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Oppression of Minority Shareholders: Protecting Minority Rights

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OPPRESSION OF MINORITY SHAREHOLDERS: PROTECTING MINORITY RIGHTS*

F. HODGE O'NEAL**

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I. INTRODUCTION

Unfair treatment of holders of minority interests in family companies and other closely held corporations by persons in control of those corporations is so widespread that it is a national business scandal. The amount of litigation growing out of minority shareholder oppression—actual, fancied or fabricated—has grown tremendously in recent years, and the flood of litigation shows no sign of abating.

Minority holdings in thousands of close corporations throughout the United States have been made virtually worthless by the machinations of those in control of the corporations. Minority shareholders frequently are deprived of any income from the corporations, either in the form of dividends or salary; they are not allowed any effective voice in business decisions; and they are denied any information about corporate affairs. Often, they are eventually eliminated from the corporation at a fraction of the real value of their interests.

Harm to corporate enterprises and the economy from shareholder oppression and the consequent friction and litigation among shareholders includes heaving loss of working hours of key corporate personnel; impaired efficiency of corporate managers; diminished confidence of banks, suppliers, customers and employees in the corporate enterprises wracked by friction; heavy litigation expenses for all parties involved; and the drying up of sources of risk capital for closely held enterprises, because many investors have become afraid to take a minority position in an enterprise.

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A lawyer has difficulty in finding an accurate and comprehensive treatment of techniques used to squeeze out or oppress minority shareholders or the tactics and maneuvers useful to a minority shareholder in resisting oppression. Judicial decisions involving shareholder disputes are poorly digested. Literature on shareholder oppression and "corporate dirty tricks" is fragmentary and scattered. In addition, much of corporate practice relating to shareholder disputes is not reflected in case decisions or statutes. Many disputes are settled and thus never appear in court decisions.

This paper outlines and discusses briefly: (1) the most frequent causes of dissension among shareholders in a close corporation; (2) the techniques used by controlling shareholders to eliminate minority shareholders from an enterprise or otherwise oppress them; (3) rights and tactics minority shareholders can use to protect their interests; and (4) advance planning and contractual arrangements that protect minority shareholders.\(^1\)

II. Causes of Shareholder Disputes

Some of the causes of shareholder disputes are those one would expect. Among these are greed and the desire of majority shareholders for absolute power over the enterprise; personality clashes among the shareholders; and especially in family companies, marital discord and family quarrels among shareholders.

Basic conflicts of interest and long-drawn-out disagreements over business policy are common causes of dissension. The most frequently occurring conflict of interest is between active shareholders, i.e. shareholder-officers or employees, and shareholders who are not active in the business. The former want the corporation to pay high executive salaries and declare small or no dividends, while the latter want the corporation to keep salaries down, thus increasing corporate earnings, and pay generous dividends.

Disregard of corporate ritual, neglecting to keep proper records, and failure of the participants to distinguish whether they are acting as shareholders, directors or officers are also common causes of friction. As a consequence of these shortcomings, there may be no way to establish unequivocally who took what action when.

An obstreperous or uncooperative minority shareholder is sometimes a cause of dissension. Time and again, when questioned about squeeze-out problems, lawyers and other business advisers comment on the problem of the minority shareholder who "throws'his weight around" and makes life miserable for management. An unreasonable and obstreperous share-

\(^1\) For a comprehensive discussion of these topics, see F.H. O'Neal & R. Thompson, O'Neal's Oppression of Minority Shareholders (2d ed. 1985).
general give company managers a "rough time." Some corporate officers say they have to spend more time and thought in keeping minority shareholders pacified than in operating the business.

A minority shareholder may try to force a buy-out of his interest at an exorbitant price or may attempt to exact some other concession as a precondition to corporate peace. Occasionally a minority shareholder will block action advantageous to the corporation or disrupt its business with the objective of aiding a competing enterprise. Naturally, majority shareholders and corporate management welcome an opportunity to eliminate an unruly, uncooperative or disloyal associate from the enterprise.

Entry of a minority shareholder into a competing business can be a cause of friction. Typically, an unhappy shareholder, having developed skill in the particular type of business operated by the corporation, establishes a similar business or goes to work for another company in a similar business. This often occurs in the second or third generation of a family company when the sons and grandsons of the minority founding "partner-shareholder" are persons of considerable ability and will not take orders from less able majority shareholders.

An important cause of dissension in close corporations is the difficulty an unhappy minority shareholder has in disposing of his interest. Usually the only prospective purchasers of a minority interest in a close corporation are the other shareholders of the corporation, which of course is under the control of the other shareholders. If the other shareholders refuse to buy or offer only a token purchase price, the unhappy shareholder is "locked" into the corporation.

Even if majority shareholders are initially inclined to treat a minority shareholder fairly when he decides to withdraw from the business, the difficulty of valuing a closely held business interest may lead to disagreement over the value of the minority holder's interest. By definition, there is no trading market for closely held stock.

The difficulty of valuing a business interest may produce a squeeze-out when majority shareholders want to sell all the corporation's assets or to merge the corporation with another company. Because of statutory or charter super-majority vote requirements, the consent of some or all of the minority shareholders may be necessary to effectuate the transaction. Minority shareholders may refuse to vote for the transaction because they believe the majority is trying to sell out too cheaply; their personal financial position or sentimental attachment to the business may make them reluctant to sell; or they may suspect that the majority stands to benefit in some clandestine way, e.g., by a side deal between the majority shareholders and the acquiring company, such as a long-term employment contract or a covenant not to compete, in which the minority will not share. Similarly, majority shareholders may want to sell their stock to an outsider who is willing to buy all the corporation's stock but not less than all, and a minority shareholder refuses to sell. In these situations,
not share. Similarly, majority shareholders may want to sell their stock to an outsider who is willing to buy all the corporation's stock but not less than all, and a minority shareholder refuses to sell. In these situations, majority shareholders may resort to a squeeze play to eliminate the recalcitrant shareholder.

The corporate charter and bylaws and other written documents which participants in an incorporated enterprise frequently execute do not cover all aspects of their business bargain. Important arrangements among participants in small business enterprises are often oral and sometimes nothing more than vague understandings, never even definitely stated orally. In a large number of the reported cases, an aggrieved minority shareholder-plaintiff alleges but has difficulty proving a shareholders' agreement covering matters in dispute.

Many strong and rather obvious reasons exist for reducing all aspects of the participants' business bargain to writing. In the first place and perhaps most important the process of planning and drafting written instruments causes the parties and their legal advisers to think through the ramifications of the proposed relationships more carefully and make decisions on matters which otherwise might escape their attention and remain undecided. Hiatuses which might give rise to disputes and squeeze-outs are thus eliminated. Second, the existence of written documents minimizes the chance of misunderstanding and increases the probability that the parties will voluntarily comply with the terms of the bargain. A bargain in writing has a psychological effect on the parties and tends to reduce disputes, unfounded claims, squeeze plays and litigation.

