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## Business Law

### Downsizing Shareholders' Fiduciary Duties

The fiduciary obligations of corporate shareholders, which expanded radically with the *Hagshenas* case two decades ago, were controlled by an amendment to the Business Corporation Act. Here's a brief history.

By Lin Hanson

Growing up in the "doo-wop" era of the 1950s I remember the 1962 Neil Sedaka hit "Breaking Up Is Hard to Do." It provides an excellent theme for this look at the fiduciary duties of shareholders in Illinois.

Prior to 1990, lawyers gave little thought to fiduciary duties of shareholders. We were, of course, familiar with the duties of officers and directors of corporations to deal fairly with other shareholders, particularly minority shareholders, and to avoid misappropriation of corporate opportunities and competition with the corporation. These obligations were well recognized, and when one accepted a directorship or an office, the accompanying obligation was part of the job.

## ***Hagshenas* hits like a thunderbolt**

That's why *Hagshenas v Gaylord*, 199 Ill App 3d 60, 557 NE2d 316 (2d D 1990) hit the legal profession and the business community like a thunderbolt. Recall that in that case, a 50 percent shareholder in a travel agency sought initially to dissolve the corporation because of a deadlock with the other 50 percent shareholder. Evidently, the parties differed about how the agency ought to be operated, and the plaintiff sought to dissolve the company and go his own way. He resigned as both an officer and a director, seeking to free himself of his fiduciary obligations.

His corporate "partner" counterclaimed against him for breach of his fiduciary duties as a shareholder. The trial court denied the dissolution, and a judgment was entered against Hagshenas for breach of fiduciary duties. The court found that actual damages were too uncertain to calculate and granted an equitable remedy, requiring him to surrender his shares in the corporation.

It was Hagshenas' contention that after resigning as an officer and director he owed no duty to the corporation, citing *Dangeles v Muhlenfeld*, 191 Ill App 3d 791, 548 NE2d 45 (2d D 1989) and *Voss Engineering, Inc v Voss Industries, Inc*, 134 Ill App 3d 632, 481 NE2d 63 (1st D 1985). Gaylord, however, contended that Hagshenas' standing as a 50 percent shareholder was enough to impose a fiduciary duty.

The court recognized that the subject corporation, Imperial Travel, was not a statutory close corporation under the Illinois Close Corporation Act. It did, however, find Imperial to be a common law close corporation. The court cited *Galler v Galler*, 32 Ill 2d 16, 203 NE2d 577 (1964), writing that "[in *Galler*] the supreme court defined a close corporation as 'one in which the stock is held in a few hands, or in a few families, and wherein it is not at all, or only rarely, dealt in by buying or selling.'" Id at 27, 203 NE2d at 583.

It went on to find a fiduciary obligation in the close corporation context for a 50 percent shareholder, citing *Illinois Rockford Corp v Kulp*, 41 Ill 2d 215, 242 NE2d 228 (1968). The court said, "We find it implicit that people who enter into a small business enterprise, as in this case, place their trust and confidence in each other. Thus we find support for finding a fiduciary duty from *Kulp*...which held a fiduciary relation exists in all cases in which a confidential relationship has been acquired." *Hagshenas* at 72, 557 NE2d at 324.

## **Further expansion of fiduciary duty**

Suddenly, at least in the close or quasi-close corporation case, Illinois shareholders found they had fiduciary duties to the corporation and the other shareholders. Corporate lawyers began to seek a "fix" for the *Hagshenas* case. But at least on the facts the case was limited to a 50/50 shareholder relationship in a quasi-close corporation.

