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Arrangements Which Protect Minority Shareholders Against "Squeeze-Outs"

In this Article, Professor O'Neal suggests the preventive means that may be taken to protect the minority shareholders of a corporation from oppression or elimination by other owners of the enterprise. After discussing many of the techniques which are used to "squeeze out" minority shareholders, the author studies the most frequent causes of "squeeze-outs" and suggests preventive devices which may be used either to eliminate many of those causes or to settle disputes that may arise.

F. Hodge O'Neal *

INTRODUCTION

"Squeeze-out" means the use of strategic position, management powers, or legal device by some owners in a business enterprise to eliminate other owners. The term is used here also to cover oppressive action to reduce the participation of some owners or to deprive them unfairly of income or advantages.

Each year squeeze-outs and attempted squeeze-outs bring friction, impaired efficiency of key personnel, and expensive litigation to hundreds, perhaps thousands, of businesses. Sometimes the strife, litigation, and unfavorable publicity completely destroy a business.

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This Article is based in large part on a chapter in a study by the present author and Jordan Derwin, of the New York Bar, entitled Expulsion or Oppression of Business Associates: "Squeeze-Outs" in Small Enterprises. The study, financed by a grant from the Small Business Administration, is one of a number of research projects being conducted at Duke University School of Law on the legal aspects of planning for small businesses. The complete report of the study, several hundred pages long and rather heavily documented, is being published by Duke University Press.
Damage to a minority owner caught in a squeeze-play may be catastrophic. He may lose any effective voice in making business decisions. He may be denied access to information on business affairs and decisions. If he has put practically everything he owns into the enterprise and expects to support himself from the salary he receives from the company—as is frequently the case—he may find that he has been deprived of his principal means of livelihood by discharge from company employment. Finally, the squeezed minority owner may find that his investment in the enterprise is practically worthless because: (1) he receives no income from it; (2) he cannot use his interest as security for borrowing; and (3) he cannot regain the funds he has in the business because a purchaser for his interest cannot be found.

The lawyer of persons acquiring minority interests in a business enterprise does not properly serve his clients unless he advises them of the risks involved and takes affirmative steps to protect them at the time the enterprise is organized or they acquire shares in it. The atmosphere of optimism and good will that prevails during the initial stages of a business undertaking should not be allowed to obscure the possibility of future disagreements and conflicts. Furthermore, even though the business participants are close friends or members of a single family, that fact does little, if anything, to diminish the likelihood that disputes will ultimately occur.

This Article first sets forth in brief fashion the techniques which are used to squeeze out minority shareholders. It then discusses the measures which can be taken to avoid squeeze-plays and oppression of minority shareholders.

I. SQUEEZE-OUT TECHNIQUES

The circumstances which set the stage for coercion of business associates and the methods of applying pressure are so infinitely various that it is impossible to prepare a complete list of squeeze-out techniques. Thus, the techniques mentioned here are illustrative only; other squeeze-out methods undoubtedly will occur to imaginative businessmen and lawyers.

A. WITHHOLDING DIVIDENDS

By far the most frequently used squeeze-out technique is the withholding of dividends. By suppressing dividends, majority shareholders may be able to force a minority shareholder to sell his interest to them at a price considerably below its actual value. Sometimes the minority shareholder is bluntly told that he might as well sell out because dividends will not be paid as long as he
holds the stock. On other occasions, reasons why dividends cannot be paid are carefully fabricated and then courteously explained to the minority shareholder. For example, in a recent federal court case arising out of Louisiana, the squeezers informed the minority shareholders that they (the squeezers, who were president and vice-president of the corporation, a lumber company) were young men, with children of their own and with long futures ahead in the business; that they wanted to avoid double taxation by paying themselves higher salaries and bonuses rather than dividends; that they intended to engage in an intensive reforestation program, together with capital improvements to the lumber mills, during which there would be little or nothing in the way of dividends paid to the shareholders; and that these goals could best be accomplished with the stock in the hands of only a few persons.

B. ELIMINATING MINORITY HOLDERS FROM COMPANY EMPLOYMENT

A dividend squeeze is largely ineffective, of course, if the squeezee is drawing a substantial salary from the company. Therefore, whenever a prospective squeezee is an employee of the company, the dividend squeeze is invariably accompanied by elimination of the squeezee from the directorate and summary termination of his employment.

