

**LITIGATING CLOSELY HELD BUSINESS DISPUTES AND THE
APPLICATION OF RHODE ISLAND'S RECEIVERSHIP STATUTE**

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I. INTRODUCTION¹

The duties imposed on shareholders of closely held corporations are often found to be akin to those of partners. In *A. Teixeira & Co., Inc. v. Teixeira*, 699 A.2d 1383 (R.I. 1997), the Rhode Island Supreme Court stated that shareholders in closely held corporations owe a fiduciary duty to each other when they are few in number, participate in management decisions, and act as if they are partners. Over the past century, courts of virtually all jurisdictions, including the Rhode Island Supreme Court in *Teixeira*, have quoted the eloquent language of Chief Judge Cardozo in *Meinhard v. Salmon*, 249 N.Y. 458 (N.Y. 1928), who stated:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the 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 market place. 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 attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions (*Wendt v. Fischer*, 243 N. Y. 439, 444). 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.

¹ Please note that although Associate Justice Michael Silverstein participated as a panel member in the seminar for which these materials were prepared, Judge Silverstein did not participate in the drafting of the written materials and as such they do not necessarily reflect his views of Rhode Island law.

These materials explore the rights afforded to minority shareholders of a closely held corporation and the common law and statutory remedies available under Rhode Island law when there has been a breach of fiduciary duty by the majority/controlling shareholders.

II. INTAKE AND COMPREHENSIVE REVIEW

A comprehensive intake and review process should be conducted before electing a strategy for resolving disputes among shareholders of closely held corporations. The following factors should be fully explored by counsel:

1. Is the dispute a family dispute among first generation owners; or is the dispute a second generation family dispute?
2. Do the shareholders work in the company and if so, how long have the parties worked together? Has there been a change in work habits, commitment to the business, or performance over time that has contributed to the dispute?
3. Who are the shareholders, officers, directors and key employees?
4. How many people are employed by the company?
5. What are the assets of the company?
6. What is the value of the business?
7. Is there any intellectual property, and if so is it owned by the company or by one or more shareholders or related entity?
8. Do the shareholders also share ownership in real estate or another business venture?
9. What, if any, debts or obligations of the company have been guaranteed by the shareholders?

10. To what degree is compensation, dividends or other shareholder distribution the underlying source of conflict?
11. Do the shareholders have employment agreements with the company?
12. Is there a shareholder's agreement with or without buy-sell provisions or provisions relative to dispute resolution?
13. Has any party engaged in dishonest, illegal or other blatant misconduct?
14. Have the parties accurately reported earned income to the state and federal taxing authorities?
15. What was the precipitating event for the current dispute?
16. Are there any third parties such as an accountant, family member, friend or advisor who might be helpful in brokering an agreement to resolve the dispute?
17. What are the financial positions of the parties and the company? Is the company solvent?
18. Has any shareholder loaned monies to the company and, if so, are the loans secured?
19. Is there a bank or other secured lender?
20. What is the level of business sophistication of the parties?
21. Have the parties been involved in litigation in the past?
22. What is the client's true objective?
23. Does the client want to continue in the business or be bought out?
24. Can the client afford both the time and expense of protracted litigation?
25. Are the client's expectations reasonable?

III. CHARACTERISTICS OF A CLOSELY HELD CORPORATION

Shareholders may elect to form a Rhode Island close corporation by including a heading in the Articles of Incorporation immediately after the name of the corporation stating that it is a close corporation pursuant to R.I. Gen. Laws § 7-1.2-1701. By making this election, the parties may include certain provisions in the close corporation's organizational documents that would otherwise be deemed invalid under the Rhode Island Business Corporation Act (the "Act"), R.I. Gen. Laws §§ 7-1.2-101 et seq. These provisions include:

- (a) restricting or assigning to one or more shareholders or other individuals, any or all of the powers normally vested in the board of directors or providing that the corporation has no board of directors;
- (b) granting the right to one or more shareholders to dissolve the corporation at will or upon the happening of a specified event;
- (c) imposing restraint on the transfer of shares of the corporation.

R.I. Gen. Laws § 7-1.2-1701(a)(2008).

