1998

Should the Illinois Courts Care about Corporate Deadlock

Thomas J. Bamonte
Chicago-Kent School of Law

Follow this and additional works at: http://lawecommons.luc.edu/luclj
Part of the Antitrust and Trade Regulation Commons, and the Courts Commons

Recommended Citation
Available at: http://lawecommons.luc.edu/luclj/vol29/iss3/4
Should the Illinois Courts Care About Corporate Deadlock?

Thomas J. Bamonte*

I. INTRODUCTION

The so-called Chicago School of Law and Economics has contributed many things to the practice and study of corporate law. For present purposes, its most important contribution may be its insight that a corporation is a "nexus of contracts." In other words, the business enterprise is the product of a large number of relationships between capital suppliers and managers, employees and managers, the enterprise and its customers, and the like. Much of the success of an enterprise depends on the quality of these relationships.

At least in the broad sense of the term, corporate deadlock, which occurs when the relationships between—or among—the principal shareholders and managers of a corporation break down, is certainly not an infrequent occurrence. There are as many possible reasons for deadlock as there are business enterprises. Corporate principals may find themselves at loggerheads because of personality differences, different investment horizons and risk preferences, honest policy differences over the direction of the enterprise, alleged self-dealing by one or more individuals, struggles over succession issues and the like. The opportunity for deadlock is enhanced in the relatively small business, such as the "corporate partnership" between two or perhaps a few more individuals, where the same people assume multiple functions: suppliers of capital, including sweat equity; directors; officers; and shareholders.

* Deputy General Counsel, Chicago Transit Authority; Adjunct Professor, Chicago-Kent School of Law. Mr. Bamonte was a member of the committee that drafted the 1995 amendments to the Illinois Business Corporation Act discussed in this Article, but the views he expresses on those amendments are his own. This Article is adapted from Mr. Bamonte's remarks at the 1997 Family Business Legal & Financial Advisor Conference at Loyola University School of Law on November 11, 1997.


2. See Jensen & Meckling, supra note 1, at 311.
It seems obvious that a business enterprise is harmed when the principals have fundamental disagreements that result in deadlock. Thus, it seems reasonable to expect the courts to be active in attempting to promptly resolve these disputes. Yet, the courts take a decidedly nonchalant approach to the real-life problems of deadlock and are reluctant to intervene on the sole ground that the principals in a corporation are deadlocked. Their behavior begs us to reexamine whether and to what extent deadlock harms an enterprise in a fashion that should attract the law's attention, and to determine the competence of the courts to resolve a deadlock.

Courts are quick to abandon this "hands-off" approach once a deadlocked party takes aggressive self-help measures designed to break the deadlock. Thus, the law of deadlock must be considered in context with the extensive jurisprudence that has arisen regarding the shareholder remedy for oppression, the expansion of fiduciary duties in the close corporation context, and statutes that give complaining shareholders a cause of action to seek dissolution of their corporation or an alternative remedy such as a buy-out of their shares when those controlling the enterprise act wrongfully. Thus, the law of corporate deadlock can best be understood as a judicial high wire act. On the one hand, the courts are reluctant, for good reason, to intervene when the principals in a business enterprise are deadlocked. On the other hand, their hands-off approach provides an incentive for frustrated parties to take self-help measures to break the deadlock that may harm the enterprise more than prompt judicial intervention might have.

This Article discusses why the law of corporate deadlock is so non-interventionist. The Article contrasts this hands-off approach to the more interventionist stance taken by the courts when a corporate principal takes self-help actions, and focuses on the expanded shareholder remedies provisions of the Illinois Business Corporation Act ("BCA"). Further, the Article argues that there are two instances in which the courts should use their expanded equitable powers to intervene in deadlock situations: (1) when the deadlock threatens the

---

3. See Thomas J. Bamonte, Amendments to the Shareholder Remedies Section of the Illinois Business Corporation Act, 84 ILL. B.J. 256 (1996); see also infra note 13 (naming the few reported Illinois cases dealing with corporate deadlock).
4. See infra Part III.A.
5. See infra Part III.B.
6. See infra Part III.B.
7. See infra notes 13-19 and accompanying text.
8. See infra Part II.
9. See infra Part III.
business enterprise itself with serious harm; and (2) when the shareholders, in good faith, are unable to resolve their differences and creative intervention by the court may help to secure a resolution of the problem.

II. THE COURTS AND THE PROBLEM OF CORPORATE DEADLOCK

Illinois law recognizes the seriousness of corporate deadlocks. Section 12.56 (a)(1) of the BCA authorizes the courts to order the dissolution of a corporation, or some equitable alternative to dissolution, when the shareholders or directors are deadlocked and the corporation faces irreparable harm or the business of the corporation no longer benefits the shareholders.

There is relatively little reported Illinois law on the issue of corporate deadlock. Two explanations come to mind. First, the principals in the ongoing dramas of corporate deadlock may not consider deadlock itself to be a problem serious enough to justify the cost of filing suit against a fellow participant in the enterprise. Second, even if deadlock poses significant real-life problems for the corporate principals, the courts do not view deadlock as a serious enough problem to warrant a large expenditure of judicial resources.