C. SIPHONING OFF EARNINGS BY HIGH COMPENSATION TO MAJORITY SHAREHOLDERS

Majority shareholders escape the hardships of dividend suppression by occupying corporate offices and compensating themselves handsomely as employees of the corporation. As one court put it:

[When] dissension and disagreement arise, the majority attempts to oust the minority, not only of control, but of a fair return upon the investment. Instead of treating all the stock alike, and distributing the profits fairly and proportionately by way of dividends, the majority first elect themselves directors, then as directors elect themselves officers, and then distribute among themselves a substantial part of the profits in the way of excessive salaries, additional compensation, and other devices.\(^2\)

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D. Changing the Corporate Structure

State statutes generally give to holders of a specified percentage of the shares of a corporation the power to make fundamental corporate changes such as charter amendments, merger, consolidation, dissolution, and sale of substantially all corporate assets. Under these statutes, there is considerable leeway for majority shareholders to take unfair advantage of a minority. As Dean Elvin R. Latty has said:

With the virtual disappearance of "vested rights" and the almost limitless present-day scope of charter amendment, a shareholder holds that bundle of rights that we call his shares virtually at sufferance; votes of others may transform that bundle into one utterly, perhaps shockingly, different.3

A case in the state of Washington4 illustrates the devastating way in which the majority's power to effect a fundamental change in the structure of a corporation (in this case, a merger) can be used to oust a minority shareholder or to deprive him of his role in management. Plaintiff, a minority shareholder of Ziebarth Corporation, blocked a proposed sale of all of its outstanding stock by refusing to consent to the transaction. The majority shareholders then organized a dummy corporation, taking all of its outstanding common stock, and made themselves its directors. Shortly thereafter, by a two-thirds vote, the shareholders of the original corporation approved a merger with the dummy corporation under the terms of which each share of common stock in the original corporation was to be exchanged for one share of redeemable preferred stock of the dummy corporation, the apparent intention being to redeem the stock of the dissenter. The court sustained the merger against allegations of fraud and unfairness. Among other things, the court commented that the dissenting shareholder was not actually injured by the merger, as a statute in the state gave him a right to have his shares appraised and purchased by the corporation.

E. Issuing Additional Stock

Majority shareholders can often diminish the minority's proportionate voting rights and proportionate claim on earnings and assets by causing additional stock to be issued to themselves at

3. Latty, Some Miscellaneous Novelties in the New Corporation Statutes, 23 LAW & CONTEMP. PROB. 363, 387 (1958). In some states the corporation statute gives some protection to minority shareholders by providing that a charter amendment which affects the rights or preferences of a class of stock is subject to the right of the class affected to vote thereon as a class. See, e.g., N.C. GEN. STAT. § 55-101 (1955).
less than its value. A minority shareholder's pre-emptive right (his right to subscribe to his proportionate part of new issues of shares) is not an effective bar to such a scheme. Majority shareholders, for instance, may deliberately cause the new shares to be issued at a time when a minority shareholder is in financial straits and cannot raise funds to buy his part. Furthermore, the doctrine of pre-emptive rights is subject to exceptions which open up ways for a disproportionate amount of new shares to be issued to majority shareholders. The doctrine is usually held not to apply to stock issued in exchange for property needed by the corporation, and, according to some authorities it does not apply to stock issued in satisfaction of a pre-existing debt. Therefore, sophisticated squeezers can circumvent a minority shareholder's pre-emptive right by causing the corporation to issue the new stock to them, or to their relatives or friends, in return for property; or they can make a loan to the corporation and, after the lapse of a "decent" interval, cause the corporation to satisfy the debt by issuing shares.

Even assuming that a minority shareholder has pre-emptive rights which cannot be circumvented and that he can raise funds to buy his proportionate part of a new issue of shares, it may still be unfair to force him to make further investments in the company in order to preserve his existing interest. If the company's earnings have been used to pay handsome salaries to majority shareholder-employees and if the minority shareholder has received little or nothing in the way of dividends, naturally he will be very reluctant to send "good money after bad" by investing additional capital in the business.

F. Siphoning Off Earnings by Contractual Arrangements

Corporate profits are often siphoned off by some type of contract between the majority shareholders and the corporation. For example, property owned by majority shareholders may be leased to the corporation at a high rental; or other corporations owned by the majority shareholders may be paid large fees by the company for rendering management, consulting, or other services to it.

G. Appropriating Corporate Opportunities; Splitting Off Part of the Business

Other fairly common practices are for some of the owners of the business to appropriate its opportunities for themselves or to cause part of its operations, usually the most profitable and promising part, to be split off and transferred to them.

