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The Duty of Corporate Directors to Pay Dividends

BY RANDALL K. JUSTICE

I. INTRODUCTION

Directors have a great deal of power in the corporate world. However, they also have clearly defined obligations. One of these obligations is to pay shareholders dividends on their investments.\(^1\) In determining when dividends should be paid, the directors must look at the financial state of the corporation, the expectations of the shareholders, and the requirements for fulfilling their fiduciary duties.

This Note will examine the recent dividend policies of American corporations and how the business judgment rule has been used by courts to give directors discretion in determining when to pay dividends. Part II of this Note will deal with shareholder expectations.\(^2\) This Part will include an analysis of the recent trends in the payment of dividends by the largest corporations. Part III will discuss the application of the business judgment rule and the intrinsic fairness test to a board of directors’ decision regarding distributions to shareholders.\(^3\) This Part will examine the circumstances

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\(^1\) The term “dividend” has slightly different meanings depending on the context in which it is used. For example, the Internal Revenue Code defines a dividend as “any distribution of property made by a corporation to its shareholders — (1) out of its earnings and profits accumulated.” I.R.C. § 316(a) (1998). This is an expansive definition which is much broader than many individuals would use to define dividend. Most investors and members of the general public consider dividends cash payments made, pro rata, to the shareholders of a corporation. See BLACK’S LAW DICTIONARY 478 (6th ed. 1990). For the purposes of this Note, the general public’s definition of dividend will be used.

\(^2\) See infra notes 8-20 and accompanying text.

\(^3\) See infra notes 21-148 and accompanying text.
surrounding cases where directors have been absolved from liability for their decisions, including the most notable case, *Dodge v. Ford Motor Co.*,\(^4\) where a shareholder was successful in compelling the directors of a corporation to pay dividends. Part IV will analyze two special issues dealing with suits to compel the payment of dividends.\(^5\) These issues are whether the suit should be brought as a derivative action against the corporate directors or as an individual action against the corporation\(^6\) and the special problems associated with a closely held corporation.\(^7\) Part V will explain why the courts have taken the correct approach in actions against directors to compel the payment of dividends.

**II. SHAREHOLDER EXPECTATIONS**

Investors purchase stock to obtain a “return on their investment,” which “is measured by both dividends and appreciation in share value over time.”\(^8\) “The shareholders forming an ordinary business corporation expect to obtain the profits of their investment in the form of regular dividends.”\(^9\) In the early 1990s, many corporations slowed the rate of growth of their dividends or stopped paying dividends completely.\(^10\) This trend continued through the early part of 1996, when dividend payments were at “‘lows not seen for the last 100 years.’”\(^11\) As the

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\(^5\) *See infra* notes 149-65 and accompanying text.

\(^6\) *See infra* notes 149-59 and accompanying text.

\(^7\) *See infra* notes 160-65 and accompanying text.


\(^9\) *Dodge*, 170 N.W. at 682 (quoting 1 *VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS § 447, at 421 (2d ed. 1886).*).

\(^10\) For example, during the first nine months of 1995, dividend payments of Standard & Poor’s (“S&P”) corporations only rose 4.1% over the prior year, which was below expectations. In addition, 59 S&P corporations had not declared a dividend, compared to 53 the year before. *See Shirley A. Lazo, Profits are Hot, Dividends Not: Investors Would Rather Have Future Gains, BARRON’S, Oct. 9, 1995, at 30, 30.* The Standard & Poor’s 500 is “an unmanaged benchmark of common stock performance consisting of 500 of the largest U.S. publicly traded companies.” *Kenneth H. Rosenbaum, Plan to Retire Independently Wealthy, CHI. BAR ASS’N REC., Feb.-Mar. 1996, at 44, 46.*

economy and corporate earnings improved, corporations began paying larger dividends.\(^\text{12}\) Almost half of the companies on the Standard & Poor’s 500 raised the amount of dividends they paid in May 1996.\(^\text{13}\) This “was the biggest one-month batch of dividend increases since January 1981.”\(^\text{14}\)

Although the overall amounts of dividends have increased, minority shareholders in closely held and family-owned corporations are in many instances refused dividends by the corporate directors.\(^\text{15}\) This occurs because of the nature of the ownership interest and the position of control in the corporation that majority shareholders often hold. The majority shareholders in these types of corporations are normally directors who can appoint themselves as the chief officers of the corporation and then set high salaries for themselves in order to avoid double taxation of the income they receive. If this income were in the form of dividends instead of executive compensation, it would face taxation “at both the corporate and individual level.”\(^\text{16}\) The directors then do not declare dividends because they have already received income from the corporation.

This system works well for the shareholders who also hold positions in the business, but leaves out the minority shareholders who depend on dividends as the only form of return on their investment. This practice can also be used to force minority shareholders to sell their stock to the majority at prices significantly below the stock’s book value.\(^\text{17}\) These sales do give the former minority shareholders some return on their investment, but they take away the future economic benefits of stock ownership as well as the control over the company which stock ownership provides. Although many investors do nothing about these practices, there has been a significant increase in the number of complaints filed by minority shareholders against majority shareholders for the payment of dividends.\(^\text{18}\)

\(^{12}\) See id.