10. See infra Part IV.
11. See infra Part IV.
13. See, e.g., Gidwitz v. Lanzit Corrugated Box Co., 170 N.E.2d 131 (III. 1960) (ordering dissolution of a close corporation based on oppressive conduct of its president when he failed to procure shareholder support for corporate action and shareholders were otherwise deadlocked); Kaluzny Bros. v. Mahoney Grease Serv., 518 N.E.2d 1269 (III. App. Ct. 1988) (upholding dissolution of joint venture although it was profitable when deadlock caused majority of disputes); Smith v. Shrader Co., Inc., 483 N.E.2d 283 (III. App. Ct. 1985) (declining to dissolve corporation because no legitimate shareholder deadlock was established where shareholders were merely unable to agree regarding terms of voluntary dissolution or redemption of shares); Mandell v. Centrum Frontier Corp., 407 N.E.2d 821 (III. App. Ct. 1980) (upholding dissolution of partnership when partners were deadlocked regarding sale of property); Callier v. Callier, 378 N.E.2d 405 (III. App. Ct. 1978) (finding evidence of failure to agree on redemption of shares and terms of voluntary dissolution insufficient to order dissolution based on corporate deadlock); Ward v. Colcord, 249 N.E.2d 137 (III. App. Ct. 1969) (holding dissolution may be appropriate when bylaws require unanimous consent for corporate action but shareholders do not agree); Regas v. Danigeles, 203 N.E.2d 730 (III. App. Ct. 1964) (comparing land trust to other business enterprises and ordering dissolution of trust due to management deadlock regarding tenants of trust-owned building); Frerk v. Frerk, 188 N.E.2d 773 (III. App. Ct. 1963) (affirming appointment of interim receiver for deadlocked corporation pending dissolution); Polikoff v. Dole & Clark Building Corp., 184 N.E.2d 792 (III. App. Ct. 1962) (refusing to liquidate corporation upon application of minority shareholders when no evidence of deadlock, oppression, or corporate waste was present).
Based on my experience, the first explanation does not suffice. Corporate principals view disputes with other major participants in the corporate enterprise as very serious problems, both to themselves and to the enterprise itself. Deadlock is often viewed as, at best, a temporary, fragile and unacceptable accommodation that only postpones the inevitable clash for control of the enterprise. More often, deadlock is viewed as the result of one party getting the advantage over other corporate principals. In other words, deadlock often amounts to an assertion of veto power over the direction of the enterprise by one party, who attempts to hold up for personal gain other principal members of the corporate enterprise by asserting this veto power. The deadlock results when the other principals refuse to bend to the wishes of the party with the veto power. Needless to say, enterprises with two fifty percent shareholders are tailor-made for deadlock situations.

However, as observed by Professor Charles Murdock in his important article, mere allegations of corporate deadlock "do not get the judicial blood boiling." Even though judges are human, and no doubt enjoy dramatic cases more than run-of-the-mill disputes, a glance at the docket of most courts shows that a low entertainment quotient cannot explain why courts do not intervene more aggressively in corporate deadlock cases. There are several other possible reasons why courts are reluctant to intervene based solely on allegations of corporate deadlock. First, courts are not especially well-equipped to wade through the often tangled web of business and personality issues that tie up a company in a deadlock. Deadlock cases generate the sort of quarrelsome "he said, she said" questions that are messy, time-consuming and difficult for a court to resolve. It also is difficult for the courts to make the type of business judgments that are often the basis for a deadlock. Should a business expand or contract? Should the principals take out their profits or plow earnings back into the company? What is the best product mix for the company? How should the company be financed? Should the business be sold or passed on to the next generation of family members? The common law and the corporate law statutes provide few, if any, answers to these type of questions. There may be a real social cost to delegating


15. See, e.g., Callier, 378 N.E.2d at 408 (explaining that "[t]he term deadlock and irreparable injury are both undefined and troublesome").
these types of decisions to the courts. The cold shoulder the courts currently give the merely deadlocked participants in a business venture may be a healthy message to corporate principals to go back and work out their differences because the deadlocked participants know the most about their personal financial situations, the company, and the markets in which the company competes.

The second reason why the courts may be reluctant to intervene when deadlock alone is at issue is because such intervention may waste judicial resources. Common sense suggests that in the fullness of time, many disputes, even between business principals who are bitterly divided, will be resolved. Changes in the fortunes of the company, the financial situation or health of the company principals, or a myriad of other factors may be a catalyst for a resolution of the disputes that produced the deadlock. Likewise, the intervention of third parties, such as in the form of pressure applied by the company’s lawyer or banker, or by family members or business associates, may bring the principals to the table and lead to a resolution of their differences. Thus, courts have good reason to be cautious before committing scarce judicial resources to resolve corporate deadlock disputes. Market forces, family considerations, good advice and subtle pressure from third-party advisors and financiers, and a renewed appreciation of the value of mutual self-interest may serve better to resolve a deadlock than a contentious court battle.

The third reason courts appear reluctant to intervene in corporate deadlock situations goes to the heart of the question of what is a corporation. As has been well-documented, the prevailing view of what is the corporation has changed quite dramatically over time. Over several centuries the private business corporation emerged from the municipal corporation as a distinct legal entity. The practice of chartering corporations for specific public purposes emerged in the middle of the last century. It was only after general incorporation laws came into vogue that it truly became possible for corporations to be conceptualized as private entities or associations, and corporate law was understood as a form of private ordering, rather than as a species

---


18. See Millon, supra note 16, at 207 (noting that public functions corporations included private banks, insurance companies, public utilities, and charitable and municipal corporations).
of public law.\textsuperscript{19}

The view of the corporation as the product of private ordering has continued to prevail to this day.\textsuperscript{20} It is that understanding of the corporation that no doubt accounts for the reluctance of the courts to intervene in disputes solely on the grounds of corporate deadlock. If the courts conceptualize the corporation as the product of private ordering, then a deadlock among the principals appears to be akin to an unfortunate spat between private parties, and not something that warrants judicial attention. Courts that subscribe to the notion that corporate law is a form of private ordering among private parties are not inclined to view judicial intervention as necessary in corporate deadlock situations to protect the "public interest" from the harms associated with deadlock. Courts, likewise, trust in the market to supply the deadlocked principals with strong corrective medicine if, in fact, the deadlock begins to harm the operations of the enterprise.

The final reason that courts are reluctant to intervene in deadlock situations is because deadlock is not necessarily bad. Just as deadlock can be the product of selfish and narrow-minded corporate principals who block advancement of the business, it also can result from attempts by wise and farsighted corporate principals to save the company from rash financial or business decisions. Corporate democracy presumably produces the same sort of "deadlocks" that are a feature of political democracy itself. These deadlocks can provide a healthy breathing space for competing demands and issues to be thrashed out in due course. Judicial intervention in deadlock situations can produce an unnatural end to a healthy decision making process.

In sum, the judicial reluctance to intervene in corporate deadlock situations is consistent with the limits of judicial competence, the privatization of corporations and corporate law, and the fact that deadlocks are often a perfectly acceptable outcome during the life cycle of an organization.

