid.[24] Just as the existence of a debt owed by the corporation to the majority is not enough by itself, the finding of an adequate surplus alone is not sufficient evidence of bad faith.[25] However, where a surplus exists bad faith may be more easily found if there is other evidence pointing to improper motivation.[26]

An examination of the prior relations between the minority and the majority plus the history of the dealings of the majority with the corporation may reveal evidence of an improper motive for the actions of the majority which damaged the minority interest. This evidence can be divided into two classifications: evidence of an attitude of hostility towards the minority, and evidence of prior activities of the majority which, though not openly hostile, were unfair to the minority.

There are numerous ways the majority can express a hostile attitude towards the minority. Strained relations and the previous effort of the majority to buy out the minority are indications of the majority's hostility.[27] The adoption of an amendment of the by-laws for the purpose of forcing plaintiff to resign as officer has been used as evidence to sway the court to find bad faith.[28] And in one case the court was influenced by a letter written by defendant which was susceptible of the interpretation that he would use his power as the majority stockholder to the detriment of plaintiffs, and by evidence of oral declarations to the effect that he would not pay dividends as long as plaintiffs were

order overruling the demurrer and continuing the temporary injunction against the issuance of stock until final determination.

[24] See Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1939); Anderson v. W. J. Dyre & Bro., 94 Minn. 30, 101 N. W. 1061 (1904); Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692 (Sup. Ct. 1947); Gaines v. Long Mfg. Co., 234 N. C. 331, 67 S. E 2d 355 (1951); Patton v Nicholas, 154 Tex. 385, 279 S. W. 2d 848 (1955).

[25] Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692 (Sup. Ct. 1947); Jones v. Costlow, 349 Pa. 136, 36 A. 2d 460 (1944); Keough v. St. Paul Milk Co., 205 Minn. 96, 118, 285 N. W. 809, 821 (1935) (dictum).

[26] See Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1939); Jones v. Van Heusen Charles Co., 230 App. Div. 694, 246 N. Y. Supp. 204 (3d Dep't 1930); Patton v. Nicholas, 154 Tex. 385, 279 S. W. 2d 848 (1955). In Gottfried v. Gottfried, 197 Misc. 562, 73 N. Y. S. 2d 692, 695 (Sup. Ct. 1947) it was said: "There are no infallible distinguishing ear-marks of bad faith. The following facts are relevant to the issue of bad faith and are admissible in evidence: Intense hostility of the controlling faction against the minority; exclusion of the minority from employment by the corporation; high salaries, or bonuses or corporate loans made to the officers in control; the fact that the majority group may be subject to high personal income taxes if substantial dividends are paid; the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible. But if they are not motivating causes they do not constitute bad faith as a matter of law."

[27] See Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953).

[28] Kavanaugh v. Kavanaugh Knitting Co., 226 N. Y. 185, 123 N. E. 148 (1919) (corporate dissolution).

stockholders and of the circulation of letters among corporation employees charging plaintiffs with petty faults.[29]

Falling in the other category, that of acts which though not clearly hostile, are illegal or unfair to the minority, would be the payment to defendant majority stockholders of salaries in excess of their worth,[30] and conversion of corporate property by a majority stockholder.[31] Also the sale of stock at a par value less than the fair value would be unfair to a minority unable to purchase its pro rata share, and reduction of par shortly before the sale would be some evidence of a deliberate intention to be unfair.[32] It is interesting to note that, except in *Bennett v. Breuil Petroleum Corp.*,[33] neither of the two classifications of evidence above mentioned seem to have been used in determining the existence of bad faith in the cases where pre-emptive rights had not been denied.[34]

An extensive loss to the minority, especially when coupled with a gain to the majority, is probably enough to raise a logical doubt as to the likelihood of there being a sufficient business reason for the transaction causing the loss. Apart from this, however, the plight of a greatly injured plaintiff might also have a psychological impact on a finder of fact. A judge or juror could conceivably be more easily persuaded that the majority was motivated by bad faith when the damage to the minority is unusually serious. This suggests that when the courts in the older cases refused to interfere in the internal affairs of the corporation, saying that if plaintiff could not exercise his pre-emptive rights he could sell them,[35] they sensed the inequity in allowing such injury to be without judicial remedy and felt a need to justify their decisions.

A basic fact to consider has been the general refusal of the courts to interfere in corporate business. This appears to have been one of policy. Perhaps the courts felt that a bad faith motive was too intangible[36] to

[29] Patton v. Nicholas, 154 Tex. 385, 279 S. W. 2d 848 (1955) (withholding of dividends).