\(^{13}\) See id.

\(^{14}\) Id.

\(^{15}\) See Barbara Marsh, Minority Shareholders Stand Up, Demand to be Heard: Rights Movement Is Gaining Better Terms from Closely Held Companies, WALL ST. J., Feb. 23, 1993, at B2.

\(^{16}\) Id.

\(^{17}\) See id. (explaining that the shares are sold below book value because they lack marketability).

\(^{18}\) “Requests for help from minority shareholders in closely held corporations have risen to several a month from one a year in the last two years . . .” Id. (citing information provided by the United Shareholders Association, a Washington advocacy group).
The question is, how can the investors make sure they continue receiving dividends? The traditional answer was by their choice of directors. The idea was that "[w]hen shareholders elect directors as their representatives, the directors’ objective should be the highest possible return for those they represent." However, the courts’ application of the business judgment rule has severely limited the ability of shareholders to compel the payment of dividends.

III. SHAREHOLDER ACTIONS TO COMPEL DIVIDENDS

The courts in several states have taken the lead in litigating issues relating to corporate dividend policy. These courts have used virtually the same standards to judge director action—the business judgment rule and the intrinsic fairness test. When the business judgment standard is applied,

the court will examine the decision only to the extent necessary to verify the presence of a business decision, disinterestedness and independence, due care, good faith, and the absence of an abuse of discretion. If these elements are present—and they are presumed to be present—and the case does not involve fraud, illegality, ultra vires conduct or waste, then the court will not second guess the merits of the decision.

This places the burden of proof on the plaintiff in an action to show that application of the business judgment standard is inappropriate.

When the plaintiff is successful in shifting the burden of proof to the directors, the intrinsic fairness standard is applied by the courts. This standard requires that the directors prove the price set for payments of dividends was fair and they dealt fairly with the shareholders in making the decision regarding whether dividends should be paid.

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19 Neis, supra note 8, at 49.
20 See infra notes 28-131 and accompanying text. For an explanation of the business judgment rule, see infra note 21 and accompanying text.
Another common factor in cases regarding dividend policy is the use of derivative actions.23

A shareholder derivative action is a lawsuit brought by one or more minority shareholders in order “to enforce a corporate cause of action against officers, directors, and third parties.” The shareholder “asserts on behalf of [the] corporation a claim belonging not to the shareholder, but to the corporation,” in order to remedy an alleged wrong to the corporation “[w]hen the corporate cause of action is for some reason not asserted by the corporation itself.”24

This form of action allows individual shareholders to go forward with a claim even though they may not have the right to go forward with an individual cause of action. The application of these factors by courts in different jurisdictions is shown by the following cases.

A. Revised Model Business Corporation Act States

The Revised Model Business Corporation Act ("RMBCA") section 8.30 sets forth the generally accepted duties of a director.25 These duties include acting in good faith, exercising due care, and acting loyally.26 These standards of conduct determine how a director’s actions will be judged. “[T]he manner in which the director performs his duties, not the correctness of his decisions” will determine if the director has breached these duties.27 Thus, directors are given a great deal of discretion in making corporate decisions. These decisions determine if the corporation pays dividends, buys new machinery, or takes any other actions. The potential for an abuse of this power by a given director or board of directors therefore obviously exists. These potentials for abuse, along with the importance of decisions the directors make, are reasons to allow shareholders to question the decisions of directors in civil actions.

Making a decision as to when to declare and pay dividends is one of the functions of the corporation’s board of directors.28 The language of the

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24 BLOCK ET AL., supra note 21, at 709 (footnotes omitted).
26 See id.
27 Id.
28 See id. § 6.40.
RMBCA does not require a board to declare dividends, but gives the board the discretion to declare dividends when the financial condition of the corporation would not be adversely affected. This decision, however, should be made only after determining what is required to satisfy the obligations which directors have to shareholders.

The Kentucky Business Corporation Act follows the RMBCA’s treatment of dividend payment. The directors of Kentucky corporations owe the corporation and its shareholders the duties of good faith, due care, and loyalty. The Kentucky courts have determined that the “undivided profits of a corporation in a sense or qualifiedly belong to the stockholders, but disposition or distribution thereof rests within the fair discretion of the directors.” If the directors do not breach their fiduciary duties, they will not be forced to declare dividends.

The business judgment rule prevents a director who has not acted improperly from facing liability for the acts of the board of directors. "Under the rule, courts will not second-guess a business decision, so long as corporate management exercised a minimum level of care in arriving at the decision." This rule "protects a board’s decision regarding payment of a dividend or the making of a distribution. . . . unless withholding the distribution is explicable only on the theory of an oppressive or fraudulent abuse of discretion." Therefore, as long as the directors have used their knowledge of the corporation and their judgment as to what would be best for the corporation, the courts will not second-guess their decisions. This principle is applied almost uniformly in states with a developed corporate law, such as Delaware and New York.