III. \textit{BEYOND DEADLOCK: JUDICIAL INTERVENTION IN DISPUTES BETWEEN CORPORATE PRINCIPALS}

Even though the Illinois courts are reluctant to intervene in pure corporate deadlock situations, they are not hesitant to intervene when disputes between corporate participants move beyond the deadlock

\textsuperscript{19} See \textit{id.} at 211-216 (discussing the natural entity theory of corporations which holds that corporations are empowered through their shareholders, not through the state).

\textsuperscript{20} See \textit{id.} at 229-231 (noting the new economic theory emphasis which describes a corporation as a "nexus of contracts").
In the 1995 amendments to the BCA, the Illinois General Assembly signaled its intention that courts continue to actively exercise their equitable powers in intra-corporate dispute situations. However, the judicial decisions concerning the valuation of the interests of disgruntled minority shareholders serve as a check on these two developments.

A. The Shareholder Remedies

As Professor Murdock documented, Illinois was one of the first states to give minority shareholders a remedy against "oppression" at the hands of those in control of the company. The BCA has long provided that shareholder oppression provides a ground for the dissolution of the corporation or the imposition of an alternative remedy, such as the buy-out of the shares owned by the complaining shareholder.

As a practical matter, the cause of action for shareholder oppression is confined to the close corporation setting. Many courts recognize that close corporations are different from public companies in certain important respects. First, it is much more common in a close corporation than in a public company for the large shareholders to also be involved in the day-to-day operations of the company and derive a substantial share of their income from salaries and other perquisites.

---

22. See infra Part III.B.
23. See Murdock, supra note 14, at 455 n.199. Illinois first included “oppression” as a ground for corporate dissolution in 1933. See id. (citing 1933 Ill. Laws 308, 351); see also Harry J. Haynsworth, The Effectiveness of Involuntary Dissolution Suits as a Remedy for Close Corporation Dissension, 35 CLEV. ST. L. REV. 25 (1986-1987) (discussing Gidwitz v. Lanzit Corrugated Box Co., 170 N.E.2d 131 (1960), as one of the first cases to use oppression as a basis of relief for minority shareholders in a close corporation).
24. See 805 ILL. COMP. STAT. 5/12.55 (West 1996). The predecessor of the current section 12.55 of the BCA provided that a court “in lieu of . . . ordering dissolution, may retain jurisdiction and:
   (1) Appoint a provisional director;
   (2) Appoint a custodian; or
   (3) In an action by a shareholder, order a purchase of the complaining shareholder’s shares . . . .”
Id. at 5/12.55 (a)(1)-(3).
25. See, e.g., Galler v. Galler, 203 N.E.2d 577, 583-584 (Ill. 1964) (highlighting the defining characteristics of a close corporation).
26. See, e.g., Battaglia v. Battaglia, 596 N.E.2d 712, 719 (III. App. 1992) (stating that “the conduct of the brothers over the course of 40 years indicates that they maintained a fiduciary duty to each other similar to that of partners”); see also Illinois Rockford Corp. v. Kulp, 242 N.E.2d 228, 233 (III. 1968) (holding that shareholders
A common result is that corporate principals do not hold diversified investments. Instead, most of their capital is tied up in a single enterprise, and thus, they are inclined to aggressively protect their perceived economic self-interest, and are particularly vulnerable to exploitative actions by others in the enterprise.\textsuperscript{27}

Second, the relationship between the corporate principals in the small company may be more than merely commercial–family and friendship ties may also bind corporate principals.\textsuperscript{28} However beneficial these personal and family relationships between the principals of a close corporations are when setting up and capitalizing an enterprise, they often add to the ferocity of the dispute when the principals clash.\textsuperscript{29} Third, there is no ready public market for the stock of the close corporation, denying shareholders the exit remedy that is available to shareholders of public companies.\textsuperscript{30}

The absence of a ready market for the stock of close corporations and the heavy dependence of the corporate principals on salaries rather than dividends as a source of income, provide an opportunity for exploitative self-dealing by those in control of the corporation. A classic example of oppressive conduct occurs when those in control of the corporation freeze out a minority shareholder with a substantial investment by removing the shareholder from the board, terminating the shareholder from his or her job and then causing the company not to pay any dividends.\textsuperscript{31} This tactic allows those in control of the corporation to pay themselves a sizable salary, while depriving the frozen out shareholder any return on his or her substantial investment in the enterprise.\textsuperscript{32}


27. \textit{See Frank H. Easterbrook \& Daniel R. Fischel, The Economic Structure of Corporate Law,} 229-230 (1991). In contrast, shareholders of public companies typically are far more diversified because their capital investments may bear little or no relation to their employment.

28. \textit{See id. at} 228. \textit{See generally} \textit{1 F. Hodge O'Neal \& Robert B. Thompson, O'Neal's Oppression of Minority Shareholders} § 3:06 (2d ed. 1985 \& Supp. 1997) (discussing a squeeze-out technique that involves eliminating minority shareholders from directorate and excluding them from company employment).

29. \textit{See id.} § 2:02.

30. \textit{See Galler,} 203 N.E.2d at 583-84; \textit{see also} Easterbrook \& Fischel, \textit{supra} note 27, at 230-32.


32. \textit{See generally} O'Neal \& Thompson, \textit{supra} note 28, § 3:02 (outlining generally a variety of devices that majority shareholders typically use to benefit themselves at the
As might be expected, there is no bright-line test for what types of shareholder conduct constitute the "oppression" of a shareholder. Distinguishing "oppression" from mere heavy-handedness by those in control of the corporation inevitably involves a highly case-specific weighing of the facts and equities. Illinois has a fairly rich jurisprudence in this area. Most states have joined Illinois in recognizing a cause of action for shareholder oppression. Courts utilize two main approaches. The first approach is to analogize the major shareholders in the close corporation to partners in a partnership and hold major shareholders to a higher fiduciary duty standard. The expense of minority shareholders).