Skilled lawyers, if consulted in time, can decrease substantially the number of squeeze plays by removing some of the causes of squeeze-outs and by taking the suitable precautionary steps to protect holders of minority interests. Unfortunately the atmosphere of optimism and goodwill which prevails during the initial stages of a business undertaking usually obscures the possibility of future disagreements and conflicts among the participants. Furthermore, even if the participants foresee the possibility of future dissension, they are reluctant to call in and pay the costs of legal counsel to provide against contingencies.

Legal services cost money, of course, but preventive legal advice is inexpensive when compared to the cost of litigation which may result from the failure to seek out competent legal assistance. The widespread reluctance of the participants in small businesses to obtain competent legal advice undoubtedly contributes to the number of squeeze-outs. Similarly, the unfortunate fact that many lawyers do not fully understand the situations which give rise to squeeze-outs and are not thoroughly familiar with rather complex and sometimes highly technical precautions which are necessary to protect minority interests, also increases the number of squeeze-outs.
III. Common Squeeze-out Techniques and Oppressive Corporate Practices

Holders of a majority of the voting shares in a corporation, through their ability to elect and control a majority of the directors and to determine the outcome of shareholders' votes on other matters, have tremendous power to benefit themselves at the expense of minority shareholders. The following are a few illustrations. Majority shareholders may refuse to declare dividends and may drain off the corporation's earnings in a number of ways. Exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, high rentals for property the corporation leases from majority shareholders, and unreasonable payments to majority shareholders under contracts between the corporation and majority shareholders or companies the majority shareholders own are three major ways. Majority shareholders may deprive minority shareholders of corporate offices and of employment by the company or may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested. Majority shareholders may also organize a new company in which the minority will have no interest, transfer the corporation's assets or business to it, and perhaps then dissolve the old corporation; or they may bring about a merger under a plan unfair to the minority. These techniques, however, are merely illustrative of those to which resourceful squeezers may resort.

Traditionally, American courts have been reluctant to interfere in the internal affairs of corporations, even when minority shareholders claim they are being squeezed out or otherwise oppressed. In denying relief to squeezes, the courts rely on one or both of the following principles: (1) the principle of majority control; or (2) the business judgment rule. Furthermore, many courts apparently feel that there is a legitimate sphere in which controlling shareholders can act in their own interest even if the minority suffers.

The withholding of dividends is a frequently used squeeze-out technique.\(^2\) It is simple to apply and generally exerts great pressure on minority shareholders pressed for funds. This squeeze-out technique can be especially devastating in a Subchapter S corporation, as a minority shareholder can be required to pay federal income taxes on income which he is not actually receiving but which for tax purposes is being attributed

to him. By declaring no dividends at all or keeping dividend payments low, majority shareholders may be able to force a minority shareholder to sell his interest at considerably less than its actual value.

A minority shareholder who challenges the directors' failure to pay adequate dividends faces many obstacles in obtaining a remedy from the courts. The chief barrier, attributable to the general acceptance by the courts of the business judgment rule, is the hesitancy of courts to substitute their judgment for that of directors. Even if a minority shareholder undertakes the arduous task of substantiating an argument that dividends are being wrongfully withheld, the directors, by presenting an alternative analysis of the enterprise's financial and business condition to support their "business judgment" in withholding dividends, can usually persuade the court not to grant relief. In most jurisdictions the doctrine is well settled that whether or not dividends are to be declared and, if so, when, how, and in what amount they are to be paid, are primarily matters for the sound discretion of the directors.

Nevertheless, there are limits to the directors' privilege to retain earnings in the business, and the courts, particularly in cases involving close corporations, will grant relief where the minority can prove the directors have abused their discretion by acting arbitrarily, fraudulently, or in bad faith. Where fraud or bad faith are absent, but the directors have unreasonably or arbitrarily refused to declare dividends, the decisions are in conflict on whether the courts will interfere and compel the payment of dividends.

Controlling shareholders in a close corporation frequently eliminate a minority shareholder from the board of directors and discharge him from company employment. The abrupt removal of a minority shareholder from positions of employment and management can be a devastatingly effective squeeze-out technique. A person acquiring a substantial interest in a close corporation often invests a large percentage of his personal resources to acquire that interest. Typically, he enters the corporation expecting to participate actively in the corporation's affairs as a key employee and perhaps as a director and principal officer. He may give up other employment with accumulated seniority and security features to work full time for the corporation. He may have no income other than his salary. As a close corporation usually does not pay dividends or pays only small and infrequent dividends, a shareholder who is excluded from employment is effectively denied anything more than a token return on his investment, even though the investment may be substantial. Therefore, discharge of the shareholder-employee often produces an immediate financial crisis for him. He is forthwith deprived of his sole source of

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income; the majority shareholders, in order to make the squeeze more effective, may cause the corporation to cancel its insurance policies on him and may try to deprive him of every economic benefit he derives from the corporation so that he may even find himself without life, accident, hospitalization or health insurance or the prospect of income when he reaches retirement age.

The rule has long been established that directors can remove a corporate officer or employee with or without cause, although the corporation will be liable for breach of whatever rights an employee has under an employment agreement. Furthermore, in many states corporations statutes now give holders of a majority of a corporation's shares power to remove directors with or without cause. Even in states without statutes empowering shareholders to remove a director without cause, majority shareholders can of course replace a director when his term (usually one year) has expired, at least if the corporation does not have cumulative voting for the election of directors. In the meantime, majority directors render the undesired member of the board relatively ineffective by methodically outvoting him. At the next annual shareholders' meeting, majority shareholders simply leave the undesired shareholder off the board and elect someone in his or her place.

In 1976, the Supreme Judicial Court of Massachusetts delivered a ground-breaking decision, Wilkes v. Springside Nursing Home, Inc.4 If this decision is followed in other jurisdictions, Wilkes will provide considerable protection to the minority shareholder-employees of close corporations. In this case, the four owners of a nursing home understood at the time of incorporating that each would be a director of the company and participate actively in management and decisionmaking and that each would receive the same amount of money from the business as the others, as long as he assumed an active and ongoing responsibility for its


In In re Topper, 107 Misc.2d 25, 433 N.Y.S.2d 359 (1980), the court held that the majority shareholders' conduct in removing the minority shareholder as an officer and discharging him as an employee of the two corporations of which he was a one-third owner justified involuntary judicial dissolution of the two corporations. The court reasoned that the majority shareholders acted "opressively" by severely disappointing the minority shareholder's reasonable expectations and effectively squeezing him out of the company. The court considered it irrelevant whether the controlling shareholders removed the minority shareholder for good cause or in the exercise of good business judgment. Moreover, the court indicated that it was empowered to permit the two controlling shareholders to purchase the petitioner's shares as an alternative to dissolution, pursuant to N.Y. BUS. CORP. LAW § 1118 (McKinney 1976).
burdens. However, they did not enter into a formal shareholders’ agree-
ment allocating control and earnings or into employment contracts with
the corporation. The work of establishing the business and operating it
was apportioned among the participants. Wilkes took charge of upkeep
and maintenance of the physical plant and grounds; Riche supervised
kitchen facilities and food; Pipkin handled medical problems; and Quinn
dealt with personnel and administration, served informally as a manag-
ing director, coordinated the activities of the shareholders and served as
a communication link when matters were discussed and decisions made
without a formal meeting. Pipkin later sold his shares to Connor, who
was elected a director and served as the corporation’s financial adviser.