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29 See id. § 6.40(c).
32 See K.R.S. § 271B.8-300.
33 Taylor v. Axton-Fisher Tobacco Co., 173 S.W.2d 377, 380 (Ky. 1943) (citing Smith v. Southern Foundry Co., 179 S.W. 205 (Ky. 1915)).
34 See Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374, 377 (7th Cir. 1984) (applying the Illinois business judgment rule to an action for breach of directors' fiduciary duties).
36 11 id. § 1041.20 (perm. ed. rev. vol. 1995) (footnotes omitted); see also id. § 5325.
37 See, e.g., Whittemore v. Continental Mills, 98 F. Supp. 387, 390 (S.D. Me. 1951) (explaining that the directors' decision will normally control, unless the directors acted improperly).
38 See infra notes 40-81 and accompanying text.
39 See infra notes 82-131 and accompanying text.
B. Delaware

The Delaware General Corporate Law states that "[t]he directors of every corporation, subject to any restrictions contained in its certificate of incorporation, may declare and pay dividends upon the shares of its capital stock."40 "There is no statutory requirement to pay any dividend."41 This broad discretion given to directors allows them to determine when, and if, dividends will be paid in a given year. The shareholders do not have any statutory rights that can be enforced in court. The only way a shareholder can force the payment of dividends is by showing an abuse of discretion or fraud by the board of directors.42

In Baron v. Allied Artists Pictures Corp.,43 a shareholder, John Baron, attempted "to have the 1973 election of directors declared illegal and invalid."44 The owners of preferred stock in Baron were given the authority to elect a majority of the board of directors if six or more quarterly dividend payments were in arrears.45 Baron claimed that the directors had not paid the accumulated dividend arrearages on the preferred stock, even though the corporation possessed sufficient surplus funds to pay these arrearages.46 By not paying the dividends due the preferred shareholders, the directors would keep their positions on the board. Although Baron did not expressly challenge the failure of the board to pay dividends, the court held that the election of directors could not be addressed without addressing the dividend arrearages issue.47

The court in Baron examined the decision of the board not to declare dividends and found that the board of directors in a Delaware corporation has a great deal of discretion in declaring dividends. The decision of the board will not be disturbed unless the directors have breached their fiduciary duties.48 Either "fraud or gross abuse of discretion must be

44 Id. at 655. After filing the first action, the shareholder filed a similar action concerning the 1974 election of directors. Those actions were consolidated and both were before the court in this case. See id.
45 See id.
46 See id. at 657.
47 See id.
48 See id. at 658-59.
shown" for the court to find that the duties of the directors have been breached.\textsuperscript{49} The court declined to find that preferred dividends in arrears must be paid as soon as there are sufficient funds to pay them.\textsuperscript{50} In addition, the court held that the recent financial history of the corporation had to be taken into consideration when determining if the directors had breached their fiduciary duties. Since Allied had recently suffered poor financial results, the court refused to find that the directors had acted in bad faith.\textsuperscript{51} Therefore, the court declined to force the directors to declare dividends on the preferred stock and turn control of the corporation back over to the common shareholders.\textsuperscript{52}

However, the court did give the common shareholders some encouragement, holding that the directors "cannot be permitted indefinitely to plough back all profits . . . so as to avoid full satisfaction of the rights of the preferred to their dividends and the otherwise normal right of the common stockholders to elect corporate management."\textsuperscript{53} If the corporation continued to have profits, the directors would not be able to retain control by refusing to pay the preferred dividends. The directors' fiduciary duty was to pay off the preferred dividend arrearages as soon as prudently possible.\textsuperscript{54}

Delaware courts have long asserted their authority to force the payment of a dividend.\textsuperscript{55} However, more than a surplus in the corporate accounts must be shown to convince the court that a dividend should be compelled.\textsuperscript{56} In \textit{Eshleman v. Keenan},\textsuperscript{57} the company had retained revenues.\textsuperscript{58} The directors argued that although this suit, a derivative action brought by the plaintiffs against the directors, was not technically a suit for the payment of dividends, it would have the same effect. Therefore, the plaintiffs should be paid their proportional share of the recovery instead of the corporation being paid the full amount.\textsuperscript{59} The court examined the company's financial condition, but refused to allow the directors to reduce their liability by only paying the plaintiffs instead of paying the corporation.\textsuperscript{60}

\textsuperscript{49} Id. at 659.
\textsuperscript{50} See id.
\textsuperscript{51} See id.
\textsuperscript{52} See id.
\textsuperscript{53} Id. at 660.
\textsuperscript{54} See id.
\textsuperscript{56} See id.
\textsuperscript{57} Eshleman v. Keenan, 194 A. 40 (Del. Ch. 1937).
\textsuperscript{58} See id. at 42-43.
\textsuperscript{59} See id. at 41-42.
\textsuperscript{60} See id. at 44-45.
Eshleman differed from the typical suit to compel the payment of dividends because the defendants attempted to have the court declare a dividend. However, the court looked at the nature of a derivative action and the general principles of when dividends should be declared and found that declaring a dividend was not the proper course of action. Even though the directors acted improperly, resulting in a likely breach of their fiduciary duties, the court determined that the recovery was the property of the corporation. This recovery could be paid out as dividends, but did not have to be paid to the shareholders.