35. See generally Revised Model Business Corporation Act Ann. § 14.30 (1984) (stating that most jurisdictions allow suits to be brought by shareholders to cover deadlock situations and claims of oppression, illegality, fraud or waste). Most jurisdictions follow the Model Act pattern of explicitly allowing a shareholder to bring an action for judicial dissolution on grounds of oppressive shareholder conduct. See id. Those jurisdictions that do not specifically refer to this ground of dissolution include: Delaware, District of Columbia, Hawaii, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Minnesota, Nevada, New Hampshire, North Dakota, Ohio, and Oklahoma.

second approach is to examine the conduct challenged by the disgruntled shareholder and find liability if that conduct was contrary to the reasonable expectations of the shareholders when they entered into the business enterprise.\(^{37}\) These approaches are not mutually exclusive, rather, they are generally complementary. For example, the rationale for imposing enhanced fiduciary duties may well be that when initially establishing the business, the principals reasonably expect that their conduct vis-a-vis each other will be higher than the commercial norm.

Delaware is a notable exception to this trend. Following the lead of some powerful critics of the expansion of fiduciary duties, the Delaware Supreme Court adamantly refuses to apply different fiduciary duty standards in the close corporation setting.\(^{38}\) Its rationale for this rule is to encourage close corporation shareholders to contract with each other for enhanced legal duties rather than enlisting the courts to rely upon general equitable notions to develop such rules.\(^{39}\)

\(^{37}\) See generally Stefano v. Coppock, 705 P.2d 443 (Alaska 1985) (holding that forced buy-out of a minority shareholder of a closely held corporation was not an abuse of discretion); Rosenthal v. Rosenthal, 543 A.2d 348 (Me. 1988) (holding that in the absence of a showing of bad faith or fraud, the business judgment rule prevents a finding that family members breached duties to each other); Zimmerman v. Bogoff, 524 N.E.2d 849 (Mass. 1988) (holding that where parties' dispute was purely private and did not fall within unfair or deceptive trade practice legislation, joint venturer's duty to each other was not breached); Fox v. 7L Bar Ranch Co., 645 P.2d 929 (Mont. 1982) (holding that dissolution of a family corporation was warranted by finding of oppression based on the expectations of the shareholders); Brenner v. Berkowitz, 634 A.2d 1019 (N.J. 1993) (holding that minority shareholder had to establish nexus between fraudulent and illegal acts and minority shareholder or her interest in the corporation); In re Kemp & Beatley, Inc., 473 N.E.2d 1173 (N.Y. 1984) (holding that fraudulent and oppressive conduct by the company's board of directors warranted judicial dissolution); Meiselman v. Meiselman, 307 S.E.2d 551 (N.C. 1983) (involving involuntary dissolution of family corporations); Balvik v. Sylvestre, 411 N.W.2d 383 (N.D. 1987) (holding that the trial court abused its discretion in ordering dissolution); Masinter v. WEBCO Co., 262 S.E.2d 433 (W. Va. 1980) (finding that mere procedural irregularity in holding of corporate meetings is not sufficient to constitute a cause of action under "freeze-out" theory). The "reasonable expectations" approach has not been expressly adopted by the Illinois courts. See 805 ILL. COMP. STAT. 5/12.56. See also MINN. STAT. ANN. § 302A.751 subd. 3a (West 1985 & West Supp. 1998) (directing courts to "take into consideration ... the reasonable expectations of the shareholders"); N.D. CENT. CODE ANN. § 10-19.1-115(3) (Michie 1995 & Supp. 1997) (also directing courts to consider the reasonable expectations of the shareholders).

\(^{38}\) See, e.g., Nixon v. Blackwell, 626 A.2d 1366, 1380-81 (Del. 1993) ("[I]t would be inappropriate judicial legislation for this [c]ourt to fashion a special judicially-created rule for minority investors.").

\(^{39}\) See Blackwell, 626 A.2d at 1380. The court also pointed out that Delaware, like many states, has a special close corporation statute that allows businesses to
Delaware’s approach makes sense—for Delaware. By holding that its general corporate law, which is by far the most developed in the country, applies in the close corporation context, the Delaware courts have helped enhance the attractiveness of Delaware as a place for incorporation of non-public companies.\(^4\)

At the same time, the relatively high cost of incorporating in Delaware may screen out many enterprises whose principals lack the sophistication or the resources to negotiate a shareholders agreement or take other steps to define up front the obligations they owe to one another.\(^4\) If the pool of potential Delaware corporations is limited to a relatively sophisticated group, then it may make sense, from a policy perspective, to apply a uniform set of rules to all Delaware corporations. These same considerations do not apply in other states, where a far greater proportion of the businesses incorporated are relatively unsophisticated; thus, different legal standards governing close corporations makes better sense.\(^4\)

**B. The Amended Shareholder Remedies of The Business Corporation Act**

Before the 1995 amendments to the shareholders remedies section of the BCA, the statute provided that a court could order dissolution of the corporation or an alternative remedy such as a buy-out of the disgruntled shareholder’s stock if the shareholder could prove that it incorporate as close corporations. See *id.* The court reasoned that because the legislature specifically addressed the problems of the close corporation, it was not the court’s role to step in and add its own set of rules. See *id.*


was a victim of oppressive conduct, fraud and the like. The realization that the courts were being overly conservative in applying these remedies propelled the effort to amend the shareholder remedies section.

Most notably, in *Coduti v. Hellwig*, the Illinois Appellate Court held that in order to be entitled to any remedy for oppressive or other wrongful conduct, a shareholder must first establish that the misconduct was serious enough to warrant dissolution of the corporation. This ruling made it extremely difficult for shareholders to secure any remedy when they were victims of oppressive conduct because dissolution is a "drastic remedy," that, in effect, destroys the enterprise in order to save the complaining shareholder. By requiring shareholders to first prove the appropriateness of dissolution before being entitled to any remedy, *Coduti* turned a much less intrusive remedy, such as a buy-out of the complaining shareholder's shares, into a "drastic remedy." Indeed, after the General Assembly adopted the amendments discussed below, the Illinois Supreme Court, interpreting the pre-amendment state of the law, rejected the *Coduti* approach and held that shareholders need not prove the necessity of dissolution in order to be entitled to a less drastic alternative remedy. Had that ruling come a few years earlier, there might well have been no initiative by the corporate bar to press for changes to the shareholder remedies provisions of the BCA.