A dispute developed between Quinn and Wilkes, and the other two
shareholders sided with Quinn. As a consequence of this dispute, the
board of directors terminated Wilkes’ salary and increased Quinn’s
compensation. At their next annual meeting, the shareholders failed to
reelect Wilkes a director, and the directors did not elect him an officer.
Further, the other shareholders informed Wilkes that neither his services
nor his presence at the nursing home were wanted. The other sharehold-
ers did not claim that Wilkes had neglected his duties or had engaged in
misconduct; his elimination was based solely on their desire to deny him
income from the corporation.

The court held that the removal of Wilkes as a director and officer
breached fiduciary duties the other shareholders owed him, and it
remanded the case for the determination of damages, indicating that
Wilkes should be allowed to recover from the other participants “ratably,
according to the inequitable enrichment of each, the salary he would have
received had he remained an officer and director.”

The court relied heavily on the writings of commentators, including
those of this writer, and on an earlier Massachusetts decision which held
that “stockholders in the close corporation owe one another substantially
the same fiduciary duty in the operation of the enterprise that partners
owe to one another,” that is, a duty of “utmost good faith and loyalty.”
The court in the Wilkes case pointed out that majority shareholders, by
terminating a minority shareholder’s employment and severing him from
the directorate and a corporate office, may effectively frustrate the
minority shareholder’s purposes in entering into the corporate venture
and deny him an equal return on his investment.

The court cautioned, however, that the strict good faith standard it was
affirming has to be tempered to avoid hampering effective management
and that a balance has to be struck between the majority’s fiduciary

5 Wilkes at 846, 353 N.E.2d at 661.
7 Wilkes at 847, 849, 353 N.E.2d at 662, 664.
obligations and majority rights. The court commented that those in control of a corporation must have a large measure of discretion in establishing a corporation's business policy, e.g., in declaring or withholding dividends, deciding whether to merge, establishing officers' salaries, dismissing directors with or without cause, and hiring and discharging corporate employees. The court emphasized that the proper approach is to analyze the controlling shareholders' action in the particular case and ask whether the controlling shareholders can demonstrate a legitimate business purpose for their action; and further, that whenever controlling shareholders assert a business purpose for action detrimental to minority shareholders, the latter should be allowed to demonstrate that the business purpose can be achieved by an alternative course of action less harmful to the minority.

Another commonly used squeeze-out technique is for majority shareholders to siphon off corporate wealth by causing the corporation to pay its majority shareholders, and perhaps members of their families, excessively high compensation for services rendered as directors, officers or key employees. Majority shareholders commonly compensate themselves not only by straight salaries but also by bonuses, pensions, profit-sharing, generous expense accounts, medical and health programs, company-purchased insurance and various other so-called "fringe benefits."

A minority shareholder who has been removed from company employment must watch the majority shareholders and their families live handsomely on compensation from the corporation and enjoy the prestige, privileges and patronage that accompany control of a corporation and holding its principal offices, while he and his family receive no financial return or any other benefit from his investment in the company.

The payment of excessive compensation, in addition to siphoning off a corporation's earnings and thus reducing its "net assets value," may well lead to an understatement of the corporation's earning power. Thus, the payment of excessive compensation over a period of time may redound to a minority shareholder's detriment when the corporation sells its business and assets or merges with another company, because its apparent earning power, that is, its earning power as reduced by the excessive compensation, may be reflected in the price the corporation receives for its assets or in the terms of the merger agreement. Similarly, an understatement of earning power may adversely affect the price a minority shareholder receives under a dissenters' rights statute when he objects to a merger, a sale of substantially all the corporation's assets, or other fundamental corporate change carrying appraisal rights and requests the corporation to buy his shares at their appraised value.

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8 Id. at 848, 353 N.E.2d at 663.
9 Id.
10 Id.
Whenever a corporation is paying excessive compensation to majority shareholder-employees, a minority shareholder may be able to obtain relief by bringing a derivative action on behalf of the corporation based on the theory that the excessive compensation constitutes waste or misuse of corporate assets. In this way a minority shareholder may be able to recover for the corporation some of the compensation already paid and prevent future excessive payments. However, it is to be noted that funds recovered for the corporation would still be under the control of the majority shareholders.

Nearly all judicial pronouncements on compensation, despite their varying formulations, seem to assume that relief should be granted only after a finding that compensation being paid is unreasonably high. Whether compensation being paid a particular officer or employee is reasonable is a difficult question of fact. Among the factors that courts say they consider in passing on the reasonableness of compensation are the following: the employee's qualifications and ability; the quantity and quality of services rendered; the time devoted to the company; the difficulties involved and responsibilities assumed in the work; the success he or she has achieved; the profits resulting to the corporation from the employee's efforts; the amounts under his or her jurisdiction; the size and complexities of the business; the corporation's financial condition; increases in the volume or quality of the corporation's business; prevailing general economic conditions; and perhaps the most significant of all, the amount of the compensation in question as compared with compensation paid to employees by similar companies for comparable work.

An attempt to squeeze out a minority shareholder often includes deliberate withholding of information from the shareholder. The chance of a squeeze technique succeeding is usually improved if the squeezee remains in the dark about the affairs of the corporation and the actions of its directors and officers. The type of information withheld varies with the squeeze techniques being employed, but most commonly concerns the value of the enterprise and of an interest in it, the corporation's prospects for profitable operations in the future, the controlling shareholders' plans for the business, and any plans they may have for disposing of their interests in it. Since the public reporting and disclosure requirements of the federal securities law do not apply to close corporations, shareholders in a close corporation do not have access to sources of information available to securities holders in a public-issue corporation.

Controlling shareholders and directors may force a minority shareholder to litigate in order to effectuate his inspection rights, and they may use a multitude of delay tactics in that litigation. In Alabama, a minority shareholder, objecting to action by persons in control of a small Alabama bank, took his case to the Supreme Court of Alabama three times and had to litigate in a federal District Court and the United States Court of Appeals for the Fifth Circuit on the preliminary question of
whether he could inspect bank books and records.\textsuperscript{11} During the course of the litigation, the bank's officials attempted to obtain amendments of the Alabama statutes to diminish shareholder inspection rights.