The Supreme Court of Delaware reaffirmed its position on whether to compel dividend payment in Gabelli & Co. v. Liggett Group, Inc. In Gabelli, the Liggett Group ("Liggett") was the target of a tender offer by Grand Metropolitan Limited’s ("Grand Met") subsidiary, GM Sub Corporation ("GM Sub"). After an increase in the tender amount, the board of directors of Liggett recommended the acceptance of the offer by the shareholders. GM Sub announced that it or another subsidiary of Grand Met would merge with Liggett and all shares of Liggett not tendered would be repurchased at the same price as the tender offer. The plaintiffs held their shares until the merger, expecting to receive the normal quarterly dividend of $0.625 per share, which they believed had accrued since the tender offer.

After Liggett did not declare a dividend for the third quarter, the plaintiffs filed suit alleging a breach of the fiduciary duty of Grand Met as majority shareholder of Liggett to pay the third quarter dividends. This complaint was dismissed, and an amended complaint was filed which alleged that Grand Met breached its fiduciary duties by setting the same per share price for the shares purchased as a result of the tender offer and the merger and "without consideration for the dividend which was being omitted." The trial court granted Liggett’s motion for summary judgment.

The Delaware Supreme Court found "this case commenced as, and continues to be, no more nor less than an action to compel the declaration
and payment of a dividend by the Board of Directors of Liggett for the benefit of about 13% of its stockholders.\textsuperscript{70} The court held that Liggett’s board had exercised its business judgment in deciding not to declare a dividend.\textsuperscript{71} The court stated that “before the courts will interfere with the judgment of the board of directors in such matter, fraud or gross abuse of discretion must be shown.”\textsuperscript{72} The court did not find any allegation of fraud or any abuse of discretion on the part of the board. Therefore, the court refused to compel the directors to declare a dividend.\textsuperscript{73}

The plaintiffs “attempted to avoid the force and effect of the law governing the declaration of dividends”\textsuperscript{74} by asserting that Grand Met’s actions should be evaluated by the intrinsic fairness test.\textsuperscript{75} Gabelli & Co., the minority shareholder that filed the suit, attempted to show that Grand Met had engaged in self-dealing by taking for itself the dividend to which the minority shareholders were entitled.\textsuperscript{76} The court held that Gabelli’s position was “manifestly untenable.”\textsuperscript{77} There was no indication that any right to a third quarter dividend had been established. Gabelli & Co. could have tendered its shares after the initial tender offer. Furthermore, the price was fair, and there was “no valid reason in July to expect extra compensation for its stock, by dividend or otherwise, over and above that paid to the great majority of its fellow stockholders in June.”\textsuperscript{78} Therefore, the court refused to apply the intrinsic fairness test to Grand Met’s actions.\textsuperscript{79}

This decision properly applied the standards used by Delaware courts. The plaintiff attempted to gain extra compensation for the stock in the form

\textsuperscript{70}Id.  
\textsuperscript{71} See id.  
\textsuperscript{72} Id. at 280 (citing Moskowitz v. Bantrell, 190 A.2d 749 (Del. 1963)).  
\textsuperscript{73} See id.  
\textsuperscript{74} Id.  
\textsuperscript{75} See id. For a description of the intrinsic fairness test, see supra note 22 and accompanying text.  
\textsuperscript{76} The plaintiff rests its entire case upon the statement in Sinclair (280 A.2d at 720) that self-dealing “... occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary.”  
\textsuperscript{77} Id. at 281 (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).  
\textsuperscript{78} Id.  
\textsuperscript{79} See id. The court stated that “Gabelli has demonstrated no such ‘self-dealing’ or ‘detriment’ as to warrant the application of the Sinclair intrinsic fairness test.”  
\textsuperscript{Id.
of dividends. If the court had allowed this to occur, the shareholders who accepted the initial tender offer would have received less compensation for the same transaction. This was a case where the plaintiff attempted to exploit the corporation rather than gain dividends which should have been paid anyway.

These cases clearly demonstrate that the Delaware courts place a large burden on the shareholder who attempts to force the directors of a corporation to pay dividends. The Delaware statutory and case law both favor the business judgments of directors over the desires of investors to achieve a return on their investment in the form of dividends. This approach, however, is not limited to Delaware. New York\footnote{See supra notes 25-39 and accompanying text.} and the states under the RMBCA\footnote{See infra notes 80-127 and accompanying text.} follow the same general approach.

C. New York

The New York Business Corporation Law gives directors authority to determine when dividends will be paid.\footnote{See infra notes 82-131 and accompanying text.} The statute states that "[a] corporation may declare and pay dividends or make other distributions in cash . . . except when currently the corporation is insolvent or would thereby be made insolvent, or when the declaration . . . would be contrary to any restrictions contained in the certificate of incorporation."\footnote{See infra notes 80-127.} This language does not require the directors to declare a dividend, but gives them the discretion to use their judgment in deciding when a dividend should be paid.