A. Duties Owed by Shareholders of Close Corporations

In *A. Teixeira & Co., Inc. v. Teixeira*, 699 A.2d 1383, 1387 (R.I. 1997), the Rhode Island Supreme Court held that a fiduciary duty may exist among shareholders in a "less-than-thirty-shareholder corporation"² where the shareholders act among themselves as partners in a business venture for mutual profit or loss. Whether or not a fiduciary duty exists in any particular case is a question of law for the court, one that may only be answered after engaging in a fact-intensive inquiry. *Notarantonio v. Notarantonio*, 941 A.2d 138, 145 (R.I. 2008) (citing *A. Teixeira & Co. v. Teixeira*, 699 A.2d 1383, 1387 (R.I. 1997)).

The issue in *Teixeira* was whether two shareholders breached a fiduciary duty to the other shareholders of the corporation by

² Although not stated in the decision, the "less-than-thirty" number may derive from § 7-1.2-1702 (e)(1)(ii) which allows a shareholder to demand termination of a close corporation when the number of shareholders exceeds thirty.

participating in a new venture that was arguably a corporate opportunity. While making it clear that the shareholders in *Teixeira* owed each other fiduciary duties, the Court ruled that the duty was not breached because the corporation was financially unable to avail itself of the opportunity pursued by the shareholders. *See also Notarantonio*.

In *Broccoli v. Broccoli*, 710 A.2d 669, 673 (R.I. 1998), the Rhode Island Supreme Court, citing its decision in *Teixeira*, acknowledged the fiduciary duties owed to each other by three brothers who were each one-third shareholders of two related close corporations. However, the Supreme Court reversed the decision of the trial court which ruled that two brothers had breached their fiduciary duty to the third brother by causing one corporation to loan \$64,000 to the related corporation without notice to the third brother. The Court reversed the trial court primarily because even if the third brother had been given notice of the proposed loan, his one-third stock ownership would not have been sufficient to block the loan transaction. Moreover, the court found that the third brother did not receive notice of the proposed loan because of his refusal to communicate with his brothers. *Id.*

In *Bogosian v. Woloohojian*, 167 F.Supp.2d 491, 497 (D.R.I. 2001), *aff'd*, 323 F.3d 55 (1st Cir. 2003), the United States District Court for the District of Rhode Island applied Rhode Island law in finding that shareholders in a close corporation who actively participate in the management of a corporation owe each other a fiduciary duty. In finding that the three shareholders owed a fiduciary duty to each other, the District Court was persuaded by the facts that the three shareholders were actively involved in the management and operation of the business and that, as equal shareholders, each shareholder shared equally in the profits and losses of the business. *Id.* Having found that a fiduciary duty existed, however, the District Court found that it was not a breach of fiduciary duty for two shareholders to vote to remove the third shareholder from her position as President of the company since there was no legitimate expectation to remain indefinitely in the position of President. *Id.* at 498. Similarly, the Court ruled that it was not a breach of fiduciary duty for the two shareholders to terminate the employment of the third. The Court found that by voluntarily refusing to perform work for the company, the

shareholder had relinquished her otherwise legitimate expectation of employment. *Id.*

In *Lawton v. Nyman*, 327 F.3d 30, 39 (1st Cir. 2003), the First Circuit cited the Rhode Island Supreme Court's decision in *Teixeira*, and opined that the Rhode Island Supreme Court would impose a heightened fiduciary duty among shareholders of a closely held family corporation. The *Lawton* case addressed the issue of required disclosures by officers and directors of a close corporation who are also controlling shareholders of the corporation when offering to buy, or authorize the corporation to redeem, the shares held by minority shareholders. The First Circuit held that, in such a transaction, majority shareholders were bound by a duty to disclose to the minority shareholders material, undisclosed information in their possession. *Id.* at 40 (citations omitted). The First Circuit affirmed the District Court's decision that the majority shareholders had breached their fiduciary duty to their fellow minority shareholders by their "concerted, accelerating effort to buy up the minority shareholders' stock, thus increasing the defendants' ownership of the company." The majority shareholders in *Lawton* sought to increase their ownership in anticipation of a sale of the company.