*Hagshenas v. Gaylord*, perhaps the most important Illinois corporate law decision in the last decade, illustrates the problem with the courts' overly conservative approach to shareholder remedies. *Hagshenas*' notoriety stems largely from the court's holding that large shareholders in close corporations may owe a fiduciary duty to the company and the other shareholders, even if the shareholder no longer is an officer or director of the company, no longer plays an active role in operating the company, and no longer receives a salary from the company. But *Hagshenas* is also important because it illustrates how

---

43. See 805 ILL. COMP. STAT. 5/12.55 (West 1996).
45. Coduti, 469 N.E.2d at 231.
46. See Central Standard Life Ins. Co. v. Davis, 141 N.E.2d 45, 51 (Ill. 1957). But see Murdock, supra note 14, at 440-447 (arguing that corporation financial markets are liquid enough to preserve the intrinsic value of businesses that must be dissolved).
47. See infra notes 62-74 and accompanying text.
50. See id. at 321. The notion that shareholders in Illinois close corporations have
the courts’ reluctance to intervene in disputes among deadlocked shareholders of close corporations can encourage these shareholders to engage in costly and disruptive self-help measures that may have a far greater adverse impact on the company than a well-crafted judicial remedy earlier in the process.

*Hagshenas* involved a successful travel agency business jointly owned and operated by two husband and wife couples.  

Relations between the two couples deteriorated and Hagshenas unsuccessfully tried to sell his shares.  

Hagshenas then petitioned the circuit court under the shareholder remedies section of the BCA, arguing that the shareholders were deadlocked and that dissolution of the company or a buy-out of his shares was appropriate.  

The circuit court denied the petition; the appellate court, when reviewing the case, did not discuss enhanced fiduciary duties in some circumstances is well established.  

*See, e.g.*, Rexford Rand Corp. v. Ancel, 58 F.3d 1215, 1217 (7th Cir. 1995) (stating that "a shareholder in a close corporation owes a duty of loyalty to the corporation and to the other shareholders."); Sebastian v. Zuromski, No. 91-C4529, 1993 WL 78713, at *3 (N.D. Ill. Mar. 18, 1993) (holding that a thirty-three percent shareholder who resigned as officer and director but was unable to sell stock back to the corporation "may have owed a fiduciary obligation to the corporation and its shareholders" until the final sale of stock or dissolution of the company); *In re Dearborn Process Service, Inc.*, 149 B.R. 872, 880 (Bankr. N.D. Ill. 1993) (finding that "shareholders in a closely held corporation owed a fiduciary duty to deal with the utmost good faith, fairly, honestly, and openly with their fellow stockholders."); *Illinois Rockford Corp. v. Kulp*, 242 N.E.2d 228, 233 (Ill. 1968) (concluding that "[t]he decision to form and operate as a corporation rather than as a partnership does not change the fact that they were embarking on a joint enterprise, and their mutual obligations were similar to those of partners" (quoting *Tilley v. Shippee*, 147 N.E.2d 347, 352 (Ill. 1958))); *Doherty v. Kahn*, 682 N.E.2d 163, 175 (Ill. App. Ct. 1997) (concluding that an enterprise in which four shareholders "are directors and officers and participants in the day-to-day operations" was "clearly an enterprise closely resembling a partnership"); *Giammanco v. Giammanco*, 625 N.E.2d 990, 1002 (Ill. App. Ct. 1993) (recognizing principle that "as the sole and coequal shareholders [the parties] . . . owed each other a fiduciary duty similar to that of partners"); *Battaglia v. Battaglia*, 596 N.E.2d 712, 719 (Ill. App. Ct. 1992) (holding that three shareholder-director brothers "maintained a fiduciary duty to each other similar to that of partners"); *see also* *Zokoych v. Spalding*, 344 N.E.2d 805, 819 (Ill. App. Ct. 1976) (finding that "in a two-man corporation stockholders owe each other the duty to deal fairly, honestly and openly"). Other Illinois decisions recognizing the enhanced fiduciary duty standard in the close corporation context include the following: *In re Kids Creek Partners*, 212 Bankr. 898, 936 (Bankr. N.D. Ill. 1997); *Adverse L.A. Inc. v. Shine*, 1996 U.S. Dist. LEXIS 9448 (N.D. Ill. June 11, 1996); *Robinson v. The Midlane Club No. 94-C1459*, 1984 U.S. Dist. LEXIS 14790 (N.D. Ill. Oct. 17, 1994); *Ruca Hardware, Ltd. v. Chien*, No. 94-C3635, 1994 U.S. Dist. LEXIS 14064 (N.D. Ill. Sept. 30, 1994); *Cafeas v. Deltaan & Richter*, P.C., 699 F. Supp. 679 (N.D. Ill. 1988); *Levy v. Markal Sales Corp.*, 643 N.E.2d 1206 (Ill. App. Ct. 1994); *Jaffe Commercial Fin. Co. v. Harris*, 456 N.E.2d 224 (Ill. App. Ct. 1983).

51. See *Hagshenas*, 557 N.E.2d at 318.

52. See id. at 324.

53. See id.
the correctness of the circuit court's rationale for its decision.\textsuperscript{54}

More than a year passed and the relationship between the parties deteriorated further.\textsuperscript{55} Frustrated by the circuit court’s refusal to intervene and by the parties’ inability to resolve their disputes, Hagshenas resigned as an officer and director of the company.\textsuperscript{56} He then set up a competing travel agency and recruited both customers and employees from his old business, in which he remained a fifty-percent shareholder.\textsuperscript{57} The appellate court held that Hagshenas’ actions violated a fiduciary duty he owed to the company and the other shareholders based upon his continued presence as a fifty percent shareholder.\textsuperscript{58} It explicitly based this fiduciary duty Hagshenas owed as a shareholder on the analogy of a close corporation to a partnership.\textsuperscript{59} The power Hagshenas could continue to wield as a fifty-percent shareholder was important to the court’s analysis.\textsuperscript{60}

