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Origin, Development, and Current Status of Fiduciary Duties in Close Corporations: Has Indiana Adopted a Strict Good Faith Standard?

John R. Van Winkle*
Gary R. Welsh**

Introduction

Indiana, like the majority of other jurisdictions, has long recognized that directors and officers of corporations owe certain fiduciary duties to others in the corporation. The general common law rule, applicable to private corporations of all sizes, requires corporate directors and officers to conduct themselves and discharge their duties fairly, honestly, and openly.[1] Although not technically considered trustees, corporate directors were held by courts in equity to stand in a fiduciary relationship to the corporate entity and to the shareholders.[2]

In many jurisdictions, courts and legislatures have differentiated public and widely held corporations from close corporations, imposing more stringent fiduciary duties on directors and shareholders of close corporations.[3] Analogizing close corporations to partnerships and joint ventures, these courts and legislative bodies reason that the nature of the relationship generally existing between shareholders and directors in close corporations justifies or mandates a higher standard of duty.

To preserve and protect the principles of corporate democracy and majority governance, those courts applying a strict good faith test also tend to establish a burden-shifting and balancing test. When the majority

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* Partner, Bingham Summers Welsh & Spilman, Indianapolis; B.A., 1966, Butler University; J.D., 1970, Indiana School of Law—Indianapolis.

** B.A., 1984, Eastern Illinois University; J.D., 1993, Indiana University School of Law—Indianapolis.

1. *See* Hartung v. Architects Hartung/Odle/Burke, Inc., 301 N.E.2d 240 (Ind. Ct. App. 1973) (citing Hill v. Nisbet, 100 Ind. 341 (1885)); *see also* Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957).

2. *See* 1A William M. Fletcher, Cyclopedia of the Law of Corporations § 838, at 177 (Rev. ed. 1983) (Supp. 1991).

3. *See generally* F. Hodge O'Neal & Robert B. Thompson, O'Neal's Oppression of Minority Shareholders (2d ed. 1991); Henry F. Johnson, *Strict Fiduciary Duty in Close Corporations: A Concept in Search of Adoption*, 18 Cal. W. L. Rev. 1 (1981); Charles W. Murdock, *The Evaluation of Effective Remedies for Minority Shareholders and Its Impact upon Valuation of Minority Shares*, 65 Notre Dame L. Rev. 425 (1990); Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 Notre Dame L. Rev. 456 (1985).

or controlling group of shareholders face a claim of breach of fiduciary duty, courts require them to establish a legitimate business purpose for their action.[4] In turn, minority shareholders must demonstrate that the majority could have achieved this legitimate objective by an alternative course of action less harmful to the minority.[5]

One may argue that the Indiana Court of Appeals in *W & W Equipment Co., Inc. v. Mink*[6] implicitly adopted a strict good faith standard, applying a burden-shifting and balancing test. If in fact adopted, a strict good faith standard would clarify the status of the law in Indiana and a more specific standard will be available to determine when, and under what circumstances, a breach of fiduciary duty occurs.

The purpose of this Article is to describe the origin, development, and current status of the law in Indiana regarding fiduciary duties in close corporations. Additionally, it will assert that Indiana implicitly has adopted a strict good-faith standard, as well as a burden-shifting and balancing test. Part I explores the origins of the fiduciary duty in close corporations. Part II discusses the relationship of shareholders in close corporations as an "incorporated partnership," a concept Indiana courts have adopted. Part III maintains that Indiana implicitly has adopted a strict good faith standard of care that shareholders in close corporations owe to other shareholders. Part IV discusses the various contexts in which Indiana courts have found a fiduciary duty. Finally, Part V discusses procedural issues and damage questions relevant to breach of fiduciary duty claims.

I. Origins of Fiduciary Duty

The law of trusts forms the basis for fiduciary duties. Early common law definitions stated that a "fiduciary" is "a person holding the character of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor with which it requires."[7] Stated in more general terms, a "fiduciary" is "a person having a duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking."[8] Fiduciaries in a corporation, however, are not trustees in the strict sense of the term because they do not have title to the estate. Rather, they are fiduciaries because they control the corporation's property.[9]

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4. *See, e.g.*, Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976); Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 511 (Mass. 1975).

5. *Wilkes*, 353 N.E.2d at 663.

6. 568 N.E.2d 564 (Ind. Ct. App. 1991).

7. Black's Law Dictionary 563 (5th ed. 1979).

8. *Id.*

9. 18 Paul J. Galanti, Indiana Practice on Business Organizations § 25.10, at 705 (1991).

The United States Supreme Court, in a leading case of *Pepper v. Litton*,[10] applied common law fiduciary principles by analogy to explain the appropriate rules of conduct for the directors of a corporation vis-a-vis the corporate entity and the shareholders.[11] Justice Douglas, speaking for the Court, detailed a frequently cited code of conduct for the corporate fiduciary:

> He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.[12]

Determining that a person is a fiduciary gives direction to further inquiry: To whom is the person a fiduciary? What are that person's obligations? How has that person failed to discharge those obligations? What are the consequences of the fiduciary's deviation from that duty?[13] The common law has long recognized that directors and officers of corporations are in a fiduciary relationship with the corporation and its shareholders.[14] The director's duty to the corporation and its shareholders is one of complete loyalty, honesty, and good faith.[15] As a fiduciary, "a director's first duty is to act in all things of trust wholly for the benefit of the corporation."[16] This includes a duty to disclose information

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10. 308 U.S. 295 (1939).
11. *Id.* at 311.
12. *Id.*
13. SEC v. Chenery, 318 U.S. 80, 85-86 (1943).
14. *See* 1A FLETCHER, *supra* note 2, at 177.
15. *Id.*
16. *Id.* at 178.

to those who have a right to know the facts.[17] A director is not ordinarily liable for the misconduct of a codirector. However, a director is liable for the misconduct when he or she actually participates in the wrongdoing, or when he or she learns of a codirector's misdeeds and either fails to take action or acquiesces.[18] A director is under a duty to disclose the misconduct of the codirector to the other directors to avoid liability for the acquiescence.[19]

Dominant or controlling shareholders in a corporation have a fiduciary obligation to the corporation and other shareholders similar to that of directors. Courts subject their dealings with the corporation to rigorous scrutiny.[20] Whenever other shareholders challenge their conduct, the controlling shareholders bear the burden of proving that the corporation conducted the transaction in good faith and with fairness.[21] The basic test is "whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[22]

Thus, under the traditional standards of corporate fiduciary duty, the minority shareholder in either a public or a close corporation has the legal right to initiate a suit against the majority shareholders and directors, if the majority shareholders and/or directors engaged in self-serving conduct.[23] In practice, however, corporate offenders traditionally have been protected by two very important corporate principles: (1) the business judgment rule, and (2) the principle of majority control.[24] Because of these rules, courts traditionally have been reluctant to interfere in the internal affairs of a corporation. An early Indiana Supreme Court decision evidences such reluctance:

> It is the policy of the law to leave corporate affairs to the control of the corporate agencies, and the courts are not warranted at the suit of minority stockholders in interfering with the management of such agencies, even though it may be unwise, and may result in loss, except in a plain case of fraud, breach of trust, or such maladministration as works a manifest wrong to them.[25]

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17. *Id.*.
18. Dotlich v. Dotlich, 475 N.E.2d 331, 343 (Ind. Ct. App. 1985).
19. *Id.*
20. Pepper v. Litton, 308 U.S. 295 (1939).
21. *Id.*
22. *Id.* at 306-07.
23. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505, 513 (Mass. 1975).
24. 1 O'Neal & Thompson, *supra* note 3, § 3:03, at 4.
25. Raff v. Darrow, 111 N.E. 189, 191 (Ind. 1916).