B. Special Duties Applicable to Attorney Shareholders

An attorney who decides to become a shareholder of a close corporation for which the attorney acts as corporate counsel, is subject not only to the fiduciary duty owed by one shareholder to another, but also by the Rules of Professional Conduct concerning business transactions with clients. *DiLuglio v. Providence Auto Body, Inc.*, 755 A.2d 757, 770 (R.I. 2000). The attorney is required to inform the corporate client, in writing, of the potential conflict between the interests of the attorney as a minority shareholder and the interests of other shareholders, creditors and employees of the corporation. *Id.* In addition, the attorney must obtain the client's written consent to the transaction and provide the client with reasonable time to obtain independent legal advice. *Id.* Failure to comply with these requirements makes the transaction voidable at the option of the client within a reasonable time after the client learns or should have learned of the pertinent facts. *Id.* This is true even if the arrangement is economically fair to all parties. *Id.*

C. Extension of Fiduciary Duty to Managers and Members of Limited Liability Companies

At least one recent Rhode Island Superior Court case extends the fiduciary duty owed by shareholders of a close corporation to Managers of a closely-held limited liability company. While the court in *Marsh v. Billington Farms, LLC*, 2006 R.I. Super. LEXIS 119, recognized that the Rhode Island Supreme Court has not yet addressed what duty, if any, is owed by a Manager of a limited liability company to the members of the company, the court looked to Delaware law for guidance. *Id.* at *12. Generally, under Delaware law, managers of limited liability companies owe the same fiduciary duty to the members of the company as a corporate director owes to the shareholders of the corporation. *Id.* at *13. Relying on the guidance provided by Delaware law and the Rhode Island Supreme Court's decision in *Teixeira*, the Court found that the members of the limited liability company owed each other and the company a fiduciary duty "...of utmost care, loyalty and good faith". *Id.* at *15.

D. Shareholder Oppression

A minority shareholder who is being mistreated may assert a claim for oppression. That claim may take the form of a civil action seeking injunctive relief and/or damages. Alternatively, the aggrieved shareholder may seek dissolution of the corporation and appointment of a receiver pursuant to R.I. Gen. Laws § 7-1.2-1314, provided the petitioning shareholder satisfies one of the statutory conditions for relief. These conditions include demonstrating that "the acts of the directors or those in control of the corporation are illegal, oppressive, or fraudulent." R.I. Gen. Laws § 7-1.2-1314(a)(1)(ii)(2008). While illegal and fraudulent activity can be defined objectively, the statute contains no definition of what constitutes "oppressive" conduct. Likewise, the Rhode Island Supreme Court has not established a formal definition of what conduct constitutes shareholder oppression, although the subject is addressed at length in *Hendrick v. Hendrick*, 755 A.2d 784 (R.I. 2000).

Hendrick involved a dispute over a family run golf course. A dispute arose when one shareholder died and another shareholder

attempted to force the executrix of the deceased shareholder's estate to sell all shares in the corporation. The executrix argued that a Purchase Agreement applied only to shares held by the deceased shareholder at the time he entered into the Purchase Agreement. When it became clear that the executrix would not convey the stock, the majority shareholders authorized several corporate actions, which the executrix argued were oppressive to her as the minority shareholder. The corporation declared no dividend the next year, instead electing to pay exorbitant bonuses to the majority shareholders. The executrix was also fired from her employment with the company after eighteen (18) years of service, and was denied access to the corporation's financial records. Finally, the majority shareholders caused the corporation to purchase vacant land abutting land owned by one of the controlling shareholders, his wife and his son.

The Court in *Hendrick* recognized that neither the statute³ nor any previous opinions of the Court defined shareholder oppression in relation to close corporations. Looking at decisions of other courts, the Court noted that other courts defined oppression to include "...conduct which deviates from a heightened good faith standard that exists in closely held corporations, a more stringent standard than found in their public counterparts." *Hendrick*, 755 A.2d at 791 (citations omitted). The Court also discussed the more recent trend of defining oppression as conduct "that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the closed corporation." *Id.* at 791 (quoting *In re Rambusch*, 143 A.D.2d 605, 533 N.Y.S.2d 423, 425 (N.Y.App.Div. 1988)). The Court stated that oppression "can manifest itself in a range of actions designed to disadvantage or freeze out a minority shareholder." *Id.* at 791. These actions include (a) a refusal to declare dividends, (b) payment of exorbitant salaries and substantial bonuses to the majority shareholders and possibly their family members, (c) a refusal to allow the minority shareholder to hold a corporate office or to be employed by the corporation, (d) wasting of corporate assets and (e) withholding relevant financial information. *Id.* at 791-792 (citations omitted).