Some, but not all later decisions, have limited Hagshenas’ extension of fiduciary duties to shareholders to situations where the shareholder has the power to play a major role in operating the company.\textsuperscript{61}

We can only speculate what might have happened had the circuit court in Hagshenas been more willing to step in and attempt to craft an equitable solution to the dispute that drove the principals apart. The shareholder remedies section of the BCA, as amended, attempts to give circuit courts the tools to intervene creatively in such disputes.\textsuperscript{62} The amendments rest on the principle that close corporations substantially differ from large public companies, and thus create a new section—section 12.56—that is devoted solely to the remedies available to the shareholders, officers and directors in non-public Illinois companies.\textsuperscript{63}

\textsuperscript{54} See id.
\textsuperscript{55} See id.
\textsuperscript{56} See id.
\textsuperscript{57} See id. at 318-19.
\textsuperscript{58} See id. at 323.
\textsuperscript{59} See id. at 323-324.
\textsuperscript{60} See id. at 323.
\textsuperscript{61} See also Reese v. Forsythe Mergers Group, 682 N.E.2d 208, 215 (Ill. App. Ct. 1997) (finding Hagshenas is not applicable in public company settings). Compare Dowell v. Bitner, 652 N.E.2d 1372, 1379 (Ill. App. Ct. 1995) (finding that a 23% shareholder who did not have power to “hinder, influence or control” the corporation did not owe fiduciary duties), with Rexford Rand Corp., 58 F.3d 1215 (concluding that a 25% shareholder breached fiduciary duty owed to corporation).
\textsuperscript{62} See 805 ILL. COMP. STAT. 5/12.56 (West 1996). For a list of alternative remedies under section 12.56, see infra note 70.
\textsuperscript{63} See 805 ILL. COMP. STAT. 5/12.56.
Perhaps most notably, section 12.56 makes changes to the “triggers” for the alternative remedies and expands the list of alternative remedies the courts may employ. As with the section 12.55 remedies for the shareholders of public companies, section 12.56 provides a remedy to shareholders of close corporations who are victims of oppressive, fraudulent or illegal conduct by those in control of the corporation. Section 12.56 provides a remedy when the directors or shareholders are deadlocked and the enterprise is crippled as a result. However, section 12.56 is unique in that it provides that close corporation shareholders have standing to bring an action “in his or her capacity as a shareholder, director or officer[.]” Section 12.56 adopts this approach because oppressive conduct may be directed at shareholders in one or more of those capacities and a remedy should be available regardless of the form of the oppressive conduct.

Even though it broadens the basis for shareholder standing, section 12.56 still requires complaining shareholders to make a substantial showing before they are entitled to relief. If they seek relief from deadlock alone, shareholders must establish that the company is threatened with irreparable harm or “the business of the corporation no longer can be conducted to the general advantage of the shareholders[.]” Establishing oppressive conduct, to say nothing of fraud or other illegal conduct, is no easy task. No one should make the mistake of interpreting section 12.56 as giving disgruntled shareholders an easy opportunity to get the relief they seek from those in control of the company.

Section 12.56 provides courts with a non-exhaustive listing of alternative remedies. These remedies range from court-ordered, non-

---

64. *See id.* at 5/12.56(a). For the list of alternative remedies under section 12.56, see *infra* note 70.
66. *See id.* at 5/12.56 (a)(1)-(2).
67. *Id.* at 5/12.56 (a)(3).
68. *See id.* at 5/12.56 (a).
69. *Id.* at 5/12.56 (a)(2).
70. *See id.* at 5/12.56 (b). The express close corporation remedies that are alternatives to dissolution are as follows:
   (1) The performance, prohibition, alteration, or setting aside of any action of the corporation or of its shareholders, directors, or officers of or any other party to the proceedings;
   (2) The cancellation or alteration of any provision in the corporation’s articles of incorporation or bylaws;
   (3) The removal from office of any director or officer;
binding mediation to a buy-out of the complaining shareholder's shares. The statute also provides that dissolution of the company is the remedy of last resort that a court may order only if all other alternative remedies prove insufficient. The amendments also make clear that the circuit court retains all of its equitable powers to shape a remedy specially suited to the circumstances of the shareholder's complaint.

When read in conjunction with the Illinois Supreme Court's decision in Schirmer v. Bear, which interpreted the predecessor statute, it seems especially apparent that section 12.56 introduces a regime that empowers courts to order shareholder remedies that are proportional to the wrongful conduct established by the complaining shareholder. With Hagshenas as an object lesson in the costs of waiting too long to intervene in shareholder disputes, Illinois courts should consider themselves empowered by section 12.56 to step in and be creative in helping corporate principals work out—or thrash out—their disputes. Thus, courts should not be reluctant to refer a case to mediation, or to enjoin challenged conduct until the propriety of that conduct is established, or take a host of other appropriate steps when the complaining shareholder has made some substantial showing of wrongdoing.

In using these equitable powers, the courts should be acutely sensitive to the form of the dispute. Some disgruntled principals want to remain in the enterprise and some are looking for an economically viable way to exit from the enterprise. A buy-out of the complaining

(4) The appointment of any individual as director or officer;
(5) An accounting with respect to any matter in dispute;
(6) The appointment of a custodian to manage the business and affairs of the corporation . . . ;
(7) The appointment of a provisional director . . . ;
(8) The submission of the dispute to mediation or other forms of non-binding alternative dispute resolution . . . ;
(9) The payment of dividends;
(10) The award of damages to any aggrieved party;
(11) The purchase by the corporation or one or more shareholders of all, but not less than all, of the shares of the petitioning shareholder for their fair value . . . .


71. See 805 ILL. COMP. STAT. 5/12.56 (b)
72. See id. at 5/12.56 (b)(12).
73. See id. at 5/12.56 (c).
74. 672 N.E.2d 1171 (Ill. 1996).
shareholder's shares is the obvious remedy of choice when the shareholder seeks to exit the enterprise, but the court's task is more complicated when the plaintiff seeks to remain in the enterprise. In that case, a court-ordered buy-out would defeat the complaining shareholder who had proven that those in control of the enterprise acted wrongly yet wanted to remain part of the revamped corporate enterprise.