The New York courts have consistently held shareholders to a high standard when they have attempted to compel the declaration of dividends. In Nechis v. Gramatan Gardens, Inc.,\footnote{Nechis v. Gramatan Gardens, Inc., 231 N.Y.S.2d 383 (Sup. Ct. 1962).} the trial court held that corporate directors must act in good faith and that shareholders must show fraud, bad faith, or an abuse of discretion to successfully compel a dividend payment.\footnote{See id. at 385 (quoting Winter v. Anderson, 275 N.Y.S. 373, 375-76 (App. Div. 1934)).} Since it found that the amount of the normal dividend declared by the company was so small, the court considered the plaintiff to be

\footnotesize{\begin{itemize}
  \item See infra notes 82-131 and accompanying text.
  \item See supra notes 25-39 and accompanying text.
  \item See N.Y. BUS. CORP. LAW § 510 (McKinney 1986).
  \item Id. § 510(a).
  \item See infra notes 80-127.
  \item See id. at 385 (quoting Winter v. Anderson, 275 N.Y.S. 373, 375-76 (App. Div. 1934)).
\end{itemize}}
requesting a partial liquidation of the company.\textsuperscript{87} As there was no allegation of fraud, bad faith, or abuse of discretion, the court granted summary judgment for the defendants.\textsuperscript{88} This decision demonstrates the importance placed not only on the form of the pleadings, but also the importance placed on the potential effect of the desired outcome.

The New York Appellate Division has reached a similar conclusion. In \textit{Cardo v. Safeway Concrete Co.},\textsuperscript{89} the court stated that "[a]bsent allegations of fraud, bad faith or dishonesty on the part of the directors, their judgment in withholding dividends from the stockholders will be regarded as conclusive."\textsuperscript{90}

The Court of Appeals of New York, the highest court in the state, has dealt with this subject many times.\textsuperscript{91} In \textit{City Bank Farmers' Trust Co. v. Hewitt Realty Co.},\textsuperscript{92} the court was faced with a family-owned company in which six children came to own all the stock. After the death of one of the children, the decedent's second wife and daughter became income beneficiaries of a trust made up entirely of his stock in the family company.\textsuperscript{93}

The company had historically paid approximately six percent in dividends annually.\textsuperscript{94} However, the directors did not pay a dividend after the death of the testator. The second wife and child claimed that there was sufficient surplus in the company to pay dividends and that they were being denied the benefit of the trust because they had no interest in the stock beyond the right to dividends.\textsuperscript{95} The court then determined that "[t]he plaintiff, to succeed on this appeal, must establish as matter of law that the action of the directors on this record was inimical to the welfare of the corporation and all its stockholders."\textsuperscript{96}

The court accepted that it had the power to force a dividend in the proper situation, but determined that this was not the proper situation

\textsuperscript{87} See \textit{id}. at 386 (quoting City Bank Farmers' Trust Co. v. Hewitt Realty Co., 177 N.E. 309, 310 (N.Y. 1931)).
\textsuperscript{88} See \textit{id}.
\textsuperscript{90} \textit{Id}. at 443.
\textsuperscript{91} See \textit{infra} notes 92-127 and accompanying text.
\textsuperscript{92} City Bank Farmers' Trust Co. v. Hewitt Realty Co., 177 N.E. 309 (N.Y. 1931).
\textsuperscript{93} See \textit{id}. at 310. As income beneficiaries, the second wife and daughter would be entitled to all income, including dividends, on the trust corpus. \textit{See id}.
\textsuperscript{94} See \textit{id}.
\textsuperscript{95} See \textit{id}.
\textsuperscript{96} \textit{Id}. at 311.
because only "[b]ad faith, fraud, or other breach of trust are grounds for equitable relief."97 The court did not find any misconduct on the part of the directors. It was an accepted corporate policy to pay off the debts of the company before paying dividends. The plaintiffs knew of this policy and had agreed that dividends would not be paid while there was debt left unpaid.98 In finding this policy a proper exercise of the directors' business judgment, the court stated, "A strong case must be made out to compel the conclusion that it must divide its profits rather than pay its debts or extend its authorized business."99 The court also held that a minority stockholder "cannot compel the directors to accept his judgment in matters of discretion."100

In deciding the case, the fact that the corporation was a family business was significant to the court.101 In a closely held corporation, the shareholders may face circumstances vastly different from those of a publicly held corporation. Often, the owners of a close corporation depend on their positions as corporate officers or the dividends that they receive for income.102 The lack of a market for the stock of a closely held corporation also serves to limit the choices shareholders have when a majority of the shareholders turn against them.103 "Traditional corporate norms, oriented as they are toward publicly held corporations, proved unsuitable for close corporations."104 This has led to changes in the fiduciary duties owed shareholders in a close corporation.105

In Cashman v. Petrie,106 the court dealt with two trusts which, combined, contained all the stock of McGuire Bros., Inc. The plaintiff trustee controlled forty-nine percent of the stock, while the defendant trustee controlled fifty-one percent of the stock.107 The plaintiffs sought a "distribution of a larger proportion of the earnings of the corporations by way of dividends to the stockholders."108 However, the plaintiffs asserted
that it was "not a minority stockholders' action to compel the declaration of increased dividends."\textsuperscript{109} The court rejected this characterization of the complaint and used the general rules applying to suits to compel dividends.\textsuperscript{110}

After examining the complaint, the court held that there were no allegations of a breach of fiduciary duties by the defendants.\textsuperscript{111} Therefore, the complaint was dismissed.\textsuperscript{112} The dissenting judge expressed the opinion, however, that the complaint had sufficiently alleged conduct which could be found to be a breach of the directors' fiduciary duties.\textsuperscript{113} This opinion was based on a prior decision holding "in effect that allegations that earnings were being accumulated for wrongful reasons stated a cause of action."\textsuperscript{114} Although a majority of the court rejected this argument, it appears that these allegations could show a breach of the directors' fiduciary duties.