³ This case was decided under R.I. Gen. Laws § 7-1.1-90, which has since been repealed and replaced by R.I. Gen. Laws § 7-1.2-1314. The two statutory provisions are virtually identical, and the language regarding oppressive conduct is identical in both provisions.

In reversing the trial court's decision granting summary judgment to the majority shareholders, the Rhode Island Supreme Court in *Hendrick* went on to say:

Oppression within a closely held corporation can manifest itself as a series of acts or a pattern of conduct by majority shareholders that can have the cumulative, overall effect of freezing out or depriving the minority shareholder of a voice in the corporation, as well as manifesting itself in more distinct, identifiable actions.

Id. at 792.

In *Marsh v. Billington Farms, LLC*, 2007 R.I. SUPER. LEXIS 105, the Superior Court found that members of an LLC may also owe fiduciary duties to each other. In *Marsh*, the limited liability company consisted of four (4) members, two (2) married couples, the Marshes and the Despres. The LLC was developing a parcel of land into a residential subdivision, with the Despres providing the infrastructure through their separate corporation, and the Marshes constructing the houses through their separate entity. When disputes arose as to what would be paid to the separate entities, the Despres canceled the construction contract with the Marsh entity and recorded a *lis pendens* against the LLC's property for the site work, causing a default on the construction financing for the property. The Court found that the Despres violated their fiduciary duties to the company and to the Marshes since the *lis pendens* made it difficult, if not impossible, for the Marshes to continue construction and because the termination of the construction contract deprived the Marshes of their expectation to receive the builder's fee from the construction of the houses. *Id.* at *36 - *37. The court held that the defendant's actions amounted to a "freeze out" of the Marshes. *Id.* at *36. The "freeze out" constituted oppressive conduct, justifying the Marshes request for dissolution of the limited liability company. *Id.*

E. Reasonable Expectation of Continued Employment

It is well established that Rhode Island is an employment at-will state and in the absence of an employment agreement, an employee has no right to continued employment and is "subject to discharge at any time for any permissible reason or for no reason at

all." *New England Stone, LLC v. Donald C. Conte, et al*, 962 A.2d 30 (R.I. 2009), *citing*, *Galloway v. Roger Williams University*, 777 A.2d 148, 150 (R.I. 2001)(quoting *DelSignore v. Providence Journal Co.*, 691 A.2d 1050, 1051 n.5 (R.I. 1997)). However, attorneys practicing in Rhode Island should be aware that a shareholder who is employed by his or her closely held corporation is not necessarily an at-will employee. To the contrary, a shareholder/employee of a close corporation may have a "reasonable expectation of continued employment" that precludes termination *without cause*. In *Hendrick v. Hendrick*, 755 A.2d 784, 791 (R.I. 2000), the Rhode Island Supreme Court recognized what it referred to as the recent trend of the "reasonable expectation" analysis in characterizing oppressive conduct by majority shareholders in close corporations; and that such oppressive conduct may manifest itself by the majority shareholders depriving minority shareholders of corporate office and employment. *See also Peter Marsh v. Billington Farms LLC*, 2007 R.I. Super. LEXIS 105. Similarly, the Federal District Court for the District of Rhode Island, interpreting Rhode Island law, recognized that a shareholder in a closely held corporation has a reasonable expectation of continued employment with such corporation. *See, Bogosian v. Woloohojian*, 167 F. Supp 2d 491, 498 (D. R.I. 2001); *See also, Broccoli v. Broccoli*, 710 A.2d 669 (R.I. 1998).

The trend of applying the "reasonable expectation analysis" that was referred to by the Rhode Island Supreme Court in *Hendrick*, is evident in decisions by courts in other jurisdictions including, without limitation, Massachusetts, New York and Minnesota. Those courts have also held that a minority shareholder in a close corporation may have a reasonable expectation of continued employment. In Massachusetts, the Supreme Judicial Court found that the deprivation of employment of minority shareholders was a particularly pernicious form of corporate freeze-out. *Wilkes v. Springside Nursing Home, Inc.*, 370 Mass. 842, 849, N.E.2d 657, 662 (Mass. 1976). The Massachusetts Court recognized that a minority shareholder's reasonable expectation of employment stems from the fact that his salary as an employee is typically the principal form of his return on investment. *Id.* at 850, *citing* 1 F.H. O'Neal, *Close Corporations* § 1.07 (1971); *See also Brodie v. Jordan* 447 Mass. 866, 871, 857 N.E.2d 1076, 1080 (Mass. 2007).

