Counsel to businesses take note: shareholders of closely held corporations have fiduciary obligations to each other greater than those in the world of publicly traded organizations. Here’s a primer on Illinois law.

This article analyzes the fiduciary duties among shareholders of the closely held corporation. Illinois is

1. A closely held corporation is also commonly known as a closed corporation and sometimes as a private corporation. Black’s Law Dictionary 391 (9th ed 2009).


The scope of this article is limited to the fiduciary duties owed to shareholders by shareholders of a closely held corporation and does not analyze the fiduciary duties owed by shareholders to the corporation or the fiduciary duties owed by officers and directors to either the shareholders or the corporation. For a discussion of these topics, see, e.g., Hagghenas v Gayford, 199 Ill App 3d 60, 557 NE2d 316 (2d D 1990); In re Joy Recovery Tech Corp, 257 BR 253 (Bankr ND Ill 2001); and Rexford Rand Corp v Ancel, 58 F3d 1215 (7th Cir 1995).
How closely held corporations are created

Most corporations in the United States are closely held, either by meeting statutory requirements or by the very nature of its corporate and shareholder attributes. Statutory creation. Statutory requirements to qualify as a close corporation vary from state to state. In Illinois, for example, the Illinois Business Corporation Act allows corporations to elect “close” corporate status. By so doing, these corporations subject themselves to provisions of the law that ease certain formalities the Act otherwise imposes. Because it is uncommon for a corporation to statutorily elect to become a close corporation, this article will not analyze or discuss these state statutes.

Creation by corporation and shareholder attributes. A corporation does not have to be incorporated as a statutory close corporation for shareholders to owe fiduciary duties. If a corporation has not statutorily elected close-corporation status and a dispute arises among shareholders, courts will consider the facts and circumstances surrounding the shareholders’ relationships and may determine that fiduciary duties exist.

Courts analogize these duties to those owed within a statutorily created closely held corporation. While there is no standard set of attributes, certain characteristics distinguish closely held corporations from their publicly traded counterparts. Typically, the stock of a closely held corporation is held by only a few shareholders, has no market in which to trade its shares, and is not freely traded. Shareholders often invest their money, time, and effort into a closely held corporation to get a voice in the management and may serve as directors, officers, and employees.

Fiduciary duties and close corporations

An exception to the rule. Generally, shareholders of a corporation have no obligations or duties to each other. In Illinois, for example, the Illinois Business Corporation Act of 1983 states that “[a] holder of or subscriber to shares of a corporation shall be under no obligation to the corporation or its creditors with respect to such shares other than the obligation to pay to the corporation the full consideration for which the shares were issued or to be issued.”

Corporate fiduciary duties can be organized into the categories of good faith, honesty, candor, and loyalty. Good faith and honesty are largely self-explanatory, and “candor” is defined as the disclosure of material facts. A claimed breach of the duty of loyalty is the most likely to be litigated and has been defined as “a person’s duty not to engage in self-dealing or otherwise use his or her position to further personal interests rather than those of the beneficiary.”

Courts impose fiduciary duties on shareholders of closely held corporations. Because of the unique characteristics of a closely held corporation, there is greater potential for actual or perceived unfairness among the shareholders. This risk, especially to minority shareholders, has led courts to extend shareholder-to-shareholder fiduciary duties.

In 1993, a bankruptcy court sitting in Illinois wrote that “shareholders in a closely held corpora-

4. It is noteworthy that in stark contrast to most states (including Illinois), Delaware does not impose fiduciary duties on shareholders of closely held corporations.
6. In this article, the phrase “close corporation” will be used by the authors to reference one that is statutorily created, and the phrase “closely held corporation” will be used to reference one that is created by virtue of its attributes. Unfortunately, courts often use these phrases interchangeably and the quotes contained within this article may reflect this inconsistency.
10. Courts will not treat the corporation as a statutory “close” corporation, but as a closely held business, with attributes as herein defined.
11. See Hagshenas at 557 NE2d at 322 (“We believe that, though [the corporation] was not organized or registered as a close corporation under the Close Corporation Act, for all practical purposes it acted as a close corporation.”).
16. 805 ILCS 5/1.01 et seq.
17. 805 ILCS 5/6.49.
19. Id.
20. The second district has explained that it is “implicit that people who enter into small business enterprise...place their trust and confidence in each other. Thus, we find...a fiduciary relation exists in all cases in which a confidential relationship has been acquired.” Hagshenas at 72, 557 NE2d at 324. The seventh circuit has further explained that: “Shareholders in closely held corporations have often invested “a substantial percentage” of their assets in the corporation....and their position in the corporation may provide them with their only source of income. Minority shareholders are vulnerable to “freeze-outs” or “squeeze-outs,” where the majority, for personal rather than legitimate business reasons, deprives the minority shareholder of his office, employment, and salary....Moreover, because no active market exists for the corporation’s stock (and prospective purchasers may be wary of buying into a small enterprise where dissenion has already occurred), the minority stockholder most likely will not be able to sell his shares for any sum approaching their fair value.” Rexford Rand, 58 F3d at 1219.
tion owe a fiduciary duty to deal with the utmost good faith, fairly, honestly, and openly with their fellow stockholders.”22 The seventh circuit similarly held that shareholders of closely held corporations are fiduciaries of each other and must act loyally, in good faith, and honestly with the other shareholders.23
Some courts analogize closely held corporations to partnerships, envisioning a fiduciary relationship similar to that among traditional partners.24 They observe that fiduciary duties between shareholders in a closely held corporation embody the corporate form, in many ways resembles a partnership. Thus, “the mere fact that a business is run as a corporation rather than a partnership does not shield the business venturers from a fiduciary duty similar to that of true partners.”25