In an interesting Delaware case, a family corporation was en-

gaged in quarrying and selling limestone and other building materials, and in conducting a highly profitable transit-mix concrete business. The company's stock was held by members of two branches of the family—the Doleses and the Schofields. Roger Dolese was president; his brother-in-law, William Schofield, was vice-president. All the shareholders had entered into an agreement not to sell their stock without first offering it to the other shareholders and to the company. After differences had arisen between Roger Dolese and William Schofield, and the Schofields had threatened legal action, Roger persuaded the Schofields to sell their shares at a specified price—a price which was alleged to be "substantially less than the real value of such stock ' . . . as Roger well knew.' "

Roger thereupon allegedly evolved a scheme for a sort of double squeeze-play, a plan which would not only eliminate the Schofields but also reduce substantially the participation of the other Doleses—Roger's mother, brother, and sisters. The story of shameful avarice and double-dealing set forth in a complaint by Roger's sisters and other relatives is in brief as follows.

Roger represented to the Doleses that it was necessary to the company's future success to eliminate the Schofields. Concealing the fact that the company had ample assets and credit to purchase the Schofield interest, he induced the Doleses to believe that the company was not in a condition to make the purchase. He organized a new company wholly owned by himself to purchase the Schofield stock. He then called a special meeting of the old company's directors, and he and a stooge (being the only directors present) passed a resolution waiving the company's right under a first-option agreement to purchase the Schofield stock. Thereafter, acting as president of the old company, as agent with power of attorney for most of his relatives, and as a trustee for one of his sisters, Roger waived both the company's rights and his relatives' rights to purchase the stock, thus opening the way for its acquisition by the new company. Subsequently, through complicated maneuvers which included partial liquidation of the old company and a "spin off" of part of its assets to the new company, Roger acquired (at a very low cost) 40 per cent of the assets of the old company and the most profitable and promising part of its business—the transit-mix concrete operations.

In effect, the payment to the Schofields for their stock was made with cash transferred by the old company to the new company, plus an amount borrowed from a bank on the security of Roger's stock and a chattel mortgage on assets transferred to the new

6. 154 A.2d at 236.
CORPORATE "SQUEEZE-OUTS"

Company. Roger attempted to explain away these transactions, claiming that they were—

designed to eliminate the threat to the business posed by the Schofields and further that The Dolese Company [the new corporation] had been organized for tax purposes in the course of consummating at great personal sacrifice a transaction which was essentially for the family's benefit.7

Setting forth this story in their complaint, two of Roger's sisters and other relatives brought a derivative suit to recover for the old company the assets and property which Roger had converted and the profits which he had gained from their use. Roger moved to dismiss the complaint, principally on the ground that the complaint showed plaintiffs had in one way or another ratified or approved the challenged transactions. The Vice Chancellor held, however, that the allegations of the complaint were sufficient to withstand a motion to dismiss, and that Roger had the burden of establishing that plaintiffs' approval had been given with knowledge of all material facts bearing on the fairness of the transaction.

The Vice Chancellor's decision was affirmed by the supreme court of Delaware, 8 which summed up the case in the following language:

If the allegations are true, Roger, as a result of the various steps taken, has appropriated for himself the most valuable part of the corporate business by using corporate funds for the purpose, and has secured the consent of the other stockholders thereto by false representations and concealment.9

The supreme court went on to say that the restrictive stock agreement—

gave the corporation some sort of expectancy in the purchase of the stock . . . . The exact scope of that expectancy is not important; it is enough to say that Roger recognized its existence and undertook (in effect) by unilateral action to waive the corporate rights for his own benefit.10

H. OTHER TECHNIQUES

Squeeze-outs have been achieved or attempted in a variety of ways other than those already discussed. A few additional examples follow:

(1) One shareholder-officer in a two-man company refuses to sign the salary checks of the other shareholder, who is devoting full time to managing the business.

7. Id. at 238.
8. 157 A.2d 784.
9. Id. at 787.
10. Ibid.
(2) Majority shareholders continue to operate one of the company's stores, even though it is losing money, in order to provide lucrative employment for themselves.

(3) Controlling shareholders of a retail store open up a competing establishment and steer particularly advantageous opportunities to the new store.

(4) Majority shareholders cause shares of a minority holder that have been pledged as collateral to be canceled on the books of the company (to destroy evidence of ownership).