In *Pedro v. Pedro*, 463 N.W. 2d 285, 289 (Minn. App. 1990)(“*Pedro I*”), two brothers sought to freeze out a third by terminating his employment. The Court of Appeals of Minnesota pointed out that the primary expectations of minority shareholders in closely held corporations: “include an active voice in management of the corporation and input as an employee.” *Id.* Rejecting the defendants’ argument that Minnesota was an “at will” state, the Court stated that “[I]n a closely held corporation the nature of the employment of a shareholder may create a reasonable expectation by the employee-owner that his employment is not terminable at will.” *Id.* On a subsequent appeal by defendants, the court stated plainly: “In addition to an ownership interest, the reasonable expectations of such a shareholder are a job, salary, a significant place in a management, and economic security for his family.” *Pedro v. Pedro*, 489 N.W.2d 798, 802 (Minn. App. 1992)(“*Pedro II*”).

In *Gunzberg v. Art-Lloyd Metal Products Corp.*, 112 A.D.2d 423, 425, 492 N.Y.S.2d 83, 85 (N.Y. App. Div. 2d Dep’t 1985), the Supreme Court of New York, Appellate Division, recognized that shareholders’ long history of taking an active part in the running of the corporation demonstrated their reasonable expectation of continued employment and participation in management.

Even if a shareholder is found to have a reasonable expectation of continued employment, that expectation will **not** protect a shareholder from being terminated for cause. In *Bogosian*, the District Court recognized that a shareholder in a close corporation relinquishes her legitimate expectation to employment when she ceases to perform any work for the corporation. *Bogosian*, 167 F. Supp. 2d at 498. In *Broccoli*, the Supreme Court found that a shareholder was justifiably terminated by his brothers after refusing to perform work at the family business after being removed as president of the corporation. *Broccoli*, 710 A.2d at 671.

As shown in the cases above, there is no set list of actions that will rise to the level of a breach of the fiduciary duty owed by shareholders to one another. While termination of employment of a shareholder may be sufficient in one case, it may not be a breach under different circumstances. The Court also may not find a breach of a fiduciary duty where the alleged breach resulted at

least in part by the action or inaction of the complaining shareholder.

IV. RESOLVING CLOSELY HELD SHAREHOLDER DISPUTES

A. Mediation/Arbitration

There are any number of good reasons to explore the possibility of alternative dispute resolution as early as possible, including: the substantial costs and delays inherent in the litigation of closely-held business disputes; the adverse effect ongoing litigation may have on the parties' (formerly close) relationship as well as the business itself; the need or desire for a confidential resolution; and the risks of an unfavorable result at trial. In some cases, the inevitably contentious nature of the litigation may serve to further alienate the parties and poison any chance of a mutually beneficial settlement short of trial. Early ADR sometimes allows the parties to resolve a dispute before positions harden and before substantial attorneys' fees are incurred. Finally, ADR sometimes offers greater freedom for the parties to fashion remedies by agreement that may not be otherwise available.

B. Litigation – Common law and Statutory Remedies

In the event litigation is deemed to be the most effective alternative, there are a number of possible litigation scenarios, including, the following:

- File a complaint on the basis of breach of fiduciary duty, breach of a shareholders' agreement, mismanagement, fraud, conversion, misrepresentation, constructive trust, unjust enrichment, wrongful discharge, self dealing, breach of the duty of loyalty.
- Include the company as a defendant to the extent that the company has engaged in wrongful conduct or is necessary in order for complete relief to be possible.
- If the company has been harmed, include a shareholder derivative count on behalf of the company.

- Seek a TRO or preliminary injunction to obtain records, preserve the *status quo*, restore what had been the status quo or enjoin specific harmful conduct.
- Seek a declaration of rights under R.I. General Laws §§ 9-30-1 *et seq.*
- Seek the appointment of a Master pursuant to Rule 53 of the Superior Court Rules of Civil Procedure and R.I. General Laws 9-15-1 *et seq.*
- File a petition for the dissolution of the corporation and appointment of a receiver pursuant to R.I. Gen. Laws § 7-1.2-1314.