[30] See Jones v. Van Heusen Charles Co., 230 App. Div. 694, 246 N. Y. Supp. 204 (3d Dep't 1930) (withholding of dividends).

[31] See Keough v. St. Paul Milk Co., 205 Minn. 96, 285 N. W. 809 (1939) (withholding of dividends).

[32] Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953) (issuance of shares).

[33] 99 A. 2d 236 (Del. Ch. 1953).

[34] It may be that such evidence of prior relations was not available, but it is also possible that the attorneys for the plaintiffs did not stress this kind of evidence in their statement of the facts on appeal. At least the reported opinions did not stress this evidence.

[35] See Jones v. Concord & M. R. R., 67 N. H. 234, 240, 30 Atl. 614, 617 (1892); Schramme v. Cowin, 205 App. Div. 520, 199 N. Y. Supp. 98, 100 (1st Dep't 1923).

[36] See Cross v. Farmers' Elevator Co., 31 N. D. 116, 126, 153 N. W. 279, 281 (1915): "His proposition, however, is that, if the motive of the directors of a corporation in selling the balance of the unsold capital stock or in taking subscriptions thereto is to take the control from one who holds the majority of the shares before such sale, such sale is fraudulent and may be set aside, even though such stock is sold at par, and the money therefor is collected. This proposition is to us a novel one, and has no support whatever in principle or in the authorities." While this

justify interference unless the facts virtually indicated a palpable fraud,[37] and that to hold otherwise would increase litigation, unduly harass those controlling the corporation, and impede the growth of industry. An early test was advanced in *Gamble v. Queens County Water Co.*:[38]

> "Their action . . . must not be so detrimental to the interests of the corporation itself as to lead to the necessary inference that the interests of the majority of the shareholders lie wholly outside of and in opposition to the interests of the corporation, and of the minority of the shareholders, and that their action is a wanton or fraudulent destruction of the rights of the minority."

This test suggests that the fortunes of the minority stockholders used to be tied to the fortunes of the corporation, but it ignores the possibility that the interest of the minority in the corporation might be destroyed without damaging the corporation.

Courts are understandably reluctant to interfere in the internal affairs of a corporation.[39] There are business risks incident to stock ownership which the minority assume in becoming stockholders.[40] The success of a corporation depends to a considerable extent on the business discretion of those in control, and courts will not substitute for it their own judgment even to protect the minority from bad judgment unless it is great enough to indicate bad faith.[41] And the old view of bad faith has apparently been adhered to in *Bellows v. Porter*,[42] wherein the minority stockholder sought damages for the dilution of the book value of his stock. The court affirmed a directed verdict for the defendant majority stockholder, and quoted language from *Gamble v. Queens County Water Co.*[43] indicating that when the act is within the powers of the corporation a court will not interfere in favor of the minority unless the action of the majority is opposed to the interests of the corporation itself. In answer to plaintiff's contention that he was financially unable to purchase any of the additional stock, the court quoted from an old case, *Schramme v. Cowin*,[44] to the effect that if the plaintiff could not exercise his pre-emptive rights he could sell them.

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pertains to an injury done to a majority by the directors rather than an injury to a minority by a majority, the analogy seems appropriate.

[37] See Essex v. Essex, 141 Mich. 200, 104 N. W. 622 (1905).

[38] 123 N. Y. 91, 98, 25 N. E. 201, 202 (1890).

[39] See Waldrop v. Martin, 237 Ala. 556, 188 So. 59 (1939).

[40] See case cited note 39 *supra*.

[41] Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 Atl. 257 (1929); Robinson v. Pittsburgh Oil Refining Corp., 14 Del. Ch. 193, 126 Atl. 46 (1924); Allied Chemical & Dye Corp. v. Steel & Tube Co., 14 Del. Ch. 64, 122 Atl. 142 (1923).

[42] 201 F. 2d 429 (8th Cir. 1953).

[43] 123 N. Y. at 99, 25 N. E. at 202.

[44] 205 App. Div. 520, 199 N. Y. Supp. 98 (1st Dep't 1923).