II. Application of Partnership Principles to Close Corporations

Historically, courts have had little difficulty applying the principles of corporate democracy to large, widely held corporations. When dealing with close corporations, however, courts wrestled with the different expectations and relationships, as well as the extent to which the participants depended upon the close corporation for their livelihood. The application of principles of strict majority control to close corporations collided with these factors and many perceived that the results were unfair to minority interests. In Judge Cardozo's opinion in *Meinhard v. Salmon*,[26] courts found a legal justification for not applying strict corporate democracy principles to close corporations. In that case, Cardozo applied the strict fiduciary standards applicable to partnerships to joint adventurers. He stated:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attribute of courts of equity when petitioned by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[27]

Following Cardozo's analogy to its logical conclusion, other courts began to apply the same fiduciary principles to directors and shareholders in close corporations. In one of the earliest of such decisions, *Helms v. Duckworth*,[28] Judge Burger declared that "stockholders of a close corporation occupy a position similar to that of joint adventurers and partners."[29] The court in *Helms* held that shareholders in close corporations "bear a fiduciary duty to deal fairly, honestly and openly with their fellow shareholders and to make disclosure of all essential

26. 164 N.E. 545 (N.Y. 1928) (Cardozo, J.).
27. *Id.* at 546.
28. 249 F.2d 482 (D.C. Cir. 1957) (Burger, J.).
29. *Id.* at 486.

information."[30] In adopting a higher standard, the court explained that the traditional view, which held that shareholders of corporations did not bear a relation of trust and confidence to one another, "ignore[d] the practical realities" of a close corporation in which "the stockholders, directors, and managers are the same persons," and in which there is a lack of division between the ownership and management.[31]

In 1975 the Supreme Court of Massachusetts, prompted by *Helms*, decided *Donahue v. Rodd Electrotype Co.*,[32] which imposed a fiduciary duty similar to that owed by partners on close corporation shareholders. In *Donahue*, a close corporation entered into an agreement with a former officer and director to repurchase his shares.[33] Donahue, a minority shareholder, objected and offered to sell her shares to the corporation for the same price and on the same terms as those given the former directors. However, the corporation refused the offer.[34] Donahue sued the majority shareholders, claiming that the repurchase agreement violated a fiduciary duty owed to her by the majority shareholders. The trial court dismissed her complaint, but the Supreme Judicial Court of Massachusetts reversed.[35] The court decided that Donahue's complaint stated a claim for breach of fiduciary duty, and considered the case in the narrow context of a close corporation.[36] The court reasoned that close corporations required distinct judicial treatment:

> Because of the fundamental resemblance of the close corporation to the partnership, the trust and confidence which are essential to this scale and manner of enterprise, and the inherent danger to minority interests in the close corporation, we hold that stockholders in the close corporation give one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another.[37]

The court in *Donahue* adopted a more stringent standard in close corporations, stating: "[S]tockholders in close corporations must discharge their management and stockholder responsibilities in conformity with [a] *strict good faith standard*."[38] To underscore the fact that the court was establishing a higher standard for shareholders in close cor-

30. *Id.* at 487.
31. *Id.* at 486.
32. 328 N.E.2d 505 (Mass. 1975).
33. *Id.* at 510.
34. *Id.* at 511.
35. *Id.* at 521.
36. *Id.* at 511.
37. *Id.* at 515.
38. *Id.* (emphasis added).

porations, the court said: "We contrast this strict good faith standard with the somewhat less stringent standard of fiduciary duty to which directors and stockholders of all corporations must adhere in the discharge of their corporate responsibilities."[39]

In this case, the repurchase agreement provided a single stockholder with a ready market for his shares and operated as a "preferential distribution of assets."[40] Thus, the court in *Donahue* concluded that the strict good faith standard in a close corporation required the controlling shareholders selling stock to the corporation "to offer to each stockholder an equal opportunity to sell a ratable number of shares to the corporation at an identical price."[41]

A year following the *Donahue* decision, the Massachusetts court tempered its holding out of a concern that the unrestricted use of the strict good faith standard might impinge unduly upon the majority's legitimate right to control the corporate activities.[42] The court in *Wilkes v. Springside Nursing Home, Inc.*[43] imposed a two-step analysis upon the strict good faith standard, establishing a burden-shifting process and a balancing test.[44] One commentator explained the *Wilkes* analysis as follows:

> First, the majority must demonstrate a legitimate business purpose for the offending action. If the majority shareholder advances either no purpose or an unsatisfactory purpose, the complaining shareholders are entitled to relief. If a legitimate business purpose is advanced, the complaining shareholders may demonstrate that the legitimate business purpose "could have been achieved through an alternative course of action less harmful to the minority's interest." The court must then "weigh the legitimate business purpose, if any, against the practicability of the less harmful alternative."[45]

Thus, when a minority shareholder brings an action for breach of fiduciary duty, the court under the *Wilkes* approach will focus on whether the majority shareholders can establish that their action served a legitimate business purpose. The inquiry does not end there. If the majority shareholders can demonstrate a legitimate business purpose, the *Wilkes* ap-

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39. *Id.* at 515-16.
40. *Id.* at 519.
41. *Id.* at 518.
42. *See* Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976). *See also* Peeples, *supra* note 3, at 498-501.
43. 353 N.E.2d 657 (Mass. 1976).
44. *Id.* at 663.
45. Peeples, *supra* note 3, at 498.

proach then affords the complaining minority shareholders an opportunity to show that the same business purpose could have been achieved via a less harmful alternative.

In *Wilkes*, four partners had formed a corporation to operate a nursing home, each owning an equal number of shares. At the time of incorporation, the partners intended that each would be a director and participate actively in the management of the nursing home. The partners also agreed that the corporation would pay each an equal salary as long as each assumed an active and ongoing responsibility in operating the business. When one of the partners became unable to perform his responsibilities due to health reasons, he sold his shares to a local banker who assumed responsibility for the financial management of the business. The banker also received an equal salary.

Later, relations between Wilkes and the other shareholders deteriorated as a result of differences over a property transaction. Wilkes gave notice to the other shareholders of his intention to sell his shares. However, Wilkes continued to fulfill his management responsibilities. Upon learning of Wilkes' intentions, the other shareholders, acting as directors, removed Wilkes as a director and officer. They informed him that his services were no longer needed.

The court in *Wilkes* reversed a lower court decision in favor of the majority shareholders on Wilkes' breach of fiduciary duty claim. The court held that the majority shareholders failed to meet their burden of showing a legitimate business purpose for removing Wilkes from the payroll of the corporation, which had never paid dividends.[46] Likewise, they failed to show a legitimate business purpose for refusing to reelect him as a salaried officer and director of the corporation.[47] The court said:

> [I]t is an inescapable conclusion from all the evidence that the action of the majority stockholders here was a designed 'freeze out' for which no legitimate business purpose has been suggested. . . . We may infer that a design to pressure Wilkes into selling his shares to the corporation at a price below their value well may have been at the heart of the majority's plan.[48]

Courts have not uniformly adopted the strict good faith standard articulated in *Donahue* and *Wilkes*. As one commentator observed: "It is disappointing to note that the *Donahue* standard has not been more

46. *Wilkes*, 353 N.E.2d at 663-64.
47. *Id.*
48. *Id.* at 664.

widely accepted. A strict standard of fiduciary duty should clearly apply to close corporations due to their unique character."[49]

III. Has Indiana Adopted a Strict Good Faith Standard?

A review of Indiana cases discussing the standard that courts should employ is necessary to determine if Indiana has adopted the strict good faith standard. As early as 1973, two years before the Supreme Court of Massachusetts decided *Donahue*, Indiana courts began treating close corporations as incorporated partnerships, as suggested by Justice Burger in *Helms*. As a result, these courts imposed a higher fiduciary duty upon the shareholders in close corporations.[50] In *Hartung v. Architects Hartung/Odle/Burke, Inc.*,[51] the First District Court of Appeals became the first court in Indiana to adopt the "incorporated partnership" concept. *Hartung* involved a close corporation comprised of only three shareholders, who also served as officers and directors. The shareholders signed promissory notes personally guaranteeing a loan, which the corporation executed in order to pay salaries and operating expenses. Hartung, the president, resigned as an officer and director after discord arose among the shareholders. The corporation later defaulted on the loan and Hartung refused to make good on his promise when the bank demanded repayment from the shareholders, leaving the other two shareholders responsible for the debt. In addition, Hartung leased the corporation's premises for his personal business behind the backs of the other two shareholders. He also began luring away corporate clients.