1. Injunctive Relief and Damages

Whether or not to seek a temporary restraining order or preliminary injunction may prove to be one of the most important decisions in the case. Some considerations include: whether an injunction advances the client's objectives; whether injunctive relief is necessary to preserve or restore the *status quo*; whether the client has effectively been frozen out from participating in the business; the likelihood that the Court will grant the motion versus the risk that it will not; the time and costs required by the motion; whether expedited discovery is possible and necessary; and the costs associated with a security bond if an injunction is entered.⁴ See *Chelo's of Woonsocket, Inc. v. Chelo & Mozzarellas of N.*

⁴ The requirements for preliminary injunction are well established in Rhode Island. The party seeking a preliminary injunction must demonstrate the following:

- (1) That it stands to suffer some irreparable harm that is presently threatened or imminent and for which no adequate legal remedy exists to restore that plaintiff to its rightful position.
- (2) That it possesses a reasonable likelihood of succeeding on the merits of its claim at trial. To make this showing, the moving party need not demonstrate a certainty of success; rather, it only needs to make out a *prima facie* case.
- (3) Having found a likelihood of success and an immediate irreparable injury, the trial justice should next consider the equities of the case by examining the hardship to the moving party if the injunction is denied, the hardship to the opposing party if the injunction is granted, and the public interest in denying or granting the requested relief. In considering the equities, the hearing justice should keep in mind that the office of a preliminary injunction is not ordinarily to achieve a final and formal determination of the rights of the parties or of the merits of the controversy, but is merely to hold matters approximately in status quo, and in the meantime to prevent the doing of any acts whereby the rights in question may be irreparably injured or endangered.

Providence, 2004 R.I. Super. LEXIS 51, (internal citations omitted). "The possibility of damaging the good will and reputation of a business 'is precisely the type of irreparable injury for which an injunction is appropriate.'" *Colannino v. Iacofano*, 2005 R.I. Super. LEXIS 10. (citing *Fund for Community Progress v. United Way*, 695 A.2d 517, 523 (1997)).

Should a shareholder dispute proceed to trial, the damages suffered by the shareholder may take a variety of forms. For example, a minority shareholder may allege that she: had her employment terminated without cause; cannot sell shares or that her shares were sold for less than full value; was denied dividends when the corporation has been profitable; had been misled as to the value of her shares or has otherwise suffered lost profits. It is often necessary to hire an expert to value the business or establish the lost profits.

Under Rhode Island law, "[t]he basic precondition for the recovery of lost profits is that such a loss be established with reasonable certainty. Although mathematical precision is not required, the [trier of fact] should be provided with some rational model of how the lost profits occurred and on what basis they have been computed." *Long v. Atl. PBS, Inc.*, 681 A.2d 249, 252 (R.I. 1996) (citations and internal quotation omitted). "We do not require mathematical certainty in this calculation. All that is required is that the court be guided by some rational standard." *Abbey Medical/Abbey Rents, Inc. v. Mignacca*, 471 A.2d 189, 195 (R.I. 1984) (citation omitted). At the same time, damages awards may not be based on speculation. *MacGregor v. R.I. Co.*, 27 R.I. 85, 60 A. 761, 762 (R.I. 1905); see *Thermo Electron Corp. v. Schiavone Constr. Co.*, 958 F.2d 1158, 1166 (1st Cir. 1992). Finally, where breach of fiduciary duty is involved, the Rhode Island courts have looked to equity for appropriate remedial principles. See, e.g., *Matarese v. Calise*, 111 R.I. 551, 111 R.I. 935, 305 A.2d 112, 119 (R.I. 1973). *Lawton v. Nyman*, 327 F.3d 30 (1st Cir. 2003).

2. Derivative Action

A shareholder who sustains damage caused by a fellow shareholder's breach of fiduciary duty, may bring suit in their individual capacity against the wrongdoer. However, injuries to the corporation may only be redressed by the corporation itself or by a

shareholder by filing a so-called derivative claim on behalf of the injured corporation. Individual shareholders have no standing to bring derivative claims, except on behalf of the entity. *See Kamen v. Kemper Fin. Servs. Inc.*, 500 U.S. 90, 95, 114 L. Ed. 2d 152, 111 S. Ct. 1711 (1991). Any judgment obtained in a derivative action is an asset of the corporation.