A squeeze-out is often effected by a director or "inside" shareholder by purchasing the shares of a minority holder without disclosing information which bears on the value of the shares. Perhaps the selling shareholder has not been active in the corporation and is not informed about its affairs. The seller may be the widow of an original shareholder who has recently died. In circumstances of this kind, can the seller, on discovering that the shares were sold for far less than their actual value, set aside the sale or recover from the purchaser damages for the losses suffered? A similar problem is raised when majority shareholders in a close corporation cause the corporation to buy a minority interest and do not reveal to the selling shareholder information affecting the value of the shares. Actually, the majority shareholders are purchasing the shares for themselves, as the benefit to them is only one step removed. A minority shareholder, whose shares are purchased by the majority shareholders or the corporation without full disclosure, has remedies under Section 10(b) of the Securities Exchange Act,\textsuperscript{12} SEC Rule 10b-5,\textsuperscript{13} and in most states under common law principles for breach of the fiduciary duty controlling shareholders owe other shareholders.

Various kinds of contracts between a corporation and its majority shareholders or businesses owned by them may be used to siphon off corporate earnings and assets. Because majority shareholders control the corporation, these contracts are not arrived at by arm's length bargaining; and not surprisingly, the terms arranged are often highly favorable

\textsuperscript{11} The cases in Alabama are: Miles v. Bank of Heflin, 349 So.2d 1072 (1977); Miles v. Bank of Heflin, 295 Ala. 286, 328 So.2d 281 (1975); Bank of Heflin v. Miles, 294 Ala. 462, 318 So.2d 697 (1975). During this litigation, the Bank of Heflin sued in the U.S. District Court in Alabama to enjoin the first decision. The minority shareholder moved to dismiss on the grounds that the merits were being determined in state court, but his motion was denied. The Fifth Circuit refused to interfere (unreported, Oct. 26, 1976), cert. denied sub nom. Miles v. Guin, 430 U.S. 966 (1977).

The U.S. District Court in Alabama finally enjoined the minority shareholder from enforcing the Alabama Supreme Court decisions, which had held that there was no "reasonable cause" for the Bank of Heflin to refuse inspection and therefore had assessed a penalty. Bank of Heflin v. Miles, No. 76-G-0791-E, slip op. (N.D. Ala. 1978). The District Court concluded that it should enjoin the state court proceedings in order to protect and effectuate its decision in Federal Deposit Ins. Corp. v. Bank of Heflin, No. 75-G-1829-E, slip op. (N.D. Ala. 1975) which had permanently enjoined the Bank of Heflin from making public any documents containing information privileged under FDIC regulation, 12 C.F.R. 308.1(c)(ii)(1980). On appeal, the Circuit Court held that the District Court properly granted the injunction which nullified the Alabama Supreme Court directive. Heflin v. Miles, 621 F.2d 108 (5th Cir. 1980).


\textsuperscript{13} 17 C.F.R. § 240.10b-5 (1980).
to majority shareholders or their other businesses and detrimental to minority shareholders. Leases and loans are two types of contractual arrangements commonly used to drain off corporate earnings. Sometimes majority shareholders drain off corporate profits by having other enterprises they own perform services for the corporation under management or service contracts which set fees considerably higher than the fair value of the services rendered. Similarly, majority shareholders may cause a corporation to purchase supplies, land or other goods from them or enterprises they own at unreasonably high prices. Further, majority shareholders may use their controlling position to buy from the corporation at unreasonably low prices products it manufactures, services it offers, or land or other assets it holds.

On occasion, a majority shareholder in a corporation will cause the corporation to purchase his shares, perhaps at an unconscionably high price. The purchase may be part of the majority shareholder's estate plan or it may be designed to "bail out" the majority shareholder at a time when the corporation's future looks bleak. Whenever a corporation contracts to purchase the shares or part of the shares of a majority shareholder or other favored shareholder at an advantageous price, a minority shareholder may be able to force the corporation to purchase his shares on the same terms. In a leading Massachusetts case, Donahue v. Rodd Electrotype Co. of New England, Inc., the court granted this kind of remedy. Rodd, the principal founder of a family-owned close corporation and reigning family patriarch, had originally held 200 shares in the company, which constituted an 80 percent interest. Rodd later brought two sons into top management jobs and made gifts of 39 shares to each of them and to one other child. Wishing to retire, Rodd negotiated for the corporation to purchase 45 of his remaining shares. His eldest son, a corporate director, represented the corporation in those negotiations. Rodd resigned, and the corporation purchased his 45 shares for $36,000 or $800 a share. Within two years, he sold or gave the rest of his stock to his three children, increasing their interests to 52 shares each.

Donahue, a minority shareholder, who owned 50 shares and who was the wife of a former employee, brought an action against the corporation and its directors and controlling shareholder claiming that the corporation's purchase of Rodd's shares constituted an unlawful distribution of corporate assets to the controlling shareholder and a breach of the fiduciary duty owed by the controlling shareholder to her as a minority shareholder. The corporation had offered Donahue a maximum of $200 a share for her stock. She based her breach of fiduciary duty charge on the

controlling shareholder's failure to accord her an equal opportunity to sell her shares to the corporation.

The Massachusetts Supreme Judicial Court accepted Donahue's theory, stating that shareholders in close corporation are subject to a "strict good faith standard" in the discharge of their management and shareholder responsibilities, a standard substantially the same as the one applicable to partners and stricter than the standard imposed on directors and shareholders of other corporations in the discharge of their corporate responsibilities. In order to insure Donahue the equal opportunity she should have received, the court remanded with directions to either (1) require Rodd to remit the $36,000 with interest to the corporation in exchange for 45 shares of the corporation's stock or (2) require the corporation to purchase Donahue's 45 shares for an equal $800 per share.15

Majority shareholders can often diminish the minority's proportionate voting rights and proportionate claim on earnings and assets by causing the issuance of additional shares of stock and controlling the disposition of the new shares. A shareholder's preemptive rights usually will not protect him from this. In the first place, majority shareholders may be able to amend the corporation's articles of incorporation to eliminate preemptive rights. Second, the utility of the shareholder's preemptive rights as a shield against squeeze-outs is considerably impaired by the numerous exceptions to those rights. For example, in the absence of a contrary charter provision, the rights do not attach to stock issued in exchange for property the corporation needs or (according to some authorities) to stock issued in satisfaction of a preexisting debt. Sophisticated squeezers can of course circumvent a minority shareholder's preemptive rights by causing the corporation to issue the new stock to them, their relatives, or their friends in return for property; or the majority shareholders can make a loan to the corporation and after lapse of a "decent" interval cause the corporation to satisfy the debt by issuing shares to themselves in payment. Third, the minority shareholder may not have sufficient funds available to exercise his preemptive rights when the new shares are issued. Majority shareholders and the directors and officers under their control may deliberately issue the additional shares at a time when it will be difficult or impossible for the minority shareholder to finance the purchase of his part of the shares and may allow him only a short time to decide whether to exercise his preemptive rights. The proposal to issue the new shares would of course probably be accompanied by a claim that the corporation needed capital for expansion or to pay its debts, and the shares probably would be offered at considerably less than their value. In a squeeze-out, it is not unknown for

15 Donahue at 582, 328 N.E.2d at 511.
the corporation to reduce the par value of its shares in order to be in a position to issue new shares below their actual value but nevertheless at par.