\textit{Gordon v. Elliman}\textsuperscript{115} dealt with a suit by the stockholders of a corporation to compel the declaration of a dividend. The trial court ordered the plaintiffs to deposit funds that would be used to cover the expenses of the corporation if the suit failed.\textsuperscript{116} The case was brought as a derivative action against the directors of the corporation. The court held that the trial court could order the shareholders to make this type of deposit.\textsuperscript{117} In determining what rights the shareholders had individually, the court stated that "[u]nless a dividend has been declared, . . . no portion of the assets of the corporation has been set aside for stockholders, and no right of action inheres in them to be paid any part of the corporation’s funds."\textsuperscript{118}

A suit to compel dividends is a suit to force the directors to fulfill their fiduciary duties. This type of case does not normally arise unless there has been some form of perceived mismanagement on the part of the directors. "[Directors] have usually sought to monopolize the earnings of the

\textsuperscript{109} \textit{Id.}
\textsuperscript{110} See \textit{id.} at 25-26.
\textsuperscript{111} See \textit{id.} at 25.
\textsuperscript{112} See \textit{id.} at 26.
\textsuperscript{113} "I fail to see why [plaintiff’s] carefully itemized allegations if proven would not make out a strong case for a holding that the piling up of reserves was in bad faith or was an abuse of directors’ discretion." \textit{Id.} at 27 (Desmond, C.J., dissenting).
\textsuperscript{114} \textit{Id.} (citing \textit{Leibert v. Clapp}, 196 N.E.2d 540 (N.Y. 1963)).
\textsuperscript{116} See \textit{id.} at 333.
\textsuperscript{117} See \textit{id.} at 340.
\textsuperscript{118} \textit{Id.} at 334.
corporation by excessive salaries or collusive agreements or to manipulate the value of the minority stockholdings in order to freeze them out." The situation is a clear breach of the director's fiduciary duties and should be addressed by the courts.

The dissent noted, however, that there are circumstances where a shareholder would be claiming an individual right. These circumstances include when there is a contract with the corporation to pay dividends or when the corporation's articles of incorporation require the directors to declare a dividend. Judge Fuld expressed the opinion that actions to compel dividends are normally rights of the shareholder, not the corporation. This concept would suggest a more active role by the courts because of the personal nature of the action. However, the application of the business judgment rule would negate any perceived benefits of proceeding against the directors for an individual harm.

The New York courts have not been completely unsympathetic to shareholders who claimed a corporation's directors had acted improperly. In Von Au v. Magenheimer, the plaintiff claimed the directors had intentionally led her to believe the company was in a poor financial condition and only small dividends could be expected in the future. Based on these representations, the plaintiff sold her stock to the defendants at a considerably undervalued price. The court held that the actions of the directors were serious enough to be considered fraud. In discussing the duties of the directors, the court stated that "[t]he defendants at least owed the plaintiff the duty to speak the whole truth, if they spoke at all."

The federal courts have reached the same conclusion when dealing with New York corporations. In Levin v. Mississippi River Corp., the court held that some abuse of discretion or bad faith must be shown before the

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119 Id. at 338.
120 See id. at 341 (Fuld, J., dissenting).
121 See id. (Fuld, J., dissenting).
122 "In an exceptional case, the failure to pay a dividend may wrong the corporation itself, a wrong which might be redressed through a derivative action." Id. at 342 (Fuld, J., dissenting).
124 See id. at 630.
125 See id. at 631.
126 See id.
127 Id.
decision of the board of directors will be reversed. The mere existence of surplus funds is not enough to convince a court to compel the payment of dividends. Absent a showing of a breach of the director's fiduciary duties, a court will not act even if the court considers a change in the dividend policy to be appropriate.

D. Dodge v. Ford Motor Co.

The leading case compelling the directors of a corporation to pay dividends is *Dodge v. Ford Motor Co.* In *Dodge*, the plaintiff wanted the court to restrain the expansion of Ford Motor Co. and to force a dividend out of surplus capital held by the company that was to be used for the expansion and improvement. Ford Motor Co. sustained rapid growth after its incorporation in 1903. By July 31, 1916, the company had approximately $52,000,000 in surplus cash. Although the company regularly paid its quarterly dividend, no special dividend was paid out of the surplus cash the company had accumulated. The plaintiffs alleged that this failure to pay a special dividend was caused by a policy of Henry Ford, a director and principal shareholder, to reinvest the profits into the company.