In determining whether a suit is derivative a Rhode Island court will employ the following standard:

The general rule is that an action to redress an injury to a corporation must be brought as a derivative suit and may not be maintained by shareholders acting in their individual capacities. However, if the injury in question is one sustained by the shareholders, directly, they may sue on their own behalf. In determining whether a particular claim is derivative or personal, the Court must consider the nature of the harm inflicted and the nature of the rights violated. *Where the injury is personalized to a shareholder and flows from a violation of rights inherent in the ownership of stock, suit may be brought by the shareholders. On the other hand, where the injury is to the corporation and only affects the shareholders incidentally, the action is derivative.*

Dowling v. Narragansett Capital Corporation, 735 F.Supp. 1105, 1113 (D.R.I. 1990) (internal citations omitted)(italics added). *See also, Dunn v. Shannon et al.*, 2005 R.I. Superior. LEXIS 69 (adopting standard employed by federal district court). In addition, “in cases where the corporation sustains the injury, the fact that the shareholders may have indirectly suffered individual losses in the form of a diminution in the value of their stock does not entitle them to bring the action in their own names.” *Dowling* at 1113.

Rule 23.1 of the Superior Court Rules of Procedure sets forth the requirements for maintaining a derivative action, including, without limitation the need for a verified complaint and the requirement that a demand be made on the corporation or reasons why a demand would be futile. *See Super.R.Civ.P. 23.1; Hendrick*, 755 A.2d at 794 (even if “demand ultimately proves futile, plain

language of [Rule 23.1] requires that plaintiff demonstrate that all avenues of redress are foreclosed before a derivative suit may be brought”).

3. Appointment of a Master

Rule 53 of the Superior Court Rules of Civil Procedure and R.I. General Laws 9-15-1 *et seq.* govern the appointment of special masters in Rhode Island. The Court, with or without agreement of the parties, may appoint a person with special expertise to serve as a master for the purpose of hearing evidence and reaching a decision on the facts or, in some cases, both the law and facts of a case. Masters can be especially helpful “when an investigation of accounts is required or the issues are complicated [...] and in matters of difficult computation of damages.” Super.R.Civ.P. 53(b)(2).

4. Appointment of Receiver Pursuant to the Court’s Equitable Powers

Superior Court judges have broad equitable powers, including the power to appoint a receiver to preserve the corporate assets and take charge of certain property, including the business itself. In *Levine v. Bess Eaton Donut Flour Co.*, 705 A.2d 980 (1998), the Rhode Island Supreme Court explained:

The appointment of a nonliquidating receiver for an ongoing, solvent corporation is an extraordinary remedy that should be reserved for extraordinary situations. *See, e.g., Prassas v. Nicholas W. Prassas & Co.*, 102 Ill. App. 3d 319, 430 N.E.2d 28, 30, 58 Ill. Dec. 86 (Ill. Ct. App. 1981) (existence of dissension, fraud, misconduct, or mismanagement that makes it impossible for business to continue or to preserve its assets); *Crippin Printing Corp. v. Abel*, 441 N.E.2d 1002, 1007 (Ind. Ct. App. 1982) (present danger to investors consisting of serious suspension of or interference with conduct of business resulting in imminent danger of corporate assets being dissipated).

705 A.2d at 983. The decision to appoint a receiver is left to the discretion of the trial justice depending on the circumstances of each case. *Id.*

5. Statutory Remedies: Sections 7-1.2-1314 and 7-1.2-1315

R.I. Gen. Laws § 7-1.2-1314-1316 supplies a minority shareholder with an extraordinarily powerful means for confronting abuse by the majority/controlling shareholders. In an action brought by a shareholder, Section 7-1.2-1314 (a)(1)⁵ empowers the Court to liquidate the assets and business of a corporation in circumstances of deadlock, illegal, oppressive or fraudulent acts by those in control, misapplication or waste of corporate assets, threat of serious harm to the corporation resulting from internal dissension between two or more factions of shareholders or a vote to dissolve by holders of more than 50% of the stock of a corporation.

In an action by a shareholder, the Court has general equity jurisdiction “power to issue any orders, injunctions, and decrees that justice and equity require, to appoint a receiver or receivers *pendent lite*, with any powers and duties that the court, from time to time, directs, and to take any other proceedings that are requisite to preserve the corporate assets wherever situated, and carry on the business of the corporation until a full hearing can be had.” Section 7-1.2-1316 (a).

