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ROSES IN SEARCH OF
GERTRUDE STEIN: THE PUZZLE OF
THE CLOSE CORPORATION

Jan G. Deutsch*

EDITORS' PREFACE

This piece was written by an academic in response to a practitioner's request. The particular puzzle posed by the practitioner was why, in dealing with close corporations, courts used concepts associated with legal categories such as trusts, partnerships, and estates rather than restricting themselves to the field of corporations. In broadest terms, the answer was that noncorporate categories attempt to resolve the same structural problems, although the terms in which the resolutions are articulated represent distinct dialects of the same language, or, in the case of an accountant dealing with a corporate problem, even a distinct language.

Given these terms, what this piece can be said to illustrate are the difficulties presented by the fact that corporate law is a field encompassing two structurally distinct forms of a single entity, and is therefore faced with the task of contradictory trends. In particular, the article attempts to demonstrate the necessary limitations on academic analysis of the precedents that constitute the language of corporate law; limitations inherent in the fact that such precedents respond to the pressures of adherence to general rules of law applicable to all corporate entities while simultaneously informed by the fact that the influence of personal, as opposed to economic, relationships has a particular significance in connection with a group of corporations designated as "close."

Q: Since you’re taking a course in Corporations at school this term, I assume you have read Donahue v. Rodd Electrotype of New England, Inc.1

A: As a matter of fact, I did read that decision, and found it puzzling in the extreme. But since we’re not practicing in Massachusetts, I stopped when I realized there was no mention of Lank v. Steiner,2 the Delaware decision we’ve discussed so often in connection with the legal problems of small businesses.

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1. 328 N.E.2d 505 (Mass. 1975). See also Wilkes v. Springside Nursing Home, 353 N.E.2d 657 (Mass. 1976), a decision which when read with Donahue nicely shows that general rules dealing with close corporations are only as general as the particular case.

2. 43 Del. Ch. 262, 224 A.2d 242 (Del. 1966).
Q: What makes Lank so crucial to an analysis of the Donahue result?
A: To begin with, the first paragraph of Donahue cites two Massachusetts cases for the proposition that "all inferences to be drawn from the facts [as found by the trial court] are open on this appeal." In Lank, however, we have an entire opinion devoted to analyzing precisely why an appellate court is justified in reaching legal conclusions different from those arrived at by the trial judge "who has heard the witnesses and has had an opportunity to gauge their credibility and reliability."

Q: But that opinion was a dissent.
A: Yes, but what it argued was that the majority had committed an error of law; that what should have been held was that persons in whom confidence or trust is reposed assume, as a result, the burden of proving that their actions with regard to persons reposing such trust and confidence meet the high standards associated with a fiduciary relation. And the holding of the Donahue case seems to be that:

In [Massachusetts] cases . . . we have imposed a duty of loyalty more exacting than that duty owed by a director to his corporation . . . or by a majority stockholder to the minority in a public corporation because of facts particular to the close corporation in the cases. In the instant case, we extend this strict duty of loyalty to all stockholders in close corporations. The circumstances which justified findings of relationships of trust and confidence in these particular cases exist universally in modified form in all close corporations . . . Statements in other [Massachusetts] cases . . . which suggest that stockholders of a corporation do not stand in a relationship of trust and confidence to one another will not be followed in the close corporation context.

Q: If that is the Donahue holding, it is more difficult than ever to understand the relevance of Lank, since the Lank dissent cites a Delaware decision as establishing the proposition that "[c]onfidential and fiduciary relations have the same meaning in law;" and Donahue seems explicitly to be confined to an interpretation of Massachusetts precedents.
A: I don't think it's valid to compartmentalize decisions in corporate

3. 328 N.E.2d at 509.
4. 224 A.2d at 248-49 (dissenting opinion).
5. 328 N.E.2d at 509.
6. 224 A.2d at 249 n.5 (dissenting opinion).
7. 328 N.E.2d at 51 (footnote omitted).
9. 224 A.2d at 250 (dissenting opinion).
law quite that rigidly. You yourself have explained to me that legal academics during the 1950's generally seemed to believe that most corporate law problems would be significantly mitigated if special provisions were made for close corporations. Yet what has happened is that those problems have been shifted in focus rather than mitigated, because the same problems are now having to be faced in deciding whether or not a given business can take advantage of the special procedures permissible for close corporations. Indeed, even the Donahue opinion itself, after stating that "[W]e limit the applicability of our holding to 'close corporations' as hereinafter defined" points out: "There is no single generally accepted definition."

Q: It may well be true that one of the prices we pay for living in a federal society is a lack of "generally accepted" definitions of legal entities, but I fail to see why that should prevent the Donahue holding from creating "generally accepted" fiduciary standards for close corporations in Massachusetts.

A: First of all, the decision cited for the description of the duty being applied was a New York precedent, Meinhard v. Salmon. Second, the Donahue court was explicit in defining the duty being made applicable to stockholders in the close corporation as "substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another"; and finally, as is made clear, in, for example, Justice Douglas' dissent in Blau v. Lehman (concerned as it was with the interpretation of § 16(b)), Meinhard v. Salmon has by now become sufficiently "generally accepted" that it cannot plausibly be limited to "the operation of the [close corporation]."