C. The Puzzling Problem of Valuation

A stock buy-out is the most common remedy sought by complaining shareholders for the simple reason that disgruntled shareholders often want to exit the company. The BCA provides that shareholders who are successful in obtaining a buy-out of their stock under section 12.56, or who have perfected dissenters rights under section 11.70, are entitled to receive the "fair value" of their stock. Since the state of Illinois has long recognized a shareholder remedy for oppressive conduct and now has an expansive alternative remedies statute, one might expect Illinois courts to define "fair value" in a way that is favorable to the dissenting or disgruntled shareholder. Likewise, one would expect Delaware, a state that rejects special treatment of close corporation shareholders, to have valuation rules that are stacked against the dissenting shareholders.

In fact, the opposite is true. The Delaware courts define "fair value" as meaning that the dissenting shareholders are entitled to their proportional share of the value of the business enterprise. The Delaware courts reject the application of "minority interest" and "lack of marketability" discounts when valuing the shares of dissenting shareholders under the theory that the shareholder being bought out is entitled to his or her full proportionate share of the value of the enterprise. The Illinois courts, however, allow the imposition of such discounts when determining the "fair value" of the stock of dissenting minority shareholders.

75. 805 ILL. COMP. STAT. 5/11.70 (West 1996).
76. See id. at 5/11.70 (c). Section 11.70 (j) of the BCA states that fair value "means the value of the shares immediately before the consummation of the corporate action to which the dissenter objects excluding any appreciation or depreciation in anticipation of the corporate action, unless exclusion would be inequitable." Id. at 11.70 (j)(1).
77. See supra notes 38-40 and accompanying text.
79. See id. at 1143.
A clear definition of "fair value" has eluded the Illinois courts thus far, but an emerging consensus seems to have developed that allows the courts to impose sizable "minority interest" and "lack of marketability" discounts when valuing the complaining shareholder's shares for purposes of a buy-out. These discounts are not required by the BCA. Rather, the courts interpret the BCA as vesting them with the discretion to impose such discounts and most courts are willing to impose them when valuing the interest held by the disgruntled shareholder who is exiting the enterprise.

The problem with such discounts is that they may result in undercompensation of a close corporation shareholder, whose return includes salary and other perquisites, as well as a share of the profits. Because these discounts can shave fifty-percent or more off the amount paid to the shareholder from the shareholder's proportionate share of the value of the enterprise, the continued use of these discounts by the Illinois courts will be a powerful disincentive for dissatisfied shareholders who wish to exit the enterprise to invoke the shareholder remedies section of the BCA.

To the extent that the Illinois courts have considered the relationship between the alternative remedies provisions of section 12.56 and the valuation provisions of the BCA, the current approach can be rationalized. Vesting the circuit courts with broad discretion in the valuation process, including the use of minority and marketability discounts, gives them the flexibility to craft a financially equitable remedy. This is consistent with the equitable powers vested in the courts under section 12.56. One of the dangers of an open-ended definition of "fair value," of course, is that in individual cases, courts will abuse that discretion and undercompensate a shareholder who has triggered the section 12.56 remedies. The larger concern, however, is that in the aggregate their low valuations, based on the application of

---


82. See, e.g., Weigel, 682 N.E.2d at 750.

83. See generally Thomas J. Bamonte, Measuring Stock Value in Appraisals Under the Illinois Business Corporation Act, 80 Ill. B.J. 236 (1992) (stating that states which do not recognize minority and marketability discounts allow for the interest of both minority and controlling shareholders to be more closely aligned toward maximizing the value of the company).

84. See 805 ILL. COMP. STAT. 5/12.56 (c) (West 1996).
minority interest and marketability discounts, will cause fewer aggrieved shareholders to utilize the new shareholder remedies provisions of the BCA than the General Assembly intended.

A legislative definition of "fair value" that clearly includes (or does not include) minority and marketability discounts would be beneficial, especially given the impact that these discounts have on the value of the complaining shareholder’s stock and, thus, the value of the section 12.56 remedies themselves. Parties can more easily bargain around a clear standard in shareholders’ agreements and the like as well. What exists at present, however, is the unresolved tension between the expansive remedial thrust of section 12.56 and the parsimonious approach to valuation taken by the courts when they value the shares held by the complaining shareholder.

IV. DEADLOCK, THE NEW SHAREHOLDER REMEDIES PROVISIONS OF THE BCA, AND THE DUTIES OF RESPONSIBLE PARTIES

The new shareholder remedies of section 12.56 of the BCA should have some effect on how the courts respond when presented with a case of corporate deadlock. As discussed above, courts are reluctant to intervene in corporate deadlock situations; this reluctance may not be all bad from a policy perspective. The adoption of section 12.56 expanded the statutory list of approved remedies that are alternatives to dissolution. Prior to section 12.56, the primary alternative remedy was the buy-out of the complaining shareholder’s stock, and this remedy was often held hostage to Coduti’s demanding proof standard. In the context of the close corporation, where a complaining shareholder may have a very sizeable portion of the stock of the company and the company’s access to capital to fund a stock buy-back is limited, such an alternative remedy can be almost as disruptive as dissolution itself.

As a result of the amendments, courts are specifically authorized to order remedies that are less disruptive to the continued operation of the company than dissolution or a buy-out of the complaining shareholder. These remedies include non-binding mediation, appointment of the complaining shareholder to the board, and other such remedies that are consistent with the courts’ equitable powers.

85. See supra Part II.
86. See 805 ILL. COMP. STAT. 5/12.56 (b). See supra note 70 listing the alternative remedies.
87. See 805 ILL. COMP. STAT. 5/12.56 (b)(1)-(10).
88. See id.
It also is important to note that section 12.56 is intended to supply the courts with the tools to intervene effectively when the complaining shareholder wishes to remain in the enterprise, which is often the case in a deadlock situation. Both dissolution and a buy-out of the complaining shareholder accommodate the disgruntled shareholder who wishes to exit the company and cash out his or her investment. However, dissolution and buy-out provide little relief to a shareholder who wishes to be involved in the enterprise. In contrast, many of the alternative remedies set out in section 12.56 can be invoked by a shareholder who wishes to remain part of the enterprise.