The aggrieved shareholders sued Hartung for breach of fiduciary duty and for contribution for his share of the loan debt. In affirming the trial court's judgment in favor of the aggrieved shareholders, the court in *Hartung* held that "shareholders in a close corporation, also referred to as an 'incorporated partnership,' stand in a fiduciary relationship to each other."[52] Describing the fiduciary duty of a director, officer, or shareholder as being "the same regardless of the capacity in which it arises,"[53] the court asserted: "The fiduciary must deal fairly, honestly and openly with his corporation and fellow stockholders . . . [and] must not be distracted from the performance of his official duties by personal interests."[54] The court in *Hartung* relied upon the *Helms*

49. Johnson, *supra* note 3, at 21.
50. *Id.*
51. 301 N.E.2d 240 (Ind. Ct. App. 1973).
52. *Id.* at 243.
53. *Id.*
54. *Id.* (citing Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957)).

decision in support of its characterization of a close corporation as an "incorporated partnership."[55]

Although a line of Indiana decisions following the *Hartung* decision recognized the higher duty shareholders in a close corporation owe to one another, none of the decisions directly applied a strict good faith standard.[56] In one of those cases, *Cressy v. Shannon Continental Corp.*,[57] the court of appeals refined the relationship of shareholders in close corporations, holding that the term "incorporated partnership" meant that this form of business enterprise was a hybrid.[58] The court stated:

> While parties incorporate to obtain the benefits of limited liability, perpetual existence of business entity or tax considerations accruing to the corporate form, they often expect to act and to be treated as partners in their dealings among themselves. When this intention is manifest and no harm results to outsiders thereby, there appears little reason to frustrate the parties' actual intent by strict adherence to the traditional norms of corporate law.[59]

Under *Cressy*, if the parties in a close corporation *intended* or *expected* to be treated as partners, the court would honor these intentions and expectations even though it required a departure from traditional corporate governance.

In another important case, *Scott v. Anderson Newspapers, Inc.*,[60] the Fourth District Court of Appeals upheld the expectations and intentions of the parties and reached a fundamentally different result than the court would have reached had it applied traditional corporate principles. The court in *Scott* went to great lengths to protect and uphold the expectations of the parties and the rights of minority shareholders. The case involved a close corporation, Anderson Newspapers (ANI), which was formed when two smaller corporations, Bulletin Printing and Manufacturing Co. and the Herald Publishing Co., consolidated under Indiana statutory law.[61] Prior to the consolidation, each company had separately operated different newspapers. In their agreement to incor-

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55. *Id.*

56. *See, e.g.*, Krukemeier v. Krukemeier Mach. & Tool Co., Inc., 551 N.E.2d 885, 888 (Ind. Ct. App. 1990); Ross v. Tavel, 418 N.E.2d 297, 304 (Ind. Ct. App. 1981); Motor Dispatch, Inc. v. Buggie, 379 N.E.2d 543, 547 (Ind. Ct. App. 1978); Cressy v. Shannon Continental Corp., 378 N.E.2d 941, 945 (Ind. Ct. App. 1978).

57. 378 N.E.2d 941 (Ind. App. 1978).

58. *Id.* at 945.

59. *Id.*

60. 477 N.E.2d 553 (Ind. Ct. App. 1985). For further discussion, see 19 GALANTI, *supra* note 9, at 195-96.

61. *Scott*, 477 N.E.2d at 558.

porate, the parties stipulated that each newspaper would continue to be printed, published, and distributed as before the consolidation. The agreement also stated that neither paper would interfere or restrict the rights of the other in respect thereto. The agreement further provided that the shareholders represented by the Bulletin group would elect a majority of the directors, and the shareholders represented by the Herald group would elect a minority of the directors. Under the agreement, neither Bulletin or Herald shareholders in the new corporation could nominate or vote upon the directors of the other group, nor could their directors participate in the conduct of the other's affairs. The majority directors elected the president and secretary of the corporation and the minority directors elected the vice president.

Both parties complied with the agreement through the first thirty years of the corporation. In 1981, John Scott, the vice president of ANI and the founder of the Herald, died. After Scott's death, his son voluntarily assumed the position of editor of the Herald and earned the same salary as his father had earned. The Bulletin group and its directors decided to exercise control over all of ANI's affairs, including the nomination and election of the Herald group's vice president, its three directors, and the appointment of the Herald's editor. The majority amended the articles of consolidation and the by-laws to provide that ANI's stockholders or its directors could transact all corporate business by a simple majority vote. The changes effectively cut off the Herald group's right to publish the Herald.

The Herald group's directors obtained a favorable declaratory judgment from the trial court.[62] On appeal, the Bulletin group's shareholders argued that Indiana's corporations statute permitted a simple majority vote to amend the articles to eliminate the original consolidation agreement.[63] In affirming the trial court's judgment, the court of appeals treated the question as a matter of contract law.[64] Because the articles clearly expressed the intent of the parties that the Bulletin group should control the Bulletin's affairs exclusively and that the Herald group should control the Herald's affairs exclusively, the court held the agreement enforceable, even though it was totally contrary to the basic corporate principle of majority governance.[65] The court declared that the "intent is the supreme mandate governing the conduct of ANI's business and affairs."[66] Construing Indiana's corporation statute, the court held that such restrictions and rights are valid in states such as Indiana which

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62. *Id.* at 556.
63. *Id.* at 560.
64. *Id.* at 559-62.
65. *Id.* at 560.
66. *Id.*

permit them to set out such restrictions in the charter rather than in a statute.[67] The court regarded the articles of consolidation as the controlling document. The basis for the ruling in *Scott*, although stated in terms of expectations, is consistent with the fiduciary relationship approach courts took both in *Hartung* and in *Cressy*.[68]

The Indiana Supreme Court has never directly addressed the precise standard courts must use in breach of fiduciary duty cases. However, in a 1977 decision, *Gabhart v. Gabhart*,[69] the court indicated a willingness to supply an equitable remedy for an aggrieved shareholder in a close corporation. In *Gabhart*, the majority shareholders effected a merger for a close corporation without a sound business reason for doing so. That merger resulted in the minority shareholder's elimination from the surviving corporation. The court in *Gabhart* decided that a minority shareholder in a close corporation could seek the equitable protection of Indiana's voluntary dissolution statute, rather than being limited to the statutory appraisal procedure.[70]

The court in *Gabhart* termed a merger that is effected for no valid business purpose, and which results in the elimination of a minority shareholder, as a "freeze-out" or a "squeeze-out."[71] The court defined a "freeze-out" or a "squeeze-out" as:

> [T]he use of corporate control vested in the statutory majority of shareholders or the board of directors to eliminate the minority shareholders from the enterprise or to reduce to relative insignificance their voting power or claims on corporate assets . . . . Furthermore, it implies a *purpose* to force upon the minority shareholder a change which is not incident to any other business goal of the corporation.[72]

The court in *Gabhart* observed that a "freeze-out" transaction may vary and is *not* limited to a merger or to consolidation disputes.[73] In deciding whether a transaction requires an equitable remedy, the court said it must recognize "conflicting policies consistent with the general goals of maximum shareholders benefit and equality of treatment."[74] Taking a view somewhat similar to the court in *Wilkes*, the supreme

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67. *Id.*
68. 19 GALANTI, *supra* note 9, § 31.5, at 196.
69. 370 N.E.2d 345 (Ind. 1977).
70. *Id.* at 356. *See* IND. CODE §§ 23-1-45-1 to -7 (1988 & Supp. 1992) (voluntary dissolution statute); *id.* §§ 23-1-40-1 to -7 (1988) (statutory appraisal procedure).
71. *Gabhart*, 370 N.E.2d at 353.
72. *Id.* (citation omitted).
73. *Id.*
74. *Id.*

court suggested that it could best handle this problem by adopting a balancing approach. The court noted: "On the one hand is the necessity to provide adequate protection for the interests and expectations of minority shareholders, and the other is the necessity of allowing sufficient corporate flexibility, as is required by modern commerce."[75]

Though the court specifically avoided addressing the question of whether a "freeze-out" transaction conducted by the majority shareholders constituted a breach of fiduciary duty,[76] the decision in *W & W Equip. Co. v. Mink*[77] is instructive on this question. The court in *Mink* emphatically declared that *Gabhart* does not say "that Indiana does not recognize freeze-out transactions as a breach of fiduciary duty."[78]

A review of the facts of the *Mink* case is instructive. The case involved a dispute between two shareholders of a small corporation over whether the retiring shareholder or a relatively new shareholder would enjoy the benefits of the corporation's assets. Two individuals, Winter and Wraight, initially formed the W & W Equipment Co. as a partnership engaged in serving as manufacturers' representatives for waste water treatment equipment. Later, the partners incorporated the business. After Wraight began contemplating retirement, the partners brought Mink into the business as a younger partner to replace Wraight. Mink became a twenty percent shareholder in a new corporation. The shareholders acted as both officers and board members of the corporation. The corporation paid salaries to the shareholders in lieu of dividends.