(5) Majority shareholder-directors in low income-tax brackets tell a minority shareholder in a very high bracket that they will declare tremendous dividends unless he sells them his shares.

II. WAYS OF AVOIDING SQUEEZE PLAYS

Whenever a participant in a business enterprise is to occupy a minority position, his attorney should study the underlying causes of squeeze-outs, eliminate as many of those causes as possible, and insist that devices be set up (if that is practicable) to settle disputes expeditiously and to guard minority owners against squeeze-out or oppression. Most prominent among the devices which may be serviceable in protecting minority shareholders are shareholders' agreements, long-term employment contracts, and charter or by-law provisions requiring high votes for shareholder and director action.

A. Careful Study of Underlying Causes of Squeeze-Outs

Even the most experienced practitioner will do well to study the causes of squeeze-outs and the recurring problem-situations which give rise to squeeze-plays. Undoubtedly such a study will suggest to a perceptive lawyer measures which will help to protect his client.

Many squeeze-outs are, of course, attributable to the avarice of unscrupulous men who take advantage of trusting or less able associates. Nevertheless, squeeze-outs result less often from sheer grabs for power or profit than might be supposed. Most squeeze-out cases are characterized by basic conflicts of interest, by protracted policy disagreements or other dissension, or by demonstrated inability of those who are squeezed out to carry a fair share of the responsibility and effort involved in operating a business.

Trouble develops most often, perhaps, when one of the original participants in an enterprise becomes inactive or his interest is acquired by an inactive owner—for example, his widow. In such a
situation, differences are especially likely to develop over the respective amounts to be allocated to salaries and dividends. When all shareholders in a corporation devote full time to its affairs, they ordinarily take most of its earnings in salaries rather than in dividends, in order to minimize double taxation. If, however, there are shareholders who are not on the payroll, this practice will obviously not be satisfactory to them.

Other patterns that may lead to serious dissension include the following:

1. The aged founder of a business, who perhaps has always run it as a one-man show, becomes more and more tyrannical, ignoring the wishes of co-owners and insisting on outmoded business methods.

2. The more competent and energetic participants in an enterprise feel that the others are holding the enterprise back or are getting an unduly large portion of its earnings.

3. One of the owners of a business acquires an interest in a competing enterprise.

4. A business is organized to exploit a new invention or patent, the inventor receiving an interest in the new enterprise. No provision is made for the company to acquire rights to new competitive discoveries of the inventor or to compensate him for improvements in his original invention.

5. A considerable number of people, perhaps employees of the business, are each issued a small number of shares. The business prospers and grows. Eventually some of the small shareholders demand dividends on what they now consider valuable property, or try to stir up conflicts among the large shareholders.

The inability of holders of minority interests to dispose of their interests without serious financial loss undoubtedly prolongs dissension, which leads to squeeze-outs in many businesses. Moreover, the difficulty of determining the value of an interest in a small business is often a starting point of dissension from which the ugly drama of a squeeze-out gradually unfolds.

The failure of small businessmen to obtain legal advice at the time a business is being organized; the failure of lawyers to foresee problems which might arise out of transitions in ownership and control, and to take steps to meet those problems; the failure to put all aspects of the business agreement into writing—these failures must bear a large part of the blame for allowing situations to develop in which a squeeze-out seems the easiest, if not the only, solution.
B. Buy-Out Arrangements

As was pointed out in the section immediately preceding, trouble quite frequently develops in a small corporation when its shares pass into the hands of an inactive shareholder, especially to the widow of one of the key participants. An obvious answer to the inactive widow problem is a buy-out arrangement under which the shares of a holder who dies are purchased by the corporation or by the other shareholders. Stock purchase agreements (providing for purchase by the corporation) and buy-and-sell agreements (providing for purchase by the other shareholders) are now widely used. Similar agreements can provide for the purchase of the shares of the holder who reaches retirement age, who becomes disabled, or who for other reasons ceases to devote substantially full time to the operation of the business. Agreements of this kind should be made in advance while all the shareholders are still active in the business; after a shareholder dies or becomes inactive, negotiations for the purchase of his shares will often be unsuccessful.