IV. FUNDAMENTAL CORPORATE CHANGES

The provisions of state corporation statutes authorizing charter amendments, mergers and other fundamental corporate changes give considerable leeway to directors and majority shareholders to take unfair advantage of minority shareholders. About half of the state statutes now permit fundamental corporate changes by an affirmative vote of the holders of a majority of the corporation’s shares. The other states require a super-majority vote, usually two-thirds, but the number of states with such a requirement has been declining.

Controlling shareholders often utilize a statutory merger as an instrument for squeezing out minority shareholders or altering their rights. In every state, the corporation statute provides a statutory procedure by which two or more corporations can be combined into a single corporation even though less than all shareholders approve. In exchange for the original shares, shareholders of a constituent corporation may be given stock of the surviving corporation with markedly different rights and preferences. If the merger plan so provides, they may receive for their shares only bonds or debentures of the surviving company and thus become subject to complete elimination from the enterprise when the bonds or debentures mature or otherwise become payable. Thus, even under a statute which provides for the conversion of shares in the constituent corporations only into “shares or other securities or obligations” of the surviving corporation, the plan of merger can provide for the surviving corporation to offer terminable debentures, callable bonds or redeemable preferred share. While the minority would thus receive an offer of “continued participation,” the effect would only be a little different from a cash offer to be paid with interest at a future time.

Under many modern corporation statutes a plan of merger may provide that shares of each merging company will be converted into securities of a corporation other than the surviving company or, in whole or in part, into cash or other property. Under these statutes, shareholders of a constituent corporation can be “cashed out” and eliminated summarily and directly from the resulting enterprise.

The Delaware Supreme Court’s 1977 decision in Singer v. Magnavox Co. held that the majority’s right to cash out the minority’s shares is not coextensive with the broad power given the majority by the statute and that use of the statutory power solely to eliminate the minority “is a

violation of the corporate process." Courts in several other states have enjoined or set aside mergers on the ground that the transaction lacked a business purpose. Some states, by statute or judicial decision, have rejected the Singer "business purpose" rationale, seeing appraisal as the minority shareholder's remedy. In *Weinberger v. UOP, Inc.*, a 1983 decision, the Delaware Supreme Court itself rejected Singer. Noting the extent to which the "business purpose" doctrine had been watered down by post-Singer Delaware decisions, the court concluded that the requirement of such a diluted business purpose for a merger offered the minority shareholder no additional meaningful protection beyond "the fairness test which has long been applicable to parent-subsidiary mergers, . . . the expanded appraisal remedy now available to shareholders, and the broad discretion of the Chancellor to fashion such relief as the facts of a given case may dictate."18

In abandoning the "business purpose" doctrine, the Delaware court in *Weinberger* measured the merger against a fairness standard:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of how the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approval of the directors and stockholders was obtained. The latter aspect of fairness relates to economic and financial considerations of the proposed merger.19

The adequacy, or lack thereof, of the statutory appraisal remedy obviously has a crucial impact on the issue of entire fairness. The *Weinberger* decision broadened the valuation method used in the appraisal process to include "any techniques or methods which are generally considered acceptable in the financial community."20 Any relief other than appraisal requires a showing of "fraud, misrepresentation, self-dealing, deliberate waste of corporate assets or gross or palpable over-reaching."21

Fairness discussions in judicial opinions increasingly refer to procedural devices intended to insure fairness, such as: (a) representation of a subsidiary by an independent negotiating committee in merger negotiations with a controlling parent; (b) approval of a merger by a majority of a corporation's minority shareholders; and (c) obtaining a fairness opinion from an independent investment banker. The extent to which mergers must include these procedural devices is unclear, and in any

17 457 A.2d 701 (Del. 1983).
18 *Id.* at 715.
19 *Id.* at 711.
20 *Id.* at 710, (citing Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del. 1952)).
event it is not yet proven that they provide a minority shareholder with any substantial protection.

The most important trend in state court decisions may be an increased disclosure obligation which courts impose on majority shareholders who propose mergers that cash out minority shareholders. Courts increasingly impose on majority shareholders a duty of "complete candor," including not just a duty to avoid affirmative misrepresentation but also a duty not to omit any relevant information in communications to shareholders.

Charter amendment can often be used, either alone or coupled with other techniques, to eliminate undesired shareholders or alter their rights. State corporation statutes authorize a great variety of changes in the rights of shareholders to be effected by charter amendment, which often can be done by a vote of a mere majority of shareholders.22 State statutes often give some protection to minority shareholders by providing that a charter amendment which affects the rights of preferences of any class of shares is subject to the right of the class affected to vote thereon as a class.

In most jurisdictions, a corporation's charter can be amended to make a nonre redeemable class of stock redeemable, to eliminate cumulative voting, or to limit or deny shareholders' preemptive rights. A minority shareholder can of course be eliminated from an enterprise by making his stock redeemable and then redeeming his stock; or he can be deprived of representation on the board of directors by the elimination of cumulative voting.

A few states even permit a charter amendment which makes nonassessable stock assessable.23 Imagine the pressure put on a minority shareholder to sell his interest if his shares are made assessable and the majority shareholders are thereby empowered to force him to add new, "good" money to a "bad" investment that is bringing him no return either in the form of dividends or salary! In at least one state, a corporation's charter can be amended to impose personal liability on shareholders for corporate debts, including the corporation's liability for salaries owed to majority shareholder-employees.24

A charter amendment to reduce the number of shares outstanding (a reverse stock split) can lead to a minority shareholder being involuntarily forced out of the enterprise. The reverse stock split may create fractional shares which the corporation, in its discretion, may purchase for cash, thus eliminating those shareholders from the enterprise.

A squeeze-out by reverse stock split occurs in the following manner.

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The controlling shareholder first votes to amend the corporate charter (in many states no more than a majority vote is required) to reduce the number of shares outstanding by consolidating the shares so that each share is converted into a small fraction (e.g., 1/600th) of a share. Any shareholder owning less than 600 shares will then be left with only a fraction of a share. In some states, the corporation statute empowers the corporation to purchase fractional shares for cash. The corporation can insure a complete cash-out of minority shareholders simply by reducing the number of shares sufficiently so that each minority shareholder has less than one share.