Eventually, Wraight retired and in 1984 moved to California. Winter and Mink each became fifty percent shareholders in the corporation. The succeeding partners paid Wraight book value for his stock in the corporation. Wraight then left the payroll. However, Wraight remained a board member to protect his interest in a loan made by the old corporation to capitalize the new corporation. Secrest, the corporation's legal counsel, served as a fourth member of the board.

A couple of years later, Winter announced that he would retire. Based upon Winter's announcement, the corporation formed a joint venture with another company. However, a dispute arose when Winter demanded half of the value of the corporation for his stock as a condition to his retirement, rather than the book value as had been paid for Wraight's stock. During the negotiations, Winter threatened to remove Mink from the business unless Mink agreed to his demand. When Mink failed to agree, Wraight successfully conspired with the other board

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75. *Id.* at 353-54.
76. *Id.* at 356.
77. 568 N.E.2d 564 (Ind. Ct. App. 1991).
78. *Id.* at 575.

members to remove Mink as a director and an officer of the corporation. This action also led to the termination of the joint venture. Mink immediately filed suit against the other board members, seeking compensatory damages for breach of fiduciary duty and dissolution of the corporation. After a bench trial, the court awarded judgment to Mink.[79] The First District Court of Appeals affirmed the judgment.[80]

On appeal, the defendant board members argued under *Gabhart* that Indiana does not recognize a cause of action for breach of fiduciary duty based upon a "freeze-out" theory.[81] The *Mink* court disagreed with the defendants. The court observed: "Although the court indicated it did not believe the judiciary should intrude into corporate management to the extent of reviewing every proposed merger for fairness to minority shareholders, it did not say . . . that Indiana does not recognize freeze-out transactions as a breach of fiduciary duty."[82] The court in *Mink* added that the *Gabhart* decision had specifically excepted plain cases of "fraud, *breach of trust*, or such maladministration as works a manifest wrong to the shareholders."[83]

As much as *Mink* represents a strong commitment to the concerns of minority shareholders in close corporations, at least one commentator prior to this decision believed Indiana courts were backing away from this commitment.[84] The 1990 First District Court of Appeals decision in *Krukemeier v. Krukemeier Machine & Tool Co.*[85] supports this proposition. In *Krukemeier*, the complaining shareholder claimed the controlling shareholders breached a fiduciary duty by receiving excessive compensation. Though the court accepted the *Hartung* characterization of close corporations as "incorporated partnerships," the court placed the burden of proving that the compensation was unreasonable upon the complaining shareholder. The court simply held that the term "incorporated partnership" referred only to the fiduciary duty that shareholders in close corporations owe to one another, and that it did not refer to the standard of proof.[86] Here, the complaining shareholder failed to meet his burden merely by showing that the compensation of the controlling shareholders increased at a time when his dividends had decreased. On the facts of this case, however, it is unlikely the minority shareholder would have prevailed even if the court had placed the burden

79. *Id.* at 569.
80. *Id.* at 578.
81. *Id.* at 574.
82. *Id.* at 575.
83. *Id.* (emphasis added).
84. *See* 19 GALANTI, *supra* note 9, at 196-99.
85. 551 N.E.2d 885 (Ind. Ct. App. 1990).
86. *Id.* at 888.

upon them.[87] In view of the *Mink* decision, any reading of *Krukemeier* that suggests that Indiana courts are backing away from a commitment to protect minority shareholders through the imposition of a stricter fiduciary duty appears unsupportable.

Although no Indiana court has expressly adopted either *Donahue*'s strict good faith standard, or the two-step burden-shifting and balancing analysis adopted in *Wilkes*, arguably the Indiana courts implicitly have adopted both. The *Donahue* and *Hartung* decisions, which adopted the "incorporated partnership" concept, both relied upon the *Helms* decision in recognizing a stricter fiduciary duty for shareholders in close corporations. Unless courts impose a higher standard on close corporation shareholders, no legal reason exists to differentiate close corporations from widely held corporations. If courts treat shareholders in close corporations as partners, the fiduciary duty arising from this relationship is no different than the ordinary duty owed by a corporate fiduciary; hence, their designation as partners is without effect.

The court in *Mink* relied on the *Wilkes* decision for the proposition that termination of employment of a minority shareholder can, under the appropriate circumstances, constitute a breach of fiduciary duty.[88] *Mink*, citing an earlier Indiana decision, also applied a burden-shifting test in determining whether the majority shareholders breached a fiduciary duty owed to the minority shareholder. The court in *Mink* observed that "[o]nce it is established that one with a fiduciary duty has attempted to benefit from a questioned transaction, the law presumes fraud. The burden of proof then shifts to the fiduciary to overcome the presumption by showing his actions were honest and in good faith."[89] The court's adoption in *Mink* of the *Wilkes* standard of employment and burden-shifting, along with the balancing approach taken in *Gabhart*, and the general language used in many Indiana decisions, support the position that Indiana courts have adopted the strict good faith standard.

IV. The Scope of the Duty in Indiana Is Broad

Regardless of whether Indiana has adopted the strict good faith standard, numerous Indiana cases demonstrate that shareholders in close corporations stand in a fiduciary relationship to one another. Moreover, these cases demonstrate that the scope of that fiduciary duty is broad

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87. The evidence showed that the defendant shareholders had been under-compensated, and that the increased pay was justified even if it meant that there were less funds available to pay dividends to the complaining shareholder. *Id.*

88. W & W Equip. Co. v. Mink, 568 N.E.2d 564, 574 (Ind. Ct. App. 1991).

89. *Id.* at 573 (quoting Dotlich v. Dotlich, 475 N.E.2d 331, 342 (Ind. Ct. App. 1985)).

enough to encompass a variety of transactions, including compensation, corporate opportunity, employment, sale of shares, misappropriation of corporate assets, mergers, and declaration of dividends.

A. Compensation

Shareholders in a close corporation commonly are employees of the corporation. Minority shareholders often disagree with the compensation decisions the majority shareholders make concerning their own compensation. Until recently, the board of directors made all compensation decisions at their discretion. *Green v. Felton*,[90] an early Indiana decision, illustrates this hands-off approach. In *Green*, minority shareholders challenged as excessive the compensation that the corporation had paid to majority shareholders as officers and directors. The majority shareholders, who had received the challenged compensation, participated as directors in approving their own compensation. In upholding the compensation, the court deferred to the business judgment of the board of directors by noting that "to give the court authority to set aside the action of majority shareholders or board of directors, legally acting under the rules of the company, legally adopted, there must appear injustice or oppression, or circumstances amounting to fraud."[91]

Today, Indiana courts are more willing to intercede in corporate decisionmaking in those instances in which the majority shareholders appropriate the profits of the corporation for their own personal use to the detriment of the minority shareholders.[92] Unlike other self-dealing transactions, in cases of compensation, the burden does *not* shift to the majority shareholders to prove that the compensation is reasonable under Indiana case law.[93] Indiana first stated this rule in *Cole Real Estate Corp. v. Peoples Bank & Trust Co.*,[94] in which the court held that a majority shareholder who treated all profits as his or her own, did not hold annual shareholder meetings, and whose salary was not approved by the directors, breached a fiduciary duty to the minority shareholders by accepting unreasonable compensation.[95]

According to one commentator, Indiana has adopted the minority view with respect to the burden of proof in compensation cases by placing that burden upon the minority shareholder to prove that the

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90. 84 N.E. 166 (Ind. Ct. App. 1908).