C. Arrangements for Settling Disputes

Often a squeeze-play can be avoided by setting up in advance—by charter or by-law provision, or by shareholders' agreement—an arrangement to resolve whatever policy disagreements or other disputes may arise from time to time among participants in an enterprise. Three approaches seem promising. One is an arrangement by which impartial outsiders will be brought in to manage the business until tempers have cooled or the parties have resolved their differences. Another approach is to provide in advance for

11. In commenting upon Krall v. Krall, 141 Conn. 325, 106 A.2d 165 (1954), which involved a dispute between a widow and the surviving shareholder of a two-man company, a New England attorney of wide experience stated:

This fact situation I have seen repeated many times, usually precipitated by the death of one of the active parties and the intrusion of an inexperienced and quite often suspicious widow into the picture. Obviously, the insured buy-sell agreement is often a convenient device to forestall this type of problem.
Letter From Donald F. Keefe to F. Hodge O'Neal, Sept. 21, 1959.

12. Of the tremendous amount of literature on buy-and-sell agreements and other buy-out arrangements the following is perhaps a fair sample: Ackerman, Corporate and Partnership Buy and Sell Agreements, in Advising California Business Enterprises 909 (Stumpf ed. 1958); Mannheimer, Insurance to Fund Stock Retirement and Buy-and-Sell Agreements, 29 Taxes 393 (1951); Murphy, Survivor-Purchase Stock Agreements, 1 PRAC. LAW 44 (1955).

13. See Mannheimer and Friedman, Buy-Out Agreements, 91 TRUSTS & ESTATES 16 (1952).

the arbitration of whatever disputes arise. In jurisdictions in which agreements to arbitrate future disputes (including disputes on management and policy questions) will be enforced, arbitration has great potential for settling quickly and satisfactorily many of the disputes which occur in small businesses and thus avoiding the long, drawn-out dissension which leads to so many squeeze-plays.10

The third approach is to set up an arrangement under which one faction of shareholders will buy out the interest of the other in the event a dispute persists for a specified period of time. A provision, for example, might require the majority shareholder in a two-man company to buy out the minority shareholder at a specified price, if for a period of two years the two failed to agree on successors for members of the board of directors. An arrangement which is becoming rather popular provides that any shareholder shall have the right to dissolve the corporation at any time but that, before exercising the right to dissolve, a shareholder must first offer his shares to the other shareholders at a specified price or at a price to be determined by formula.

In a two-man company where the shares are evenly divided, the two shareholders sometimes enter into an agreement which provides that either shareholder may at any time set a price which he is willing to take for his interest in the business or to give for the other's interest, and that the other will then have a specified period of time to decide whether he will buy or sell at that price. No instance has been found where an arrangement of this kind has been used in a company in which one shareholder owned more than half the stock; nevertheless, no reason is apparent why the shareholders in such a company could not use this type of buyout. The price, instead of being stated in terms of a half-interest in the business, would have to be set at so-much-per-share. A possible objection is that the price a majority shareholder would receive for his majority interest, if he were to become the seller, would not reflect an added element of value for power to control the corporation. Actually, however, in a buy-out arrangement among the shareholders of a small business corporation—where the participants usually consider themselves “partners” and conduct the internal affairs of the business very much as though they were part-

15. For a decision holding that only controversies “which may be the subject of an action” may be contracted to be decided by arbitration, see Application of Burkin, 1 N.Y.2d 570, 136 N.E.2d 862 (1956). The Burkin decision has been reversed in New York by statute. See N.Y. Civ. Prac. Act § 1448.
16. For a discussion of the potentialities of arbitration for settling disputes in close corporations and of the planning and drafting precautions that make arbitration provisions more effective and less vulnerable to attack, see O'Neal, Close Corporations: Law and Practice §§ 9.08–9.25 (1958).
ners—there is very little reason to provide for payment of a higher price per share to the majority shareholder than to the minority shareholder. In the business bargain which persons organizing a corporation reach before bringing the corporation into existence, they usually agree (if not expressly, then by the way shares are to be allotted) on how each of them is to participate in dividends and in assets on dissolution; if participation in assets on dissolution is to be in proportion to shareholdings, the price received by a shareholder when he sells his interest might well depend simply on the number of shares he holds, without regard to whether his holdings are sufficiently large to give control of the corporation. Of course, a shareholder with a small interest might find it difficult to raise sufficient funds to buy out the larger interest of his associate, but provision could be made for the person who buys the other's interest to have the privilege of making a relatively small down payment and of paying the balance in specified installments and at designated interest rates.

D. Shareholders' Agreements

Undoubtedly the most frequently used device for giving protection to minority shareholders against squeeze-outs is a contract among the shareholders. Perhaps one reason for the frequency with which shareholders' agreements are used is the relative ease of preparing such agreements.