Where a shareholder petitions the Court for dissolution pursuant to Section 7-1.2-1314, the non-petitioning shareholders may avoid dissolution by exercising the right pursuant to Section 7-1.2-1315 to buy out the petitioning shareholder’s equity interest at “fair value.” The non-petitioning shareholders have an absolute right to file an election prior to the commencement of the dissolution hearing, or in the Court’s discretion, “at any time prior to a sale or other disposition of the assets of the corporation.” *DiLuglio v. Providence Auto Body, Inc.*, 755 A.2d 757 (R.I. 2000).

⁵ Section 7-1.2-1314 (a)(2) empowers the Court to liquidate a corporation in an action brought by a creditor in circumstances of insolvency, misapplication or waste of corporate assets.

The “fair value” to be paid to the petitioning shareholder is determined “as of the close of business on the day on which the petition for dissolution was filed.” *Charland v. Country View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991), *appeal denied, appeal dismissed*, 626 A.2d 695 (1993). If the parties are unable to agree upon fair value, the Court will determine the value of the petitioning shareholder’s shares. *Id.* Under Rhode Island case law, there is no minority discount, no majority premium and no marketability discount in a section 7-1.2-1315 election. *Charland v. Country View Golf Club, Inc.*, 588 A.2d 609 (R.I. 1991), *appeal denied, appeal dismissed*, 626 A.2d 695 (1993). Therefore, the issues of control, majority ownership and lack of marketability of shares do not come into play. For example, if the petitioning shareholder owns 15% of the company’s stock, she will receive 15% of the fair value of the company. Section 7-1.2-1315 refers to § 7-1.2-1202 for the procedure to be used to determine fair value.

It is important to note where the parties cannot agree on the value of the shares, § 7-1.2-1315 mandates that the non-petitioning shareholder post a bond or other security sufficient to assure payment of the value of the shares, at which point the Court will proceed to determine the fair value of the shares. Because it is the non-petitioning shareholders, not the company, who can elect to purchase the shares, the bond must be posted by the electing shareholder(s) utilizing his/her/their personal assets as the collateral. Once the bond is posted, the petitioning shareholder no longer holds any voting power in the corporation, and the electing party assumes exclusive control over the company.

Upon determining the fair value of the petitioning shareholder’s stock, the Court may enter an order directing the amount of the purchase price and other terms and conditions of sale, including whether the purchase price may be paid in installments. The petitioner is entitled to interest at the rate on civil judgments from the date of the filing of the election to purchase the shares. The costs of the proceedings, including appraisers (but not legal fees or experts retained by a party) are allocated between or among the parties as the court determines. The Court also determines when the shares owned by the petitioning shareholder are to be transferred to the purchaser. § 7-1.2-1315.

As a practical matter, the source of the capital to fund the buy-out is a critical issue. Unless otherwise agreed by the parties, a section 7-1.2-1315 buyout can only be made by the non-petitioning shareholder, not the corporation. Thus, absent an agreement by the parties permitting the corporation to secure the bond, if required, and/or fund the election purchase, the Court will typically not allow the corporation to secure the bond and/or use its capital to fund an election to purchase. Therefore, if valuation cannot be agreed upon, the non-petitioning shareholder must consider his/her ability and/or risk of pledging personal assets as collateral to secure a bond. Equally important, the non-petitioning shareholder must have sufficient capital on hand or have the ability to obtain adequate credit to fund the purchase price.

Ultimately, the decision as to whether to seek dissolution and risk a buy-out election rests with the petitioning shareholder. In deciding whether to seek the appointment of a statutory receiver, the petitioning shareholder should consider (a) whether he or she is interested in being bought out; (b) whether the value of the company at the time the dissolution petition is filed would yield an amount that would satisfy the petitioning shareholder; (c) whether the company is likely to succeed going forward and to what extent there is a risk of default in payment of that portion of the purchase price that the Court may allow to be paid in installments; and (d) whether the petitioning shareholder relies on employment income or other distributions that will cease once an election is made to purchase his/her stock. Finally, the petitioning shareholder should assess the potential consequences of his/her petition, should an election *not* be made by the non-petitioning shareholder. The non-petitioning shareholder should be prepared for a potentially costly battle over the alleged grounds for appointment of a receiver; and ultimately if a receiver is appointed, the petitioning shareholder should be prepared for the results of the liquidation of the assets and the business of the company.