

**A Matter of Trust: Closely-held derivative lawsuits**  
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A shareholder may initiate a direct action lawsuit against a corporation to redress an injury inflicted by the corporation upon the shareholder. However, a shareholder may also assert a cause of action on behalf of the corporation. Such a suit, a derivative lawsuit, arises against officers or shareholders when the corporation has failed to commence suit for injuries to the corporation itself. The Illinois Business Corporations Act creates a statutory cause of action for such an event. Nevertheless, distinctive characteristics and needs of close corporations have resulted in these companies receiving disparate treatment upon litigation.

Foremost, derivative lawsuits must be distinguished for close corporations (and other closely-held firms) and widely-held and/or publicly held corporations. For the former, derivative lawsuits are categorized as “Closely-Held”. While public or widely-held corporation derivative lawsuits are designated either as “Corporate Impropriety” or “Exploitation of Control” derivative lawsuits. “Corporate Impropriety” includes derivative suits seeking to impose personal liability on the board for a discrete act of corporate wrongdoing (typically a violation of law or a regulatory requirement). Corporations in this category tend to be larger and shareholdings more widely dispersed. “Exploitation of Control” suits are limited to challenging transactions between the corporation and those who control it. The Exploitation of Control category involves corporate transactions with or on behalf of the persons who control it. For cases in this category, the corporations tend to be smaller, the plaintiffs tend to hold significant blocks of stock, and that stock tends to be thinly traded, especially compared to that of the corporations in the Corporate Impropriety category.

While public corporations tend to incorporate in Delaware, close corporations are incorporated in the state of their principal state of business. The unique treatment afforded close corporations is further evident in the adoption of special code sections governing close corporations. In Illinois, a corporation’s failure to elect close corporation status will not prevent the corporation to be treated as a close corporation if under common law principles it would qualify as a close corporation.

The most extreme statutory provision that impacts shareholders in close corporations is involuntary dissolution. The remedy of involuntary dissolution will be administered in derivative lawsuits if the defendant acts “oppressively”. While the Illinois statutes do not define oppression, the courts have supplied definitions of oppressive conduct in closely-held cases. In Illinois, there is an enhanced fiduciary duty to shareholders of a close corporation that is similar to that of partners in a partnership. The emphasis placed on fiduciary duties in closely-held cases negates a requirement of finding fraud or illegal conduct.

Close and public corporations differ in ways that make general corporate law ill suited to close corporations. A major distinction for close corporations is that shareholders of a close corporation often serve as the directors or officers. Corporate law gives controlling insiders considerable latitude to run the corporation as they see fit.

Understandably, they will generally favor their own priorities and objectives over those of the minority. Aside from their investments, these shareholders are also actively managing the company. Unlike public corporation shareholders, most close corporation shareholders' income derives solely from distributions from the corporations. Consequently, a minority shareholder is particularly vulnerable to the whims of the majority. A minority shareholder's dependence on the corporation, lack of control and a lack of market for shares all create unique circumstances for the minority shareholder.

There are several recurring scenarios that lead to derivative litigation in the close-corporation context. For example, a "freeze-out" or exclusion of a minority shareholder from management of the corporation prompts litigation. Also, disparate treatment of different shareholders, e.g., purchase of one shareholder's share for fair value and not the others. Another common scenario involves the frustration of "reasonable expectations" of a shareholder; often the minority shareholder is deprived of a prominent position (director, officer or employee). Still yet, a shareholder's attempt at competing with the corporation in another business leads to litigation.

It should be noted that situations arise where majority shareholders are the ones with the scales tipping against them. Minority shareholders may have the capacity to overpower a controlling shareholder (especially where corporate actions require supermajority approval). Of course the share liquidity issue is just as relevant for majority shareholders. Also, it might very well be that the minority shareholder brings all the expertise to the table.

Generally, cases in the Exploitation of Control and Closely-Held categories involve applications of the duty owed to minority shareholders by the majority. Derivative litigation performs the task of translating the abstract concepts of fiduciary obligation, good faith and fairness into the specific limits on the insiders' ability to favor themselves. To this end, Illinois courts have embraced the "enhanced fiduciary duty" as a solution. The expansion of the duties makes more sense since closely-held shareholders often neglect to have a shareholders' agreement in place. Thus, the old adage, "an ounce of prevention is worth a pound of cure", is quite relevant in the avoidance of derivative litigation. The presence of a shareholders' agreement significantly reduces the likelihood of a corporate breakdown. Additionally, under a longstanding history of allowing the freedom to contract, courts traditionally uphold shareholder agreements. The trick is to balance the interests of the majority and the minority. A shareholders' agreement requiring unanimous approval for corporate actions might curb arbitrary actions by the majority. Nevertheless, such a provision providing the minority with carte blanche veto power might result in the minority shareholders holding the majority shareholders hostage. Similarly, the emergence of venture capitalists as minority shareholders further necessitates the need for a well-drafted shareholders' agreement to avoid litigation scenarios.

Shareholders would be wise to employ a competent legal draftsman to produce an explicit agreement that reflects acceptable conduct by close corporation shareholders. Practitioners must communicate to their clients that the presence of a shareholders' agreement would reduce the risk of litigation. While courts navigate around the contours of fiduciary duties, a shareholders' agreement goes a long way towards preventing inequitable treatment.