91. *Id.* at 170.

92. *See* Lowry v. Lowry, 590 N.E.2d 612 (Ind. Ct. App. 1992); Cole Real Estate Corp. v. Peoples Bank & Trust Co., 310 N.E.2d 275 (Ind. Ct. App. 1974).

93. *Cole*, 310 N.E.2d at 279-80.

94. 310 N.E.2d 275 (Ind. Ct. App. 1974).

95. *Id.* at 279-80.

compensation is unreasonable.[96] In defending its new rule, the court in *Cole* said: "[A] court of equity cannot act as the regulator of a private corporation and should not substitute its judgment for that of the board of directors in determining what is a fair and reasonable compensation for corporate officers."[97] Under the majority view, once a minority shareholder alleges that the corporation is paying unreasonable compensation to a majority shareholder, the recipient bears the burden of justifying the reasonableness of her compensation.[98]

The standard of proof in compensation cases requires a minority shareholder to show that the compensation is "unjust, oppressive, or fraudulent"[99] In *Krukemeier v. Krukemeier Machine & Tool Co.*, the plaintiff-minority shareholder failed to meet this burden where the majority shareholders had increased their own salaries and reduced the minority shareholder's dividend. *Krukemeier* involved three brothers who shared equal ownership of a small, tool and die corporation. Two of the brothers were actively engaged in the operation of the business. A third brother was not actively involved in the business; however, he served as an officer and director. The two brothers attempted to buy out the inactive brother's shares in accordance with a previous buy/sell agreement, but they could not agree on a fair price. At about the same time, the two brothers acted on their belief that their pay was grossly inadequate and increased their salaries approximately threefold from the preceding year. Later, the two brothers removed the third brother as an officer and director. The third brother did, however, continue to receive his one-third share of the dividends.

The aggrieved brother brought suit against the corporation for return of excess compensation.[100] The two brothers filed a counterclaim for specific performance of the buy-sell agreement.[101] The trial court rejected the aggrieved brother's claims and ordered the corporation to redeem, and the brother to sell all of his shares at a value determined by the corporation's accountant in accordance with the buy/sell agreement.[102] The First District Court of Appeals affirmed the judgment of the trial court, holding that the majority shareholders had not breached a fiduciary duty because the evidence at trial showed that the salary increases were

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96. 19 GALANTI, *supra* note 9, at 197.

97. *Cole*, 310 N.E.2d at 279.

98. 19 GALANTI, *supra* note 9, at 197.

99. Krukemeier v. Krukemeier Mach. & Tool Co., 551 N.E.2d 885, 888 (Ind. Ct. App. 1990).

100. *Id.* at 887. The minority shareholders also sought damages for lost dividends, repurchase of stock, appointment of a receiver and declaration of a constructive trust.

101. *Id.*

102. *Id.*

reasonable in light of the corporation's profitability, that total dividends were more than three times greater than in preceding years, and that the majority shareholders approved the increases in accordance with corporate formalities.[103]

In a 1992 case, *Lowry v. Lowry*,[104] minority shareholders prevailed in a claim which alleged that majority shareholders paid themselves excessive salaries. In *Lowry*, the majority shareholders were responsible for the management of a family-owned farm. According to the evidence presented at trial, a reasonable management fee would have been ten percent of the gross profits. The challenged shareholders received payment well in excess of this amount. In addition, the challenged shareholders did not negotiate for their salaries. Instead, they paid themselves "essentially all profits realized by the corporation."[105] The court in *Lowry* concluded that the evidence supported the trial court's judgment that the majority shareholders had breached a fiduciary duty to minority shareholders by paying themselves excessive compensation.[106]

B. *Corporate Opportunity*

The "corporate opportunity" doctrine holds that "a corporate fiduciary may not appropriate to his own use a business opportunity that in equity and fairness belongs to the corporation."[107] In determining whether a corporate opportunity belongs to the corporation, the court considers the facts and circumstances of each case.[108]

The general rule is that a fiduciary cannot lure away the corporate business or clients who in equity and fairness belong to the corporation.[109] A fiduciary violates his fiduciary duty by secretly acquiring necessary corporate business property either to offer it or to sell it to the corporation at an advanced price, thus taking advantage of the corporation's necessities.[110] The fiduciary also violates his duty by using corporate property in any other way so as to injure the corporation.[111] Additionally, a fiduciary violates the corporate opportunity doctrine when he or she

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103. *Id.* at 888.
104. 590 N.E.2d 612 (Ind. Ct. App. 1992).
105. *Id.* at 621.
106. *Id.* at 622.
107. Hartung v. Architects Hartung/Odle/Burke, Inc., 301 N.E.2d 240, 244 (Ind. Ct. App. 1973); *see also* Tower Recreation, Inc. v. Beard, 231 N.E.2d 154, 155-56 (Ind. Ct. App. 1967).
108. *Hartung*, 301 N.E.2d at 244.
109. *Id.* at 245.
110. *Tower*, 231 N.E.2d at 155-56 (quoting Black v. Parker Mfg. Co., 106 N.E.2d 544, 549 (Mass. 1952)).
111. *Id.*

interferes with the corporation's property lease agreement by leasing the property for his or her own personal business without the approval of the other shareholders.[112] Several Indiana cases illustrate these corporate opportunity principles.

In *Hartung v. Architects/Odle/Burke, Inc.*, the court of appeals found that a shareholder in an architectural business violated a fiduciary duty to the other shareholders by leasing corporation offices for his own business use contrary to the interest of the corporation.[113] Further, the court found that the shareholder also violated his fiduciary duty by luring clients of the business away from the corporation and to his own business.[114] The court in *Lowry* found that the controlling shareholders of a farm corporation violated a fiduciary duty to the minority shareholders by mortgaging corporate property for their own personal benefit, without the knowledge or consent of the other directors or shareholders.[115] In *Dotlich v. Dotlich*,[116] the court held that a shareholder's purchase of a farm, which represented a valuable investment opportunity for the corporation, was a breach of fiduciary duty where the shareholder did not first make disclosure and obtain consent from the other shareholders.[117]

C. *Misappropriation of Corporate Property*

The law presumes fraud when one charges an individual standing in a fiduciary relationship with misappropriating corporate property.[118] The court in *Dotlich* noted that after such a charge, the burden of proof shifts to the party with the fiduciary duty to overcome the presumption by showing his actions were honest and in good faith."[119] In *Dotlich*, four brothers were shareholders in a family-owned business that rented heavy equipment. As the business grew, the brothers used corporate funds to purchase and maintain various real estate. However, the brother in charge of making the transactions titled the properties in his own name, instead of the corporation's name, claiming them as his own. When two of the brothers learned of the brother's self-dealing transactions, they sued him and the other brother, who aided and abetted his acts, for breach of fiduciary duty. The trial court found for the corporation, imposed a constructive trust on the property, and ordered

112. *Hartung*, 301 N.E.2d at 245.
113. *Id.*
114. *Id.*
115. Lowry v. Lowry, 590 N.E.2d 612, 622-23 (Ind. Ct. App. 1992).
116. 475 N.E.2d 331 (Ind. Ct. App. 1985).
117. *Id.* at 342.
118. *Id.*; *see also* Ross v. Tavel, 418 N.E.2d 297, 304 (Ind. Ct. App. 1981).
119. *Dotlich*, 475 N.E.2d at 342.

the self-dealing brother to reconvey the property to the corporation.[120] The First District Court of Appeals affirmed the trial court's judgment.[121] The court found that the self-dealing brother had breached a fiduciary duty by retaining title to the property acquired during the questioned transaction.[122]