Then along came *Sebastian v Zuromski*, 1993 WL 78713 (ND Ill 1993), where the court indicated that the owner of less than a controlling share who had resigned might nonetheless owe a fiduciary duty to the corporation and its shareholders. "Shareholders of a close corporation are obligated 'to exercise the highest degree of honesty and good faith in the dealings and in

handling of business assets, thereby prohibiting enhancement of personal interests at the expense of the interests of the enterprise," the court wrote, citing *Hagshenas*. "The Magistrate Judge determined that this fiduciary obligation could even constrain a person from abandoning a venture such as the small corporation in this case. Absent evidence to the contrary, Magistrate Judge Gottschall concluded that this determination precluded a finding in favor of defendant...." *Sebastian* at \*3. Now even minority shareholders might have fiduciary duties of "the highest degree." *Id.*

Another court imposed fiduciary obligations on minority shareholders in *Rexford Rand Corp v Ancell*, 58 F3d 1215 (1995). There, a previously frozen-out minority shareholder seized an opportunity when the corporation was involuntarily dissolved and formed a new entity taking the dissolved corporation's name. Even though he had been a minority shareholder, and then no shareholder at all, the defendant still owed an obligation to the corporation, the court found:

[M]inority shareholders owe a duty of loyalty to a close corporation in certain circumstances. Minority shareholders have an obligation as *de facto* partners in the joint venture not to do damage to the corporate interests. If a minority shareholder harms the corporation through "unscrupulous and improper 'sharp dealings' with the majority, he has breached his duty of loyalty." [Citations omitted.] "Conduct by any shareholder which is intended to be detrimental to the welfare of the enterprise...is a breach of a duty of loyalty which all shareholders owe to the common venture."

*Rexford*, 58 F3d at 1219-20.

The issue of fiduciary duties owed by members of an LLC has been addressed by the LLC act, 805 ILCS 180/15-3(a)-(g), which explains that members owe a fiduciary duty in the case of a member-managed LLC and have no such duties for a manager-managed LLC. An Illinois court has imposed the obligation of fiduciary duties on a member in *Anest v Audino*, 332 Ill App 3d, 468, 773 NE2d 202 (2d D 2002). The case of *Katris v Carroll*, 362 Ill App 3d 1140, 842 NE2d 221 (1st D 2005) revealed an apparent flaw in the statute, which was quickly remedied by the addition of section 3. It provides that "(3) a member is held to the standards of conduct in subsections (b), (c), (d), and (e) of this Section to the extent that the member exercises the managerial authority vested in a manager by this Act...."

## **The fix**

Many corporate practitioners felt there needed to be a way for an Illinois corporate shareholder to depart and compete in an appropriate circumstance. Committees of both the Illinois and Chicago Bar Associations, as well as the Institute for Illinois Business Laws of Chicago-Kent College of Law, undertook drafting a statute under which specified shareholders could shed their fiduciary duties.

The Institute's draft was submitted to the legislature, and ultimately passed, effective in 2005, becoming 805 ILCS 5/7.90. The elements relieving the shareholder's obligation are as follows:

1. That no prohibition against this action is contained in the corporation's Articles of Incorporation.
2. That the shareholder, when he is no longer an officer or a director of the corporation, delivers a written, irrevocable, declaration (which does NOT apply to subsequent owners of his shares such as his heirs or assignees) waiving:
  - a. His right to vote for directors or otherwise vote his shares;
  - b. His right to be an officer or director of the corporation;
  - c. In any other way to control the corporation.

The statute contains a statement that it no way limits such an individual's other fiduciary obligations but merely affects such obligations as a shareholder.

### **Breaking up: hard but not impossible**

Resigning shareholders now have recourse. With the passage of section 7.90 of the BCA, breaking up is still hard to do. But it is no longer impossible. A waiver in keeping with the statute might look like the one in the accompanying sidebar.

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## **Resignation and Statutory Waiver as Provided in Business Corporation Act, §7.90**

To: (Name and Address of Corporation)

From: (Name and Address of Shareholder)

Ladies and Gentlemen:

1. I hereby resign, effective immediately from each and every office held by me in your corporation. If I am a director, I also resign as a director.
2. Having resigned in every capacity as an officer and/or director of your corporation, I hereby irrevocably waive the right (i) to vote any shares of the corporation held by me, whether for the election of directors or otherwise, (ii) to be a director or officer of the corporation, and (iii) in any other manner to control, directly or indirectly, corporate actions or the election or removal of any director or officer of the corporation, as provided in 805 ILCS 5/7.90.

3. As provided in the statute, please give prompt notice of this waiver to the remaining shareholders.

Executed at (Where executed), on (Date executed).

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(Typewritten name of shareholder)