As with other kinds of squeeze-outs, courts have split on whether a controlling shareholder should be permitted to use a reverse stock split to squeeze out minority shareholders. The Supreme Court of Illinois upheld such a technique in *Teschner v. Chicago Title & Trust Co.*

Shareholders and directors in control of a corporation may cause it to sell its business and assets or a promising branch of its business to a company which they own, or they may organize a new corporation, taking all the shares themselves, and then cause the old company to sell its business and assets to the new company, perhaps at an inadequate price. They also may cause the price actually being paid for the corporation's business and assets to be understated and divert to themselves part of the consideration the purchaser is really paying for the business and assets, perhaps in the guise of a payment for consulting services rendered to the purchaser or a covenant not to compete with the purchaser. If a new company is organized, the directors and officers of the old company may become directors and officers of the new one, and after the transfer of assets, the business may continue very much as before. The old corporation may be dissolved, and the new company may assume its name or one that is similar.

Statutes permitting voluntary dissolution of a corporation on the vote of a specified percentage of its shareholders, especially if dissolution is not required to be under judicial supervision, open the way for majority shareholders to bring about the dissolution of a company, the liquidation of its assets and the acquisition of the assets by a concern which they own. As Professor George D. Hornstein said over 40 years ago, voluntary dissolution can be used to squeeze out small shareholders "where the corporation is obviously earning money and prospering in every way, and it is proposed, not to discontinue the business, but to turn it over to a new corporation with a slightly different name but with the same powers and some of the original owners." Indeed, the purchasing company may continue the business with the same employees and at the same location.

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26 Hornstein, *Voluntary Dissolution—A New Development in Intracorporate Abuse*, 51 *Yale L.J.* 64, 67 (1945).
Bankruptcy proceedings have sometimes been used to effectuate a squeeze-out. Majority shareholders can cause the corporation to file a voluntary petition in bankruptcy, with the expectation that they will be able to outbid minority interests at the bankruptcy sale, if indeed minority shareholders learn of the sale in time to bid.

A majority shareholder planning to use bankruptcy as a squeeze-out technique might be able to enhance his claims against the corporation by causing it to enter into a long-term employment contract with him, providing for a handsome salary and containing an acceleration clause making the salary for the whole term of the contract immediately due and payable if the corporation should be declared bankrupt or insolvent.

Statutes referred to as "appraisal statutes" or "dissenters' rights statutes" supposedly mitigate somewhat the risk of hardship or injustice to minority shareholders from mergers and certain other fundamental corporate changes. These statutes authorize a shareholder who dissent from such a transaction to demand that the corporation purchase his shares at their fair value. If the shareholder and the corporation cannot agree on a price, the statutes provide for judicial appraisal of the shares to determine the purchase price. Almost all jurisdictions confer such rights upon dissenters whenever a corporation merges or consolidates, and many jurisdictions also confer such rights whenever a corporation sells all or substantially all corporate assets. In addition, some states provide for appraisal and payment to dissenters following specified types of charter amendment, e.g., changes in corporate purposes, elimination of cumulative voting, extension of corporate life or changes in the rights of shares. The type of charter change carrying the right to payment varies from one state to another. Dissenters' rights statutes were designed to protect nonassenting shareholders against being forced to accept membership in an enterprise fundamentally different from the one in which they originally invested or to participate on a basis drastically different from the one they contemplated when they invested.

Serious gaps exist in the protection against fundamental corporate action given to minority shareholders by dissenters' rights statutes. Several different techniques usually will be available to those in control of a corporation to achieve the corporate change they desire, and not all of these methods trigger dissenters' rights. Consequently, directors or majority shareholders often can structure a fundamental change in shareholders' participation in an enterprise without giving dissenting shareholders an opportunity to have their shares appraised and purchased. Even if the transaction is structured in a way that provides dissenters' rights, the complex procedures in the appraisal process, the expense minority shareholders must incur and the possibility that a low value will result from the statutory formula may leave minority share-
holders without a practical means for obtaining fair value for the shares they are being forced to relinquish. 27

V. RESISTING SQUEEZE-OUTS AND OPPRESSION

A minority shareholder's attorney can take several steps to fight a squeeze-out or oppressive action. First, he should get information about the corporation, its operations and the oppressive action being taken by the majority shareholders and corporate directors. Some information can usually be obtained by asserting the minority shareholder's right to inspect corporate books and records, and, if the minority shareholder is a director, the director's right to inspect corporate books and records and make on-premises inspections.

Interrogatories and other discovery tools can of course be useful to a minority shareholder's attorney in obtaining information in a derivative suit or other litigation brought by the shareholder to protect the corporation or the shareholder's own interests. There are ways of challenging the attorney-client privilege and the accountant-client privilege, two privileges which are frequently asserted in efforts to avoid disclosure of communications between corporate officers or agents and corporate lawyers or accountants. Since Garner v. Wolfinbarger, 28 a 1970 decision of the Fifth Circuit Court of Appeals, the prevailing view in the federal courts has been that the attorney-client privilege cannot be used to shield communications between a corporation's attorney and corporate officers or agents from shareholder discovery if the plaintiff-shareholder shows good cause why the privilege should not be applied. The decisions suggest a general willingness to find good cause to defeat the claim of privilege if the plaintiff presents a colorable claim of breach of fiduciary duty.

An exceptionally useful source of information, the corporation's federal income tax return, is made available to a minority shareholder by Section 6103(e) of the Internal Revenue Code. That section provides, among other things, that the income tax return of a corporation or its subsidiary "shall, upon written request, be open to inspection by or disclosure to any bona fide shareholder of record owning 1 percent or more of the outstanding stock of such corporation." 29

Minority shareholders aggrieved by acts of majority shareholders or by corporate action caused by majority shareholders or corporate managers frequently have to resort to litigation to obtain any relief whatsoever. In the past, they have most often brought either (1) a derivative suit on behalf of the corporation to recover for damages it has suffered as a result of an injury to it or (2) a suit for rescission of an overly oppressive transaction where they are also shareholders or creditors of the corporation. 29
of the majority shareholders' misconduct, usually based on acts of
majority shareholders in their capacities as director or officer, (e.g., the
payment to themselves of excessive salaries, waste of corporate assets, or
the seizure for themselves of corporate opportunities) or (2) an individual
suit against the corporation or the majority shareholders to enforce a
personal right, (e.g., the right to inspect corporate books and records or a
right under a shareholders' agreement). Attorneys for minority share-
holders should not overlook the possibility of utilizing procedures or
asking for remedies that have not been readily available in the past or
have not been considered practical. Corporation statutes in a growing
number of states now encourage courts to grant remedies that previously
did not occur to courts or that courts thought they had not power to grant.
Statutes in some states empower courts, in a suit brought by a share-
holder, to dissolve a corporation or grant various forms of relief such as
the appointment of a custodian to run the corporation, the buy-out of a
minority interest by the majority, the restructuring of the corporation's
charter and bylaws, or other appropriate remedies.