Ford reportedly believed that since the shareholders had received more from their investment than they had originally paid, "they were not entitled to receive anything additional to the regular dividend... and that it was not his policy to have larger dividends declared in the future." The plaintiffs wrote to Ford requesting the payment of a special dividend. After they did

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129 *See id.* at 363.

130 *See id.*

131 *See id.* at 364.


133 *See id.* at 673.

134 *See id.* at 669-70.

135 *See id.* at 670.

136 *See id.* at 671.

137 This declaration of the future policy, it is charged in the bill, was published in the public press in the city of Detroit and throughout the United States in substantially the following language: "My ambition," declared Mr. Ford, "is to employ still more men; to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this, we are putting the greatest share of our profits back into the business."

*Id.*

138 *Id.*
not receive a reply, the plaintiffs filed an action against the company and the directors.\textsuperscript{139}

The complaint charged the directors, and specifically Ford, of acting in a way that denied the shareholders a proper return on their investment and would harm the shareholders' interest in the company. The company and the board answered by stating that the planned expansion of the company in the form of a new production plant and iron smelting facility, combined with a decrease in the price of the company's cars, would improve the company's financial position in the long term. In addition, they stated that the surplus cash was needed for these business expansions and should not be distributed to the shareholders.\textsuperscript{140} Ford also denied that he was withholding dividends from the shareholders because he believed they had received all the special dividends they were entitled to receive.\textsuperscript{141}

The court determined that the business judgment rule should be applied to the directors' decision to not pay dividends.\textsuperscript{142} The court would not disrupt the board's decision unless there was bad faith or an abuse of discretion.\textsuperscript{143} All the facts and circumstances were examined in evaluating the board's actions.\textsuperscript{144} After looking at the facts in the case, the court held that the proposed conduct by the board was "not intended to produce immediately a more profitable business, but a less profitable one. . . . The apparent immediate effect will be to diminish the value of shares and the returns to shareholders."\textsuperscript{145} In addition, the court found that Ford's motives in not declaring a dividend were to deprive the investors of a profit from their investment.\textsuperscript{146} The board's acts were considered "to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done."\textsuperscript{147} Given these determinations, the court ordered a special dividend to be declared, but did not interfere with the expansion of the business.\textsuperscript{148}

\textsuperscript{139} See id. at 671-72.
\textsuperscript{140} See id. at 673-74.
\textsuperscript{141} See id. at 675.
\textsuperscript{142} See id. at 681-82.
\textsuperscript{143} See id. at 682 (quoting Hunter v. Roberts, Throp & Co., 47 N.W. 131, 134 (Mich. 1890)).
\textsuperscript{144} See id. at 681-82.
\textsuperscript{145} Id. at 683.
\textsuperscript{146} See id. at 683-84.
\textsuperscript{147} Id. at 683.
\textsuperscript{148} See id. at 684-85.
The court's decision in *Dodge* raises an important issue. The court looked at statements made by Ford in finding that he intended to withhold dividends for improper reasons. However, the court also allowed the business expansion which was one of Ford's major goals. The decision seems to look more at the company's enormous amount of cash surplus instead of the business reasons for the decision not to pay dividends, which is what the business judgement rule requires. This principle of looking at all of the relevant circumstances also plays an important role in determining what type of action to bring.

IV. SPECIAL CONSIDERATIONS

A. *Derivative Action or Individual Action*

An important consideration for a minority shareholder planning to bring a suit compelling payment of dividends is whether the case should be brought as a derivative action or an individual action. This decision will in large part depend on the jurisdiction in which the claim will be brought. However, other factors such as the ability to obtain jurisdiction over all the directors and the nature of the company can play an important role in this determination. As was shown in *Eshleman v. Keenan*, the Delaware courts recognize that attempts to compel dividends are for the benefit of the corporation. In these circumstances, the proper form for these cases is a derivative suit. Similarly, the New York courts will allow the shareholders to bring a derivative action.

However, this procedure is not followed by all jurisdictions. In *Schuckman v. Rubenstein*, the trial court allowed an individual action even though it eventually dismissed the plaintiff's complaint for lack of jurisdiction. On appeal, the court looked at the record and determined that a majority of the members of the board of directors were not defendants. The court found that the business judgment standard applied to the decisions of the board and because the court did not have jurisdiction over a majority of the board of directors, the court refused to order the payment of dividends. "The court itself can not declare a dividend; its power is

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150 See id. at 43.
151 See supra notes 115-22 and accompanying text.
152 Schuckman v. Rubenstein, 164 F.2d 952 (6th Cir. 1947).
153 See id. at 957-58.
limited to a judgment in personam against the members of the board."\textsuperscript{154} Since a majority of the board members were not defendants and a majority vote is required to declare dividends, the court affirmed the lower court's decision.\textsuperscript{155}

A similar decision respecting the use of individual actions by shareholders was reached in \textit{Doherty v. Mutual Warehouse Co.}\textsuperscript{156} In this case, a minority shareholder attempted to compel the payment of dividends in a closely held corporation.\textsuperscript{157} However, in denying to compel payment of dividends, the court observed "[t]hat, in appropriate circumstances, a minority stockholder may invoke the jurisdiction of a court of equity to compel the declaration of dividends."\textsuperscript{158} The court also rejected a procedural claim of the defendants by determining that "[a] stockholder suing to compel the corporation to declare a dividend is enforcing a right common to himself and the other stockholders against the corporation, rather than a derivative right."\textsuperscript{159}

There does not appear to be a clear line between derivative and individual suits. Both are aimed at compelling the payment of a dividend from corporate funds and both will force the directors to act in a manner they have previously rejected if successful. However, the success of a suit may depend on whether the action is pled in the correct form. Therefore, special care must be taken to determine which type of action is required in each jurisdiction.