Some courts, however, have become less reluctant to find bad faith than they formerly were. In two cases[45] involving the issuance of stock the courts found evidence of bad faith even though the minority stockholders were not denied the opportunity to purchase their pro rata share. In one of these, *Bennett v. Breuil Petroleum Corp.*, the impracticality of borrowing on pre-emptive rights in the stock issue of a closely held corporation was recognized, and the reasoning would seem to apply also to sale of pre-emptive rights. The court also found that the price for which the new issue of stock was sold amounted to constructive fraud although it was sold at the par value. This appears to be a departure from the old common-law pre-emptive rights doctrine which said that stockholders have the right to purchase their pro rata share of new stock at par when it is sold for cash.[46] The purpose of this doctrine was to protect the stockholders' interest in maintaining their proportionate share of the stock,[47] but in closely held corporations it is likely to injure the minority stockholders when they are unable to take their pro rata share by permitting the majority to take the entire issue at an inadequate par price.[48]

Assume that the majority of a closely held corporation decides to issue the additional shares, which in quantity greatly exceed the authorized shares outstanding. Assume also that the fair value of the shares greatly exceeds the par value, and that the minority stockholder is not actually denied pre-emptive rights, but is unwilling or cannot afford to exercise them. The majority thus purchases the entire issue at par, paying for the stock by releasing a debt owed to it by the corporation. The interest of the minority in the corporation has been seriously depleted with a resulting gain to the majority.

The cases[49] indicate that in the above hypothetical situation the courts probably would not interfere with this transaction unless it appeared that new financing was apparently unnecessary or the majority stockholders had been improvident enough to disclose previously an intention to "freeze out" the minority. It is difficult to justify the argument that this type of loss is a business risk which the minority should be forced to assume. It is surely an unnecessary loss if the corporation could be refinanced by selling the stock at a higher price, and this will be true although the corporation may need refinancing. An unnecessary loss to the minority resulting in gain to the majority would in itself logically

[45] Bennett v. Breuil Petroleum Corp., 99 A. 2d 236 (Del. Ch. 1953); Gaines v. Long Mfg. Co., 234 N. C. 340, 67 S. E. 2d 350 (1951).

[46] See Annot., 52 A. L. R. 220, 239 (1928).

[47] See Note, 41 VA. L. REV. 77 (1955).

[48] *But cf.* N. C. GEN STAT. § 55-56 (b) [eff. July 1, 1957] (Supp. 1955): ". . . . Nothing herein is meant to give a shareholder the pre-emptive right to buy shares at a price determined by their par value."

[49] See note 13 *supra*.

tend to indicate bad faith as the primary motive for the majority's selling itself the stock.

The ease with which the majority of a close corporation can "freeze out" the minority in the above hypothetical situation as well as in many other seemingly valid corporation transactions leads to the conclusion that a change in the law may be desirable to protect the interests of the minority. One remedy might be to allow a minority stockholder in a close corporation appropriate legal relief upon his proof that the corporate transaction in question, engineered by the majority, is one which means gain to the majority at the expense of a loss by the minority. As an extra safeguard, the minority plaintiff should possibly be required to make a sworn allegation that there is no sufficient business reason for the action of the majority and that the motivation for the transaction is a bad-faith one designed to "freeze out" the minority. However, the minority should not be forced to prove this negative allegation; rather, the contrasting presence of a sufficient business reason and good faith should be an affirmative defense for the majority in this action.[50]

The change suggested above is a radical departure from the present case law as outlined in this Note, and is a change which surely can be effected only by legislation. It is believed that this new remedy would prevent many of the "freeze outs" which now go unredressed without unduly impairing the efficiency of corporation management.

GASTON H. GAGE

Corporations—Shareholders' Derivative and Direct Actions—Individual Recovery

In recent case of *Watson v. Button*,[1] the former owner of one half of a corporation's stock brought suit against the corporation's former general manager who had owned the other one half of the stock to recover the amonut misappropriated by the former general manager prior to their sale of the corporation to its present owners. The plaintiff and defendant had agreed to be jointly liable for the corporate debts, and, as a term of the sale, the general manager secured a release from the purchasers discharging him from any claims and demands existing against him in favor

[50] *Cf.* S. B. No. 49, N. C. Gen. Assembly, Sess. 1955 § 55-46 (h) (not enacted), which refers to a shareholder's remedy for the dilution of his holdings by the issuance of shares at an inadequate price. This omitted subsection of the proposed Business Corporation Act would have put on defendant majority the burden of proving that the offering price of shares is fair if the complaining minority show all of the following: (1) the absence of a ready and adequate market for the sale of shareholders' offer rights; (2) notification by the complaining shareholder to the corporation in writing of his inability to purchase his pro rata share and of his belief that the offer price is low enough to unfairly dilute his holdings; (3) evidence tending to show previous efforts by the directors, officers, or dominant shareholders to purchase his shares.

[1] 235 F. 2d 235 (9th Cir. 1956).