An interesting case discussing standards to be applied in determining
whether to grant dissolution, a forced buy-out, or other relief in a suit
brought by a minority shareholder is the decision of the Supreme Court
of North Carolina in Meiselman v. Meiselman. In that case, two
brothers, Ira and Michael, received from their father shares in a number
of corporations which he founded. Ira's holdings amounted to a control-
ling interest in seven of the eight companies. Michael brought a deriva-
tive action on behalf of one of the family corporations, alleging that Ira
had caused it to enter into an unfair management contract with another
company of which Ira was the sole owner. Ira then discharged Michael
from employment in the family businesses, and the relationship between
the brothers thereafter deteriorated rapidly.

Michael amended his complaint to request dissolution or, in the
alternative, a forced buy-out of his interests in the family businesses. He
relied upon a section of the North Carolina Corporation act which
provides that a court shall have power to liquidate the assets and
business of a corporation in an action by a shareholder if it is established
that liquidation "is reasonably necessary for the protection of the rights
and interests of the complaining shareholder." He further relied upon a
section of the Act which gives a court power to order alternative forms of
relief in an action by a shareholder to dissolve a corporation, including
specifically a forced buy-out of any shareholder by the corporation or the
other shareholders whenever relief other than dissolution would be

v. Meiselman: Reasonable Expectations "Determining Minority Shareholders' Rights", 62
appropriate. The trial court found that there was no oppression, over-reaching, gross abuse or the taking of unfair advantage by Ira or corporate management and rejected both of Michael's requests.

On appeal, Michael abandoned his request for dissolution, concentrating instead on the buy-out request. The Supreme Court of North Carolina decided that the trial court had applied the wrong legal standard and reversed the denial of a buy-out. It remanded the case for an evidentiary hearing on whether a buy-out would be desirable and directed the trial court to focus on whether Michael had suffered a cognizable injury to his "rights and interests," rather than on Ira's culpability. Specifically, it ordered the lower court to (1) identify Michael's "rights and interests" in the companies, including his "reasonable expectations" as ascertained by an examination of the entire history of the participants' relationship and (2) determine whether those rights or interests, including expectancies, required judicial protection. The Meiselman decision broke new ground in that the court departed from the typical judicial concern with whether majority shareholders were guilty of misconduct and focused instead on harm to minority shareholder interests, including reasonable expectations.

Minority shareholders often will find it advantageous to argue that the action taken by the controlling shareholders, director and officers is in breach of fiduciary duties owed to the corporation or to minority shareholders. Fiduciary duty principles provide an opportunity for lawyers for the minority shareholders to move the case from narrow technical grounds, where the action of the majority may be unassailable, to "broad considerations of corporate duty and loyalty."

The scope of the majority shareholders' fiduciary duties is flexible, reflecting the historical approach of the courts of equity. Any general formulation or even categorization of these duties is difficult and runs the risk of being vague and incomplete. Courts have used the fiduciary concept to adapt the law to changes in the business environment. For example, in Jones v. H.F. Ahmanson & Co., the California Supreme Court noted that the traditional rules of fiduciary obligation "failed to afford adequate protection to minority shareholders and particularly to those in closely held corporations whose disadvantageous and often precarious position renders them particularly vulnerable to the vagaries of the majority." The court, therefore, decided to impose upon controlling shareholders a "comprehensive rule of good faith and inherent fairness to the minority in any transaction where control of the corporation is material."

33 Id.
35 Id. at 112, 460 P.2d at 474, 81 Cal. Rptr. at 602.
36 Id.
sometimes use the fiduciary duty concept to prevent inequitable conduct
by a controlling shareholder which seems permissible under the bare
words of a corporate statute.

In litigation, a minority shareholder’s lawyer should request protection
of the minority shareholder's reasonable expectations. The reasonable
expectations of the shareholders, as they exist at the inception of the
two of the shareholders, is perhaps the most reliable guide
to a just solution of a dispute among shareholders in the typical close
corporation. With increasing frequency, courts are acting to protect the
reasonable expectations of minority shareholders against the unfair
exercise of majority shareholder or managerial power. This reliance by
the courts on the shareholders’ reasonable expectations as a guide for the
settlement of shareholders’ disputes is coupled with a growing judicial
resourcefulness in developing effective remedies to assure the gratifica-
tion of those expectations. Note that in protecting expectations, the courts
are focusing on the impact on shareholders of acts by those in control of
the corporation, rather than using the traditional approach of searching
for misconduct by those in control.

Where a person gives up employment to “go in business for himself”
and takes virtually all of his savings to buy a minority interest in a close
corporation which he and a few friends are forming and in which they
contemplate that each one of the shareholders will be an officer or key
employee and share in the control and the business continues for a
number of years with each shareholder serving as a director, working for

57 E.g., Hackbart v. Holmes, 675 F.2d 1114 (10th Cir. 1982)(in awarding the plaintiff a
49 percent ownership interest in a corporation, the court reasoned that a new shareholder's
reasonable expectation of receiving a growth interest in the company was frustrated when
he was issued nonparticipating preferred stock for his capital contribution); Cressy v.
that two principal shareholders intended equal ownership and control of the business and
that their expectation of equality of shareholdings carried with it a duty on the part of each
principal to disclose to the other the availability of outstanding shares for purchase and to
afford the opportunity to share in the purchase of such stock); Wilkes v. Springside Nursing
Home, Inc., 370 Mass. 842, 353 N.E.2d 657, 664 (1976)(the minority shareholder had
"invested his capital and time for more than fifteen years with the expectation that he
would continue to participate in corporate decisions"); Capitol Toyota, Inc. v. Gervin, 381
So.2d 1038 (Miss. 1980); Fox v. 7l. Bar Ranch Co., 198 Mont. 201, 645 P.2d 929 (1982)(the
court dissolved a corporation when the reasonable expectations of the complaining share-
holder were thwarted even though the shareholder had not voluntarily entered the business
relationship but instead had inherited his interest in the corporation; the court noted that
"after the death of his father, the plaintiff had a reasonable expectation of sharing in his
inheritance"); Exadaktilos v. Cinnamonon Realty Co., 167 N.J. Super. 141, 400 A.2d 554
(1980); In re Kemp & Beatley, Inc., 64 N.Y.2d 63, 484 N.Y.S.2d 799, 473 N.E.2d 1173 (1984);
In re Taine’s, 111 Misc. 2d 554, 444 N.Y.S.2d 540 (N.Y. Sup. Ct. 1981); In re Topper, 107
the company, drawing a salary, and having a voice in business decisions, then obviously it is unjust to permit majority shareholders to oust the minority shareholder from the directorate and cause the corporation to discharge him from employment, especially if the corporation is paying no dividends, as is usually the case. Surely the law must provide some remedy for this minority shareholder whose expectations of future employment have been disappointed and who has been deprived of any return at all on his investment in the company. Not to provide a remedy in circumstances of this kind is to permit the majority shareholders to exploit the minority shareholder's investment solely for their own benefit.