The nature and extent of the duty
While courts agree shareholders of a closely held corporation owe one another fiduciary duties to deal fairly with and not oppress the fellow shareholders. In stock sales, a majority shareholder must deal with a minority shareholder in good faith and disclose any material facts of which he or she is aware at the time of such purchase and/or sale.26 Most courts additionally find that shareholders who own 50 percent of the corporate stock have a duty to one another, as do shareholders who have the ability to control, hinder, and/or influence the corporation or who have a confidential relationship with one another.27

There is also authority that merely holding the status of a shareholder in a closely held corporation gives rise to shareholder fiduciary duties.28 This has become a controversial topic. For example, in 2005 the Illinois legislature added a new section to the Illinois Business Corporation Act of 1983, found at 805 ILCS 5/7.90.29 It enables a shareholder to waive certain rights in exchange for a release of fiduciary obligations based solely on shareholder status.30

By contracting up front, a shareholder might avoid a claim of oppressive conduct. As one commentator noted, “[t]he more private contracting covers the areas of dispute, the less the courts will be forced to use the blunt instrument of expanding fiduciary duties.”31

This legislative action speaks volumes in what it implies. By allowing shareholders to waive their fiduciary obligations, the legislature is arguably saying that without such a waiver, shareholder status alone gives rise to fiduciary obligations among shareholders.

What constitutes breach
While there are no bright line rules about what constitutes a fiduciary breach of good faith, candor, honesty or loyalty, case law provides helpful examples of what is and is not acceptable.
In Haghshenas v Gaylord, the second district held that a 50 percent shareholder breached his duty of loyalty by forming a new business that directly competed with the business of the corporation.32 In re Dearborn Process Service, Inc, 149 BR 872, 880 (Bankr ND Ill 1993).33

23. Rexford Rand, 58 F3d at 1219.
24. Illinois and Massachusetts courts have held that
shareholders of closely held corporations owe a fiduciary duty to one another analogous to the fiduciary duties of partners owe one another. See Donahue v Rodd Elec Co of New England, Inc, 367 Mass 578, 328 NE2d 503 (1975). For a list of Illinois cases so holding, see Barmonte, Expanding the Fiduciary Duties, 15 N Ill U L Rev at n 29 (cited in note 21).
25. Rexford Rand, 58 F3d at 1219, quoting Haghshenas at 70, 557 NE2d at 322. See also Tilley v Shippee, 12 Ill 2d 616, 623, 147 NE2d 347, 352 (1958) (“decision to form and operate as a corporation rather than a partnership does not change the fact that they were bargaining on a joint enterprise, and their mutual duties and obligations were similar to those of partners”); Illinois Rockford Corp v Kulp, 41 Ill 2d 215, 242 NE2d 228 (1968).
26. Gallar at 29, 203 NE2d at 584-85.
27. With a shareholder agreement, therefore, an individual shareholder holding less than 50% within a group may be liable for fiduciary duties.
28. See, e.g., Gary v Duff & Phelps, Inc, 672 F Supp 1086, 1090 (ND Ill 1987), relying on Jaffe Commercial Finance Co v Harris, 119 Ill App 3d 136, 143, 652 NE2d at 1379 (minority shareholder did not have a fiduciary duty to other shareholders, because the shareholder did not have the ability to control, hinder or influence the corporation).
29. Guy, 672 F Supp 1086.
30. Id; Northern Trust Co v Essanesia Theatres Corp, 348 Ill App 134, 139-144, 108 NE2d 493, 496-98 (1st D 1952).
31. See, e.g., Smith v Atlantic Properties, Inc, 12 Mass App Ct 201, 201-208, 422 NE2d 798, 800-03 (1981) (25% shareholder owed fiduciary duty to closely held corporation where 80% vote was required to declare a dividend); Haghshenas at 69, 557 NE2d at 322; Illinois Rockford at 223, 242 NE2d at 233-34 (20% shareholders of a corporation owed fiduciary duties to each other, and a fiduciary relationship exists in all situations in which a confidential relationship has been established); See Dowell v Bitter, 273 Ill App 3d 681, 690, 652 NE2d 1372, 1379 (minority shareholder did not have a fiduciary duty to other shareholders, because the shareholder did not have the ability to control, hinder or influence the corporation).
32. See Haghshenas at 72-73, 557 NE2d at 324 (setting forth the principle that a shareholder could owe fiduciary duties simply due to one’s status as a shareholder). See Rexford Rand, 58 F3d at 1220 (federal court applying Illinois law held that a majority shareholder owes a duty of loyalty to his fellow shareholders, that even a freeze-out did not deprive the shareholder of his “status as a shareholder”). But see Dowell at 691, 652 NE2d at 1379 (“something more than mere status as a shareholder in a closely held corporation is required to impose a fiduciary duty on a shareholder”)
33. 805 ILCS 5/7.90. The statute, in part, states: §7.90. Waiver. (a) Unless otherwise provided in the articles of incorporation, a shareholder who executes and delivers to the corporation a written instrument irrevocably waiving the right (i) to vote any shares held by such shareholder, whether for the election of directors or otherwise, (ii) to be a director or officer of the corporation, or (iii) to inspect or control any other corporate records or to direct or indirectly, corporate actions or any election or removal of any director or officer of the corporation, and who at the time of such waiver was not a director or officer of the corporation, shall have no fiduciary duty to the corporation or any of its shareholders arising out of the fact that such person is a shareholder of the corporation. No such waiver shall affect any breach of fiduciary duty arising prior to the effective date of the waiver.
34. 805 ILCS 5/7.90(a). Interesting to note though, under existing partnership law, a partnership agreement cannot eliminate the fiduciary obligation of partners to each other. See Saballos v Tolson, 120 Tex App 109, 460 NE2d 755, 760 (1st D 1983). If one applies the rule that shareholders of closely held corporations are subject to similar fiduciary duties as partners, it would seem that shareholder agreements cannot contractually eliminate the fiduciary duties that are imposed on shareholders.
35. Barmonte, Expanding the Fiduciary Duties, 15 N Ill U L Rev at 269 (cited in note 21).
The court said that shareholders in closely held corporations “must discharge their management and shareholder responsibilities in conformity with [a] strict good faith standard. They may not act out of avarice, expediency or self-interest in derogation of their duty of loyalty to the other stockholders and to the corporation.”37