D. Sale of Shares

The partnership expectation of shareholder equality carries with it a duty to disclose to the other shareholders the availability of outstanding shares for sale and to afford them the opportunity to share in the purchase of the available shares upon each principal in a close corporation.[123] Consideration for the issuance or sale of corporate shares must be fair.[124] Indiana permits the shareholders in close corporations to enter into fixed price stock agreements because "there is seldom a market for those shares, and it is difficult and speculative to value those shares."[125] *Cressy v. Shannon Continental Corp.*[126] involved a two-person corporation whose primary asset was an office building. Mr. Russell and Mr. Cressy formed the corporation intending to be "equal" partners. Later, the board resolved to sell additional stock. Without Cressy's knowledge, Russell soon thereafter sold the stock to his parents. Mr. DeFries, the corporation's treasurer, was also given stock in the corporation for his accounting work. Without Russell's knowledge, Cressy purchased DeFries' stock. However, Cressy was unsuccessful in attempting to secure transfer of those shares into his name on the corporate records. Consequently, Cressy filed suit. The court of appeals affirmed a judgment by the trial court holding that Cressy and Russell each breached a fiduciary duty owed to the other as shareholders in a close corporation where the shareholders intended equal ownership and control of the business.[127]

The court in *Cressy* relied on the concept of an "incorporated partnership" in departing from the traditional norms of corporate law, which would permit a shareholder to freely transfer shares in a corporation. Here, the court tailored the law to meet the expectations of

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120. *Id.* at 335-36.

121. *Id.* at 336.

122. *Id.* at 342.

123. Cressy v. Shannon Continental Corp., 378 N.E.2d 941, 945 (Ind. Ct. App. 1978); *see also* Hardy v. South Bend Sash & Door Co., 603 N.E.2d 895, 899 (Ind. Ct. App. 1992); Krukemeier v. Krukemeier Mach. & Tool Co., 551 N.E.2d 885, 890 (Ind. Ct. App. 1990).

124. *See* Garbe v. Excel Mold, Inc., 397 N.E.2d 296 (Ind. Ct. App. 1979).

125. *Hardy*, 603 N.E.2d at 899 (citing *Krukemeier*, 551 N.E.2d at 890).

126. 378 N.E.2d 941 (Ind. Ct. App. 1978).

127. *Id.* at 945.

the parties—that they be treated as partners in their dealings among themselves.[128]

In a 1992 case, *Hardy v. South Bend Sash & Door Co.*,[129] the court of appeals upheld a stock purchase agreement that allowed the shareholders to determine the method of valuation and required a shareholder wishing to sell or transfer his or her shares to first offer the stock to another shareholder.[130] The controlling shareholders purchased the shares of a minority director-shareholder. Consequently, the minority director-shareholder contended that the majority shareholders violated a fiduciary duty they owed him by failing to provide him with the corporation's financial report. The minority shareholder alleged that their failure to provide him with a report misrepresented the true financial condition of the corporation and, as a consequence, misrepresented the stock's value.

The court recognized that the shareholders owed a fiduciary duty to each other, but the existence of the duty in this instance depended upon whether the corporation or the director, individual, had been acquiring the stock from the shareholder.[131] The court noted that a director acting for the corporation in the purchase of its own stock stands in a fiduciary relationship to the stockholder from whom the director purchased the stock and is under a duty to disclose to the shareholder the facts affecting the value of the stock.[132] However, the court explained that a director who sells his own shares or "buys shares from other shareholders for his personal ownership owes no fiduciary duty to disclose information he possesses regarding the value of the stock to the other shareholders, provided that, such a sale does not affect the general well-being of the corporation."[133]

The agreement in *Hardy* dealt with the sale of shares between the shareholders. The agreement also provided that a mutual agreement of the parties and not by the financial report, would determine the stock's value. Therefore, the court concluded there was no duty to disclose the financial report. The court also found it important to note that the director-shareholder was not unfamiliar with the corporation's operation, and that the corporation had provided him with financial information on past occasions. Further, the court held that the shareholders did not breach a fiduciary duty to the minority shareholder on a theory of

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128. *Id.*
129. 603 N.E.2d 895 (Ind. Ct. App. 1992).
130. *Id.* at 899.
131. *Id.* at 900.
132. *Id.*
133. *Id.*

constructive fraud because the shareholders actively had not concealed financial information from him.[134]

E. Employment

The denial of employment to a minority shareholder in a close corporation often may produce an immediate financial crisis for that shareholder.[135] Shareholders in close corporations often invest a large part of their personal resources in the corporation expecting to serve as a key employee, a director, or as a principal officer.[136] Because close corporations typically do not pay dividends, a shareholder to whom the corporation denies employment effectively may realize nothing more than a token return on his investment, even though that investment may be substantial. A shareholder faced with this precarious situation may feel pressure to accept a majority shareholder's offer to buy his stock at a price far less than the stock's actual value.[137]

Wilkes v. Springside Nursing Homes, Inc.,[138] was one of the earliest decisions in the country to recognize a breach of fiduciary duty action for employment termination in a close corporation. As discussed earlier, the court in *Wilkes* required the majority shareholders to demonstrate a legitimate business purpose when a minority shareholder whose employment they have terminated challenges them.[139] Even when the majority shareholders assert a legitimate business purpose for their termination of the minority shareholder, "it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved through an alternative course of action less harmful to the minority's interest."[140] The court will then "weigh the legitimate business purpose, if any, against the practicability of a less harmful alternative."[141]

Thus far, one Indiana court has followed the *Wilkes* decision. The First District Court of Appeals in *W & W Equipment Co. v. Mink*[142] announced that the act of majority shareholders in denying employment to a minority shareholder in order to freeze him out may amount to a breach of fiduciary duty.[143] In *Mink*, the controlling shareholders

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134. *Id.* at 901-02.
135. For further discussion, see 1 O'Neal & Thompson, *supra* note 3, § 3.06, at 37.
136. *Id.*
137. *Id.*
138. 353 N.E.2d 657 (Mass. 1976). *See* text accompanying notes 39-45.
139. *Id.* at 663.
140. *Id.*
141. *Id.*
142. 568 N.E.2d 564 (Ind. Ct. App. 1991). *See* text accompanying notes 77-84.
143. *Id.* at 574.

argued that because the minority shareholder was an employee, they could terminate him at will under the general rule of employment relationships in Indiana.[144] The court dismissed this argument as being misplaced because the cause of action was one for breach of fiduciary duty, not for wrongful termination.[145]

The court in *Mink* based its decision on *Wilkes*, explaining that "as noted by the Massachusetts Supreme Court, the denial of employment to a minority shareholder in a close corporation 'is especially pernicious in some instances.' "[146] The court added: "A minority stockholder typically depends on his salary as the principal return of his investment, since the earnings of a close corporation are mainly distributed as salaries, bonuses, and retirement benefits."[147] The court in *Mink* relied upon *Gabhart*'s holding that a freeze-out transaction, such as a denial of employment, may amount to a breach of trust.[148]

F. Declaring Dividends

According to commentators F. Hodge O'Neal and Robert B. Thompson, the withholding of dividends is the most frequently used "freeze-out" technique in close corporations.[149] It is simple to apply and generally exerts great pressure on minority shareholders to sell their shares.[150] By not declaring any dividends or by keeping dividends low, majority shareholders may be able to force a minority shareholder to sell his or her interest for considerably less than its actual value. The technique can be particularly devastating in a Subchapter S corporation if the minority shareholder must pay income taxes on income which he or she is not actually receiving, but which for tax purposes is attributable to him or her.[151]

O'Neal and Thompson also note that corporations often couple dividend withholding with other types of oppression.[152] For example, a dividend squeeze is ineffective if the shareholder being squeezed also draws a substantial salary from the corporation. Therefore, the corporation usually terminates the shareholder's employment in addition to withholding dividends. Also, majority shareholders typically immunize

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144. *Id.*
145. *Id.*
146. *Id.* (quoting Wilkes v. Springside Nursing Homes, Inc., 353 N.E.2d 657, 662 (Mass. 1976)).
147. *Id.*
148. *Id.* at 575.
149. 1 O'NEAL & THOMPSON, *supra* note 3, § 3.04, at 13.
150. *Id.*
151. *Id.*
152. *Id.*

themselves from the adverse effects of a dividend squeeze by increasing their own salaries and benefits.[153]