VI. Arrangements Which Avoid Squeeze-Outs and Oppression: Precautions Attorneys Should Take

Many persons who become minority shareholders in a close corporation when it is being organized, or who buy into the business later, have a trusting, almost child-like innocence at the outset of their involvement. They are enthusiastic about going into business for themselves, and they anticipate both success in the business and high profits. They fail to recognize that in the absence of special protective arrangements, almost absolute control, certainly ultimate control, is in the hands of holders of a majority of the corporation's voting shares. Even if they realize that majority shareholders will be able to control the corporation, they often do not appreciate the nature and extent of the conflicts of interest that exist or may develop among shareholders.

Ideally, each prospective shareholder in a proposed close corporation should be represented by his own attorney. Similarly, separate legal representation is desirable whenever the participants are entering into a shareholders' agreement, or whenever they are considering a charter or bylaw amendment that affects control of the corporation. However, the added expense or the failure of the participants to see a need for separate representation may lead them to entrust the organization of the business and the drafting of important documents affecting their interests to a single attorney.

Whenever an attorney is asked to represent all the prospective shareholders, he should discuss possible conflicts of interest and let each prospective shareholder decide if he wants the attorney to serve as his counsel. If all of the participants want the attorney to serve, which is very often the response, he must be extremely careful to point out to them the problems, advantages, disadvantages and risks to each of them in alternative courses of action. He should also be alert to the possibility that conflicts of interest may arise at a later date, long after the corporation has been organized, and that someone may eventually review his actions and counseling to determine if he favored one shareholder over another.
A number of measures can be taken at the time a business is being organized or before friction among the participants has developed to avoid squeeze plays and oppression of minority shareholders. Attention should first be given to ways of avoiding the dissension which sets the stage for squeeze plays. The attorney should be alert to the high desirability of a careful study of the underlying causes of squeeze-outs, of comprehensive planning to eliminate as many of those causes as possible and of providing for expeditious settlement of whatever disputes develop. Even the most experienced practitioner might do well to review the recurring problem situations discussed earlier in this paper before tackling the task of protecting his or her client. A study of the underlying causes of squeeze-outs undoubtedly would suggest to a perceptive lawyer a number of preventive measures. The lawyer might, for instance, in order to avoid the dissension which usually develops after a participant in an enterprise buys an interest in a competing business, persuade the participants to include in their business bargain a stipulation prohibiting any participant from acquiring an interest in a competing business. Moreover, the lawyer probably will want to place restrictions on the transferability of the corporation's shares to help prevent shares from getting into the hands of persons who might not take an active part in conducting the business or who might be uncongenial or inclined to indulge in squeeze plays.

Several devices can be used to give affirmative protection to minority shareholders against squeeze plays. Most prominent among these devices are shareholders' agreements, long-term employment contracts, and charter or bylaw provisions requiring high votes for shareholder and director action.\(^\text{38}\)

Undoubtedly the most frequently used device for giving protection to minority shareholders against squeeze-outs is a contract among the shareholders. Among provisions which might be included in a shareholders' agreement to help forestall squeeze-outs and safeguard the interests of all shareholders on a mutually fair basis are the following: (1) specified shareholders or their nominees are to constitute the board of directors; (2) each shareholder is to be employed in a key position by the corporation at a specified salary; (3) salaries of officers and key employees are not to be changed except by unanimous consent of the shareholders; (4) each shareholder or each of specified shareholders is to have the power to veto some or all corporate decisions; (5) whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to the shareholders; (6) a shareholder will not transfer his shares until he has first offered them to the corporation and to the other

\(^{38}\) For a comprehensive discussion of these devices, see F.H. O'Neal, Close Corporations: Law and Practice, (2d ed. 1972, and annual supplements).
dividends in the amount of the excess will be paid to the shareholders; (6) a shareholder will not transfer his shares until he has first offered them to the corporation and to the other shareholders; and (7) disputes among the participants are to be submitted to arbitration for settlement. The parties might also consider including in the agreement a statement that a breach of the covenants therein will result in irreparable damage, which damage is not measurable in money, and that therefore the parties agree to injunctive relief to compel compliance.

A person who is taking a minority interest can to some extent protect himself against being deprived of employment with the company by insisting on a longer-term employment contract. Note that what is contemplated here is not an agreement among the shareholders but a contract between the corporation and a particular shareholder-employee. The employment contract, of course, should be incorporated into a formal written document, and care should be taken that the person executing the contract on behalf of the corporation has been properly authorized.

To guard against the possibility that when the corporation grows and becomes prosperous the salaries of majority shareholders will be increased without a proportionate increase in his compensation, the minority shareholder may insist that his employment contract include, in addition to a basic salary, some provision for contingent compensation (e.g., a percentage of profits) or an arrangement under which his salary will be increased in a fixed proportion with salaries of designated corporate officers. Furthermore, he might insist upon the contract including provisions for severance pay or liquidated damages in the event the corporation breaches the contract, or provisions obligating the corporation to purchase his stock or give him a lifetime pension in the event it discharges him or fails to renew his contract.

Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter or bylaws a provision requiring unanimity or a high vote for shareholder and director action. Such a provision gives a minority shareholder a veto over corporate decisions. Obviously, if a favorable vote of holders of 85 percent of the outstanding shares is required for shareholder action, a person who holds 20 percent of the shares is in a position to prevent shareholder approval of any resolution he finds objectionable. The shareholders elect the directors, at least in the absence of a shareholders' agreement designating the directors and, under modern corporation statutes, shareholder approval is required for fundamental corporate acts such as charter amendment, sale of assets, merger, consolidation or dissolution. Thus, a high vote requirement for shareholder action gives a minority shareholder a veto over the personnel of the directorate and protects him against some of the squeeze-out techniques which involve fundamental corporate acts.

A high vote requirement for shareholder action alone, however, does not give a veto over many management or policy actions which might be
used in a squeeze play. To protect a minority shareholder against certain types of squeeze plays, he needs to be given a veto over action within the province of the board of directors, including the hiring and discharge of employees, changes in employees' compensation, execution of contracts, lending of money, and the issuance of additional corporate stock. To give a minority shareholder a veto over acts of this kind, it is necessary to set a high vote requirement for director action and to couple that high vote requirement with an arrangement which assures the minority shareholder representation on the board of directors.

A shareholder can be assured of representation on the board of directors in a number of ways. Not uncommonly, when a small corporation is organized, each shareholder is given membership on the initial board. If a shareholder is on the first board of directors and unanimity is required for shareholder action, he can prevent the election of a new board. In most states, in the absence of a contrary charter or bylaw provision, the old board carries over until a new board is elected and qualifies. Another way of giving a minority shareholder representation on the board is by a unanimous shareholders' agreement which designates him or his nominee as a director. A third way is to classify the shares, giving the minority shareholder all the shares of one class and providing that each class of shares will elect a designated number of directors. It is quite common now in small corporations for stock to be classified into Class A, Class B and Class C stock, with the only difference in shares of the various classes being that each class votes for a different director or group of directors.