In In re Joy Recovery Technology Corp, a bankruptcy court sitting in Illinois remarked that “[a]ctions by shareholders that leave a company insolvent could be disloyal and in bad faith.”38 Further examples of a shareholder’s breach of the duties of loyalty and good faith include (i) depriving other shareholders the right to share in the financial benefits generated by the corporation, (ii) usurping a corporate opportunity for his or her personal benefit, and (iii) giving himself or herself and others above-market salaries and bonuses.39

**The Delaware exception – no fiduciary duty**

Unlike courts in Illinois and many other states, Delaware courts have been unwilling to impose fiduciary duties on shareholders of closely held corporations.40 In considering whether to impose special, judicially created rules to “protect” minority stockholders of closely held Delaware corporations, the Delaware Supreme Court stated as follows in Nixon v Blackwell:

A stockholder who bargains for stock in a closely-held corporation and who pays for those shares...can make a business judgment whether to buy into such a minority position, and if so, on what terms....Moreover, in addition to such mechanisms [in Delaware Corporate Law], a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive stockholder agreements, and such agreements may provide for elaborarate earnings tests, buy-out provisions, voting trusts, or other voting agreements....The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.41

Delaware is a preferred state of incorporation for publicly traded corporations.42 Many closely held corporations, however, incorporate in their home states.43 Some believe that Delaware’s reluctance to expand the fiduciary duties of shareholders should encourage closely held corporations to incorporate there.44

**Summary**

As this area of law develops through case law and statutory changes, the factors that affect fiduciary duties among shareholders include the total number of shareholders, the amount of control possessed by each, and the extent to which individual shareholders wear different hats within the corporation as employees, officers, and directors. Courts tend to move along a continuum from greater to lesser fiduciary duty as the corporation’s total number of shareholders increases and management becomes separate and distinct from the controlling shareholders.

Also, as the roles and responsibilities of shareholders become blurred when they serve as employees, officers, and directors, the fiduciary duties owed among shareholders may likewise be subsumed by the fiduciary duties inherent in these other corporate positions.

It remains unclear in most states exactly which fiduciary duties apply when or whether the mere status of shareholder in a closely held corporation is sufficient to create fiduciary responsibilities. However, there is ample case and statutory law to support the proposition that shareholders of a closely held corporation owe fiduciary duties to each other.

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36. Haghenius at 69, 557 NE2d at 322.
39. Rexford Rand, 58 F3d 1215.
40. See Nixon v Blackwell, 626 A2d 1366 (Del 1993); Bamonte, Expanding the Fiduciary Duties, 15 N Ill U L Rev 257 (cited in note 21) and Mary Siegel, Fiduciary Duty Myths in Close Corporate Law, 29 Del J Corp L 377, 409-10 (2004) (describing Delaware principles regarding fiduciary duties owed by shareholders within closely held corporations as: “Delaware Supreme Court requires corporations to elect close corporate status in order to obtain the benefits of that subchapter... reject[ing] the majority view that equates closely-held corporations with statutory close corporations...[T]he only shareholders who owe fiduciary duties are controlling shareholders, and this duty arises only when acting in a corporate, rather than in a personal, capacity.”)
41. Nixon, 626 A2d at 1379-80.
44. Bamonte, Expanding the Fiduciary Duties, 15 N Ill U L Rev at 266 (cited in note 21).

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