The corporation's board of directors has within its discretion the power to declare dividends on outstanding stock issues.[154] However, when the board of directors fails to declare a distribution of profits that a shareholder feels is warranted, the shareholder is not without a remedy in Indiana. An action will lie in equity by which an aggrieved shareholder may obtain a dividend.[155] Such equitable remedy is available both to preferred stockholders and to common stockholders alike.[156]

Because of the broad discretionary power that the law vests in the management of the corporation, the shareholder bears the "necessarily stringent" burden of proving the necessity of equitable relief.[157] The court in *Cole Real Estate Corp. v. Peoples Bank & Trust Co.* explained: "Only a clear abuse of discretion, established by proof of bad faith, oppressive or illegal action, will justify the intervention of a court of equity."[158] Directors may not use their powers "illegally, wantonly, or oppressively."[159]

In *Cole*, the Third District Court of Appeals affirmed a trial court judgment compelling the Cole Real Estate Corp. to declare a dividend for several years. Helen Cole, the majority shareholder, owned all but eighty-six of the 4,120 outstanding shares. The Peoples Bank and Trust Company held the remaining eighty-six shares in trust. The court in *Cole* cited several important facts which supported an equitable remedy for the minority shareholder: the corporation had failed to declare a dividend for sixteen years, the majority shareholder's exercise of complete control over corporate assets and operation, the majority shareholder control over all the stock other than that which the complaining shareholder held, and the corporations had accrual of sufficient earned surplus on its treasury to allow the minority shareholders a reasonable dividend.[160] The court also found that these facts supported a conclusion that Cole had "acted oppressively and in bad faith" in failing to declare a dividend.[161]

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153. *Id.*

154. *See* IND. CODE §§ 23-1-28-1 to -6 (1988).

155. *See* Cole Real Estate Corp. v. Peoples Bank & Trust Co., 310 N.E.2d 275, 280 (Ind. Ct. App. 1974).

156. *Id.* at 281.

157. *Id.* at 280.

158. *Id.*

159. *Id.* (quoting W.Q. O'Neall Co. v. O'Neall, 25 N.E.2d 656, 659 (Ind. Ct. App. 1940)).

160. *Id.* at 282.

161. *Id.* The court in *Cole* also found that Cole's conduct was oppressive because she paid herself excessive compensation.

G. *Mergers*

Majority shareholders sometimes resort to fundamental changes in the corporation, such as a statutory merger proceeding, to eliminate minority shareholders.[162] Every state has a statutory procedure by which a majority of shareholders may combine two or more corporations into a single corporation even though not all of the shareholders approve.[163] When the process results in the survival of one of the constituent corporations, we refer to the procedure as a "merger."

Most merger statutes provide that the shares of each merging company will be converted into securities of a different corporation other than the surviving company or into cash or other property.[164] Thus, the shareholders of a constituent corporation can be paid off and eliminated summarily and directly from the resulting enterprise. O'Neal and Thompson observe that merger statutes make it easier for controlling shareholders to victimize the minority shareholders by stating: "The permissive nature of most merger provisions gives managerial control to the majority and relegates minority shareholder status to that of a fungible dollar claim."[165]

The Supreme Court of Indiana recognized in *Gabhart v. Gabhart*[166] that a minority shareholder may be entitled to equitable relief where the majority effects a merger for the sole purpose of freezing out the minority shareholder. However, it expressly did not recognize such a transaction to be breach of fiduciary duty.[167] In *Gabhart*, four family members and another individual formed a corporation to operate a nursing home. The shareholders divided shares of stock equally among each of them. Each shareholder served as a director and participated in the management of the business. Later, one of the shareholders resigned as director after he became involved in another business which required him to travel out of state. The other shareholders unsuccessfully negotiated for the purchase of the departing director's shares. Having failed to purchase his shares, the other shareholders conceived and carried out a corporate restructuring in accordance with Indiana's corporate law, whereby the assets of the corporation were transferred to a new corporation in which the shareholder would own no shares. Instead, the

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162. 1 O'Neal & Thompson, *supra* note 3, § 5.04, at 21.

163. *Id.*

164. *Id.* at 23.

165. *Id.* at 25.

166. 370 N.E.2d 345 (Ind. 1977).

167. The court deliberately avoided carrying its holding any further because it was concerned that such a holding would lead to judicial review of every proposed merger. The court said, "We do not believe the judiciary should intrude into corporate management to that extent." *Id.* at 356.

new corporation would compensate the shareholder for his interest in the old corporation by issuing a debenture, which the new corporation would quickly pay off.

The "squeezed-out" shareholder did not attend the meeting at which the shareholders voted for the merger, nor did he avail himself of the statutory appraisal rights that Indiana law provides for dissenting shareholders.[168] Instead, the aggrieved shareholder filed an action in federal court in which he challenged the validity of a "freeze-out" merger. He claimed that the sole purpose of the merger was to deprive him of his equity interest in the corporation. The district court granted the defendant shareholders' motion for summary judgment, holding that appraisal was the plaintiff's exclusive remedy under Indiana law.[169] On appeal, the Seventh Circuit Court of Appeals certified several questions to the Supreme Court of Indiana because the case presented questions of first impression under Indiana law.[170]

In rejecting the controlling shareholders' argument that the complaining shareholder's sole remedy was the appraisal rights under the merger statute, the court characterized a "proposed merger which has no valid purpose" as a "de facto dissolution."[171] Accordingly, the court held that the shareholder could vote on the issue of dissolution.[172] The court also characterized such a transaction as a "freeze-out" or a "squeeze-out," but it specifically refrained from basing its decision on fiduciary principles.[173]

V. Other Issues

A. Direct Versus Derivative Actions

A derivative suit generally challenges an action taken by majority shareholders or directors based on breach of fiduciary duty.[174] In a derivative action, the plaintiff shareholder brings suit in the name of

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168. Under now-superseded law, a shareholder entitled to vote in regards to a merger plan could object and demand payment for the value of his shares. If the value could not otherwise be agreed upon, a judicial appraisal procedure was available. Ind. Code Ann. § 23-1-5-7 (West 1976), replaced by Ind. Code § 23-1-40-1 (Supp. 1992).

169. Gabhart v. Gabhart, No. 73-1632 (S.D. Ind. May 1, 1973) (order granting summary judgment).

170. Gabhart v. Gabhart, No. 75-1090, slip op. at 2 (7th Cir. March 8, 1977).

171. *Gabhart*, 370 N.E.2d at 356.

172. *Id.*

173. *Id.* Though Indiana does not recognize a merger effected for no legitimate business purpose as a breach of fiduciary duty, the Supreme Court of Delaware did so hold in Singer v. Magnavox, 367 A.2d 1349 (Del. Ch. 1976).

174. 2 O'Neal & Thompson, *supra* note 3, § 7.07, at 51.

the corporation to redress the defendant's breach of duty to the corporation and to the shareholders as a group.[175] If the plaintiff asserts personal rights, distinct from any derived injury arising from the shareholder's proportional ownership of the corporation, the suit against defendants is direct and not derivative.[176] The distinction between direct and derivative suits may be important because of the various procedural limitations on derivative suits that may affect recovery.

The general rule in Indiana is that shareholders of a corporation cannot maintain actions in their own name to redress an injury to the corporation.[177] The primary reason for disallowing shareholder actions is to prevent "multitudinous litigation and disregard for the corporate entity."[178] Defenders of the rule cite the following reasons for its defense: it protects corporate creditors by placing the proceeds of the recovery back in the corporation, it protects the interests of all the shareholders rather than allowing one shareholder to prejudice the interests of other shareholders, and it provides adequate compensation of the injured shareholder by increasing the value of the shares when the corporation receives the recovery.[179]

An aggrieved shareholder in a close corporation will ordinarily find a derivative action neither available nor attractive because it will often be difficult, if not impossible, to show injury to the corporation. If one can show an injury, a corporate recovery primarily will benefit the majority shareholders. Thus, a distribution of recovery would make a derivative suit undesirable.[180] Indiana recognizes the shortcomings of the rule in the context of close corporations. The court in *Cole Real Estate Corp. v. Peoples Bank & Trust Co.* held that a minority shareholder may institute an individual action without a previous requirement for corporate action when the directors of that corporation act in their own interests, or when a majority shareholder acts illegally or oppressively in the name of the corporation.[181] As the court in *Cole* commented: "Equity does not require the doing of a useless act."[182] Similarly, the court in *Mink* found that the reasons for requiring a derivative action

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175. *Id.*

176. *Id.* at 52.