\textbf{B. Closely Held Corporations}

The circumstances surrounding closely held corporations are much different than those of publicly held corporations.\textsuperscript{160} The close corporation is often family-owned, which can cause problems because of the relationships among the family members. In addition, the directors and officers in these companies are likely to be the majority shareholders. These control positions allow the majority to set their own compensation and determine the dividend policy that will be followed. These factors

\begin{footnotesize}
154 \textit{Id.} at 957.
155 \textit{See id.} at 957-59.
156 \textit{Doherty v. Mutual Warehouse Co.}, 245 F.2d 609 (5th Cir. 1957).
157 \textit{See id.} at 609-10.
158 \textit{Id.} at 611.
159 \textit{Id.} at 612.
160 \textit{See supra} notes 15-18 and accompanying text.
\end{footnotesize}
require a higher level of judicial scrutiny over corporate decisions which will benefit the majority at the expense of the minority.

This higher level of judicial scrutiny is shown in Santarelli v. Katz.\footnote{Santarelli v. Katz, 270 F.2d 762 (7th Cir. 1959).} In Santarelli, the court dealt with a closely held corporation originally owned by one family. One of the original owners placed part of his stock in a trust for the benefit of the plaintiff. Santarelli filed this suit to force the other members of the family to pay back excessive compensation and account for profits from side businesses that profited from the corporation.\footnote{See id. at 764-68.} After determining which actions by the majority shareholders harmed the corporation, the court examined the circumstances and held that the business judgment standard should not be available to the officers.\footnote{See id. at 768-69.} The most important facts to the court concerned the amount of control the Katz family had over the affairs of the business. The family owned between seventy and ninety percent of the stock at all times, and the board did not set the compensation level until after the complaint was filed.\footnote{Id. at 768.} This case demonstrates the higher standards that a court applies to directors of a closely held corporation in a suit by minority shareholders.

One of the more recent developments in the law surrounding closely held corporations is an Illinois statute expressly allowing the court to force dividend payment if the directors “have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent with respect to the petitioning shareholder.”\footnote{805 ILL. COMP. STAT. ANN. 5/12.56(a)(3) (West Supp. 1998).} This statute uses language which is often associated with the business judgment rule; therefore, the business judgment rule will probably be the standard used to determine if the dividends will be compelled or not. However, the statute also explicitly authorizes the court to make the corporation pay dividends. The courts likely already possessed this power, but the statutory language indicates the growing importance of this power in situations where a closely held corporation is involved.

\section{V. CONCLUSION}

The shareholders of a corporation have basic expectations when they invest in a company. These expectations include payment of a reasonable
dividend when there are sufficient funds in the company. The directors of a corporation have specific duties which they must fulfill. In fulfilling these duties, the directors must make many determinations as to what is in the best interest of the corporation. Sometimes the directors’ ideas for the future of the company do not match what the shareholders want. In these instances, the directors must evaluate all of their options and make the best decision they can.

When the directors are faced with these choices, they must be free to make an unpopular choice without the fear of the shareholders being able to hold them liable for their actions. If directors faced financial liability for every decision they made, they would be more likely to reject changes which could be beneficial for the company in the future. This could potentially harm the shareholders’ interest that the directors are attempting to protect. The business judgment rule gives directors the latitude they need to properly make corporate policy in all matters, but especially in determining when to declare dividends. This is not to say that directors should never face liability for their decisions. If the directors have abused their discretion in order to perpetuate their interests or harm minority shareholders, then they should be accountable for their actions. However, these types of cases are few and far between.

The most difficult situation for the courts is when a closely held corporation is involved. In these cases, the competing interests are often concerned with not only the dividends, but also control of the company. This can be more difficult in a family-owned corporation because of the emotional aspects surrounding the company. To resolve these disputes, the courts must balance all of these factors, while continuing to give the directors the ability to effectively make decisions. As there are more attempts to compel dividends in closely held corporations, the courts must decide if the same standards should apply to directors of publicly traded companies and closely held companies. As cases such as City Bank Farmers’ Trust Co.166 and Santarelli167 tend to indicate, this is an area where the courts may be more comfortable in applying a higher level of scrutiny because of the nature of the corporation and the situation of the shareholders. In the future, courts should move toward protecting minority shareholders in these situations by forcing directors to satisfy the intrinsic fairness test. This is the only way that minority shareholders can be sure that they will not be taken advantage of by directors who seek to increase their compensation and freeze out the minority from the benefits and successes of the corporation.

166 See supra notes 92-105 and accompanying text.
167 See supra notes 161-64 and accompanying text.