Q: Even agreeing that the confusion between partnerships and corporations and the refusal to recognize the impact of Meinhard v. Salmon on the operation of public as opposed to close corporations present theoretical difficulties, I still don't understand why Donahue is "puzzling in the extreme" if it is read simply as applying the Meinhard v. Salmon standard of fiduciary duty to the operation of the close corporation.

A: If I understand you correctly, you are arguing that, whatever the

10. 328 N.E.2d at 511.
11. Id.
12. Id. at 516.
14. 328 N.E.2d at 515 (footnote omitted).
15. 368 U.S. 403, 416-17 (1962) (dissenting opinion).
theoretical difficulties involved in defining the close corporation, no such difficulties are presented if we read Donahue as standing for the legal proposition that the Meinhard v. Salmon holding that "[j]oint adventures, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty" applies also to the stockholders of close corporations. If that were a "generally accepted" proposition of law, however, it would render Lank v. Steiner meaningless. What that case involved was the question whether one of two sons-in-law — both of whom were involved in the active management of a business — could validly exercise a stock option based on book value for the one-third of the stock held by the father-in-law and his wife. The legal question presented was whether or not the son-in-law should bear the burden of overcoming the presumption of invalidity that attaches to any transaction providing benefits to one of the parties in a fiduciary relationship. The issue in Lank v. Steiner, therefore, was whether a fiduciary relationship existed between the parents and son-in-law. Yet, on your reading of Donahue — since the business involved in Lank v. Steiner was clearly a close corporation — the fiduciary relationship in fact existed between the two sons-in-law.

Q: I'm pleased to see that they teach you to read cases closely at school, but I fear you haven't read Donahue as closely as you should. The court carefully points out, in footnote 18:

We stress that the strict fiduciary duty which we apply to stockholders in a close corporation in this opinion governs only their actions relative to the operation of the enterprise and the effects of that operation on the rights and investments of other stockholders. We express no opinion as to the standard of duty applicable to transactions in the shares of the close corporation when the corporation is not a party to the transaction. 16

A: I'm afraid that is insufficient to distinguish Lank from Donahue. The trial judge in Lank found that the father-in-law was fully aware of the difference between the market and book value of the stock (which represented the benefit conferred on the son-in-law by the stock option) on the basis that the father-in-law, "along with all the stockholders, signed a resolution at a stockholders meeting . . . authorizing the sale of corporate assets [at market value]." As a result, the transaction at issue in Lank did involve "actions relative to the operation of the enterprise."

Q: Are Lank and Donahue in fact distinguishable?

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16. 328 N.E.2d at 515.
17. 224 A.2d at 244.
A: I think so, if we focus on the fact that what *Lank* involved was a dispute among siblings. In *Donahue*, on the other hand, the court explicitly notes that:

In testing the stock purchase from Harry Rodd against the applicable strict fiduciary standard, we treat the Rodd family as a single controlling group. We reject the defendants' contention that the Rodd family cannot be treated as a unit for this purpose. From the evidence, it is clear that the Rodd family was a close-knit one with strong community of interest. 18

Q: Why does that distinction make a difference?

A: In *Lank*, "Steiner acted with his wife throughout in helping the Lanks and in making frequent visits to them. They visited the Lanks more than any of the other children." 19 As a result, the dissent concluded that "The most reasonable inferences to be drawn from the undisputed facts and testimony are, in my judgment, that a relation of trust and confidence existed between the Steiners and the Lanks such as to enable the Steiners to exert influence over the Lanks; and that the Lanks relied upon the Steiners as to the stock options." 20

In *Donahue*, on the other hand, "Harry Rodd had hired his sons to work in the family business, Rodd Electrotype. As he aged, he transferred portions of his stock holdings to his children. Charles Rodd and Frederick Rodd were given positions of responsibility in the business as he withdrew from active management. In these circumstances, it is realistic to assume that appreciation, gratitude, and filial devotion would prevent the younger Rodds from opposing a plan which would provide funds for their father's retirement." 21

Q: If that is a valid distinction, why doesn't *Donahue* stand for the proposition that the stock purchases at issue there constituted a violation of the fiduciary duties owed to a minority shareholder by a united family unit in control of the corporation?

A: I think the facts that made it impossible for that proposition to be the law of this case all occurred before 1955, and are given in the court's opinion.

In the years preceding 1955, the parent company . . . made available to Harry Rodd and Joseph Donahue shares of . . . common

18. 328 N.E.2d at 519.
19. 224 A.2d at 246 (dissenting opinion).
20. *Id.* at 249.
21. 328 N.E.2d at 520 (footnote omitted).
stock . . . Harry Rodd took advantage of the opportunities offered to him and acquired 200 shares . . . Joseph Donahue, at the suggestion of Harry Rodd, who hoped to interest Donahue in the business, eventually obtained 50 shares . . .

In June of 1955, [the corporation] purchased all . . . of its shares owned by its parent company [and the third stockholder] . . . A substantial portion of [the corporation's] cash expenditures were loaned to the company by Harry Rodd, who mortgaged his house to obtain some of the necessary funds.

The stock purchases left Harry Rodd in control of [the corporation]. Joseph Donahue, at this time, was the only minority stockholder.22

Q: That's quite a Corporations course you're taking at school. Maybe when you're finished, you'll be able not only to read cases, but ever to define a corporation; but will you be able to practice law with me?

22. Id. at 509.