177. *See* W & W Equip. Co. v. Mink, 568 N.E.2d 564, 570-71 (Ind. Ct. App. 1991).

178. *Id.* at 571 (citing Moll v. South Cent. Solar Sys., Inc., 419 N.E.2d 154 (Ind. Ct. App. 1981)).

179. *Id.*

180. *See generally* Peeples, *supra* note 3, at 481-82.

181. Cole Real Estate Corp. v. Peoples Bank and Trust Co., 310 N.E.2d 275, 278-79 (Ind. Ct. App. 1974). *See also* Scott v. Anderson Newspapers, Inc., 477 N.E.2d 553, 563 (Ind. Ct. App. 1985).

182. *Cole*, 310 N.E.2d at 279.

were not present in a breach of fiduciary action involving a close corporation.[183] The court in *W & W Equipment Co. v. Mink* cautioned that its holding did not mean that a derivative action is unnecessary if the aggrieved parties are in a close corporation. The court asserted: "Our holding is, rather, that the trial court did not err in allowing this cause of action to proceed absent compliance with the derivative requirements because there were only two shareholders, one of whom was involved in the breach of fiduciary duty."[184] Also, in *Gabhart v. Gabhart* the Indiana Supreme Court permitted a former shareholder of a merged corporation to challenge the merger action directly, because the merger would have eliminated his means of redress.[185]

Even if a person desires a derivative action, there are other limitations he or she must consider. A shareholder may not bring a derivative action where all the shareholders have participated in the alleged wrong.[186] Likewise, the corporation would not be entitled to bring an action under such circumstances.[187] In *Dotlich v. Dotlich*, the court observed that a person could bring a derivative action only if he did not participate in the wrong.[188] Further, the court noted that a shareholder is not barred from suing on behalf of the corporation simply because he also happens to be a director.[189] Finally, the court in *Dotlich* maintained that granting a director the right to sue improves "the director's performance of the stewardship obligation which he owes to the corporation and its stockholders and to protect him from possible liability for failure to proceed against those responsible for improper management."[190]

B. Damages

1. Compensatory Damages.—Indiana's corporate statute provides that a trial court may dissolve a corporation under certain circumstances, one of which is director or shareholder deadlock.[191] Shareholders in close corporations are not limited to this remedy. The injured shareholder in a close corporation may recover compensatory damages when a breach of fiduciary duty has occurred.[192] In *Mink* the defendant shareholders argued that the trial court erred in awarding the aggrieved shareholder damages in addition to dissolving the corporation.[193] The defendant

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183. *Mink*, 568 N.E.2d at 576.
184. *Id.* at 576-77.
185. Gabhart v. Gabhart, 370 N.E.2d 345, 356-58 (Ind. 1977).
186. *See* Dotlich v. Dotlich, 475 N.E.2d 331, 339 (Ind. Ct. App. 1985).
187. *Id.* at 339.
188. *Id.*
189. *Id.* at 340.
190. *Id.* at 339 (quoting Tenney v. Rosenthal, 160 N.E.2d 463, 467 (N.Y. 1959)).
191. *See* IND. CODE § 23-1-47-1 (1992).
192. W & W Equip. Co. v. Mink, 568 N.E.2d 564, 576 (Ind. Ct. App. 1991); *see*

shareholders cited *Gabhart* for the proposition that dissolution is the aggrieved shareholder's sole remedy.[194] The court correctly pointed out that *Gabhart* had addressed the narrow question of whether shareholders in a corporation which has effected a merger are limited to appraisal rights, or whether they can petition for dissolution of the corporation. The *Mink* court responded: "It does not hold that shareholders in a close corporation are prohibited from recovering compensatory damages when there has been a breach of fiduciary duty owed to them."[195]

The purpose of damages is to award or impose a pecuniary compensation, recompense or satisfaction for an injury or a wrong a party has sustained.[196] When a failure to conform to a fiduciary duty is the basis of liability, the measure of damages is the entire loss sustained.[197] The law does not require a specific degree of certainty, but probative evidence must support the award. Moreover, the court cannot base the award upon mere conjecture or speculation.[198]

In *Mink*, where an oppressive majority had squeezed the victimized shareholder out of the corporation, the court upheld an award of compensatory damages in an amount necessary for the shareholder to "re-establish himself to the position he was in" prior to the breach.[199] In Mink's case, that amount was what he needed "to start cold, acquir[e] product lines, begin [. . .] to market on brand new product lines," taking into account the "two year lag before income beg[an] to cover expenses."[200] In *Hartung*, the breaching shareholder lured away corporate clients and leased corporate office space. The court awarded the non-breaching shareholders compensatory damages as measured by the amount of fees earned on projects of the former corporate clients, the inconvenience and expense of vacating the premises rented by the corporation, and expenditures incurred in terminating the corporate affairs.[201]

2. *Punitive Damages.*—In addition to compensatory damages, one may recover punitive damages where there is clear and convincing evidence that the breaching shareholders acted with malice, fraud, gross negligence,

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also Hartung v. Architects Hartung/Odle/Burke, Inc., 301 N.E.2d 240, 246 (Ind. Ct. App. 1973) (upholding trial court's award of damages for breach of fiduciary duty).

193. *Mink*, 568 N.E.2d at 576.

194. *Id.*

195. *Id.*

196. *Id.* (quoting Indiana Univ. v. Indiana Bonding & Sur. Co., 416 N.E.2d 1275, 1288 (Ind. Ct. App. 1981)).

197. *Id.* (citing Clayton v. Farish, 73 N.Y.S.2d 727 (N.Y. Sup. Ct. 1947)).

198. *Id.* at 576-77.

199. *Id.* at 577.

200. *Id.*

201. Hartung v. Architects Hartung/Odle/Burke, Inc., 301 N.E.2d 240, 246 (Ind. Ct. App. 1973).

or oppression. Moreover, that evidence must show that the act did not result from mistake of law or fact, honest error of judgment, overzealousness, mere negligence, or other human failing.[202] The court in *Dotlich* found punitive damages appropriate where the breaching shareholder titled corporate property in his own name and claimed it as his own, even though the shareholder who merely "aided and abetted" these wrongful acts would not be subject to punitive damages.[203] According to the court in *Mink*, the breaching shareholders' scheming acts in removing a shareholder from the corporation so another shareholder could receive money upon his retirement amounted to "oppressive and malicious" conduct which supported an award of punitive damages.[204] An award of compensatory damages is not always a prerequisite to an award of punitive damages. According to *Dotlich*, a court may award punitive damages where a court previously had granted "affirmative relief of an equitable nature" regardless of whether the court has awarded compensatory damages.[205]

VI. Conclusion

The "incorporated partnership" concept of close corporations has a long history in Indiana, yet the precise fiduciary duty arising from this special relationship between the shareholders in close corporations remains somewhat elusive. In reviewing future disputes arising between shareholders in close corporations, Indiana courts should review and reflect on the origins of the "incorporated partnership" concept, and give it the full effect intended. By expressly adopting the strict good faith standard, along with a burden-shifting and balancing approach, courts may best meet the expectations and intentions of the parties in close corporations. Finally, the adoption of the strict good faith standard will clarify the status of the law in Indiana, and will provide direction as to what acts, which might otherwise be protected by the business judgment rule or corporate democracy principles, will constitute a breach of fiduciary duty.

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202. *See Mink*, 568 N.E.2d at 577; Dotlich v. Dotlich, 475 N.E.2d 331, 345 (Ind. Ct. App. 1985).

203. *Dotlich*, 475 N.E.2d at 346.

204. *Mink*, 568 N.E.2d at 577-78.

205. *Dotlich*, 475 N.E.2d at 346.