Thus, the changes brought by section 12.56 should encourage the courts to be more willing to intervene in deadlock situations with remedies designed to facilitate a negotiated resolution of the dispute. However, the courts should remain as cautious as they have been historically to invoke the strong remedies of dissolution or a forced buy-out of the complaining shareholder’s shares as a remedy. For example, had the circuit court in *Hagshenas* been armed with section 12.56, it might have responded differently and may have avoided the disruptive self-help initiative by Hagshenas.\(^9\) Consistent with section 12.56, the circuit court might have entered an order barring the parties from raiding the corporate till to pay for personal items, directing the other shareholders to provide Hagshenas with accurate information about the finances of the company, and requiring the parties to mediate their disputes. Skillful mediators are often successful in resolving the most difficult of disputes. Courts can increase the chances of successful mediation by holding out the prospect that they may turn over control of the company to a custodian or appoint a provisional director holding the tie-breaker’s vote if the parties fail to resolve their dispute and underscoring the risks inherent in further litigation.

This is not to suggest that the courts should intervene whenever one principal in an enterprise comes to court and claims that the other principals are behaving unreasonably and that, as a result, the principals are deadlocked. Section 12.56 retains the requirement that before a court will intervene, the complaining shareholder must prove that the company will be irreparably harmed by the continuation of the deadlock.\(^90\) The courts can use this requirement to weed out those deadlocks that are the result of the working of corporate democracy or that have little impact on the operation of the company.

---

89. *See supra* notes 49-63 and accompanying text.
90. *See* 805 ILL. COMP. STAT. 5/12.56 (a)(1)-(2).
In those instances where a principal demonstrates that deadlock is having a major adverse impact on the enterprise, courts should be creative in applying section 12.56, recognizing that deadlock often harms employees, suppliers and creditors of the company and, ultimately, the community at large. Certainly, a court could reasonably conclude that in view of the benefits conferred upon corporations by state law, such as limited liability, the major shareholders in corporations, large and small, should not be allowed to waste unnecessary time and resources on internecine disputes at the expense of the continued health of the enterprise. The larger the enterprise and the larger the number of constituents other than the principals, the more it makes sense to give some legal recognition to the interests of those constituents through the legal fiction of the corporation as a distinct legal entity.

This approach, of course, deviates from the prevailing view of the corporation as a purely private enterprise and corporate law as a species of private contract law. The legislature is free to revive the public law dimension of corporate law, at least to a limited extent, to encourage the courts to give consideration to the interests of the broader range of corporate constituents than the principal officers and shareholders when applying section 12.56. The General Assembly’s adoption of the so-called “other constituency” statute, which allows a board to consider the interests of employees, local communities and other corporate constituents when making decisions where control of the corporation is at stake, is just the sort of approach advocated here.

To the extent that the courts in the corporate takeover context consider the corporation to be an “entity” with its own interests separate and apart from the personal interests of the principals of the corporation, advisors of the corporation should also adopt this view in the event that the controlling parties are deadlocked. The company’s lawyers and accountants can play a creative role in facilitating a

---

91. See Millon, supra notes 16, 29-31 and accompanying text.
92. See 805 ILL. COMP. STAT. 5/8.85 (West 1996). Section 8.85 reads as follows:
In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best long term and short term interests of the corporation, consider the effects of any action (including without limitation, action which may involve or relate to a change or potential change in control of the corporation) upon employees, suppliers and customers of the corporation or its subsidiaries, communities in which offices or other establishments of the corporation or its subsidiaries are located, and all other pertinent factors.

Id.
resolution of difficulties between the principals. They can do so by attempting to bridge the emotional gulf between the two sides. And in some circumstances, they can do so by asserting the interests of the company. This can be by small gestures (e.g., insisting that all sides pay for their copying costs) and large gestures (e.g., appearing in court as separate counsel for the company).

This sometimes confrontational approach can be difficult because it may put the company advisor at odds with a corporate principal with whom the advisor has had long business and social ties. Aggressive representation of the company during intracorporate disputes, however, gives the court a reality check on the appropriate remedy to impose in deadlock situations or other kinds of litigated disputes between close corporation shareholders. Representatives for the company, if credibly independent of the disputants, can provide the court with a valuable source of information about the company and the nature of the dispute.

The BCA already allows the company to investigate claims made by a shareholder in a derivative suit. Surely, the equitable powers vested in the courts under the shareholder remedies section of the BCA likewise vest the courts with the power to order the company’s lawyer and/or other advisors to investigate, in a timely fashion, claims filed by a disgruntled shareholder and report back to the court. The court can then use the report to weigh the evidence provided by the disputants and to frame an appropriate remedy, if any.

By calling upon the company’s lawyer and other advisors to play an independent and active role in disputes under section 12.56, the courts can accomplish at least two goals. First, the courts can obtain relatively objective information about the company and the disputants and hopefully an independent perspective that will be useful in the court’s deliberations. Second, courts can reinforce the notion that the corporation as a business, and as a legal entity, has interests separate from those of its principals that are worthy of protection in litigation under section 12.56.

V. CONCLUSION

Corporate deadlock alone has not engaged the judiciary. Section 12.56 is unlikely to prompt courts to more readily intervene in pure corporate deadlock situations and impose strong remedies such as dissolution of a company or an alternative remedy such as a buy-out of the complaining shareholders’ stock. Section 12.56, however, does

93. See id. at 5/7.80(b).
provide the court with expanded powers to intervene in corporate deadlock situations using less drastic tools designed to facilitate the resolution of the dispute. Courts should utilize these powers carefully, attempting to resolve corporate deadlock situations before they ripen into full-scale warfare among the principals of the corporation. But at the same time, they must recognize that corporate deadlocks sometimes are inevitable and even desirable. In litigation over corporate deadlock, as with litigation under section 12.56 generally, the courts should attempt to utilize the advisors to the company to provide the court with some objective evidence and creative suggestions for appropriate remedies to settle the dispute between the principals. In this area especially, it is important for the advisors to the company to tread carefully and ensure that their allegiance remains with the company and not merely to one of the principals.