Among provisions which might be included in a shareholders' agreement to help forestall squeeze-outs 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) no shareholder is to acquire an interest in a competing business; (5) each shareholder or each of specified shareholders is to have the power to veto some or all corporate decisions; (6) whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to the shareholders; (7) a shareholder will not transfer his shares until he has first offered them to the corporation and to the other shareholders; and (8) 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.17

A lawyer preparing a shareholders’ agreement should study the applicable state law with great care to determine whether the provisions he wants to use are legal, and he should use caution in drafting the provisions. Shareholders’ agreements are challenged in court much more often than the average lawyer realizes. Nevertheless, provisions of the type listed in the preceding paragraph, to the extent that they will be given effect by the courts, set up a bulwark against some of the most common squeeze-out techniques. For example, a shareholders’ agreement which assures a particular shareholder that he will be employed by the corporation at a specified salary, and that if salaries are raised his will be increased in proportion to those of other participants, of course protects him against the other shareholders’ “ganging up” on him and excluding him from company employment while they siphon off corporate earnings by giving excessive compensation to themselves. Similarly, a provision requiring payment of dividends assures a shareholder that he will get some return on his investment if the business is profitable and if other participants can be prevented from draining off corporate earnings.

A study of the cases reveals that many variations are to be found in shareholders’ agreements. For example, one agreement provided that the parties “entered into a contract for the purpose of permitting equality of control, for the sharing of the corporate offices and for the payment to them of stated salaries.” Another agreement provided that each of the two principal shareholders would vote for fixed salaries for the other, that the salaries would remain in the same proportion to each other for the duration of the agreement, and that the two would divide the corporation’s profits in the same proportion when the surplus reached $10,000. Still another agreement provided that ownership of

18. For a detailed discussion of considerations affecting the validity of shareholders’ agreements and of planning and drafting precautions which can be taken to strengthen such agreements, see O’NEAL, op. cit. supra note 16, ch. V.

19. A prominent Buffalo lawyer, in discussing his firm’s use of shareholders’ agreements which allocate control and fix salaries, comments as follows:

I think that for the most part the agreements have served as a deterrent in many cases where a majority stockholder would have taken some action inimical to the interest of the minority stockholder but for the fact that the agreement did exist.


20. Heller v. Clark Merchandisers, Inc., 9 Misc. 2d 106, 154 N.Y.S.2d 150, 152 (Sup. Ct. 1955) (proceeding in the nature of mandamus held not available for enforcement of this agreement because other remedies—suit for specific performance and damages for violations of contractual rights—were available).

150 shares of corporate stock would carry with it the right to hold a corporate office.22

These cases, however, are only illustrative of the kind of clauses that can be included in shareholders' agreements.23 The resourceful draftsman will think of other provisions which will be useful in the particular business situation with which he is dealing.

E. PROVISION REQUIRING THE DECLARATION OF DIVIDENDS

Perhaps special attention should be given to the possibility of protecting minority shareholders against the majority's withholding of dividends, by using a shareholders' agreement or a charter or by-law provision which requires that dividends be paid at intervals or in specified circumstances. The most frequently used squeeze-technique, it is to be recalled, is the withholding of dividends. Naturally, a prudent businessman who is acquiring a minority interest in an enterprise or the lawyer who is advising him is likely to think of the possibility of protection through an agreement among the participants or through a charter or by-law provision which makes the declaration of dividends mandatory in certain circumstances—perhaps whenever the corporation's surplus exceeds a specified figure.24

Courts have sustained shareholders' agreements (if all the shareholders are parties)25 and charter and by-law provisions which provide for mandatory dividends in the few cases which have been decided.26 Thus, in a leading Massachusetts decision the supreme judicial court upheld a by-law providing that the corporation's net surplus should not be accumulated to an amount exceeding $1,000,000 and that whenever the surplus exceeded that amount

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24. For an agreement among all the shareholders providing that one shareholder will be general manager and will receive a salary to be fixed by the board of directors, and requiring the corporation to distribute its net annual earnings to the other shareholders, see Thompson v. Thompson, 214 S.C. 61, 51 S.E.2d 169 (1948).
25. In giving effect to a shareholders' agreement to divide corporate profits, the court in Merlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 111, 202 P.2d 748, 751 (1949), commented: "There can be no question but that an agreement between stockholders who own substantially all of the stock of a corporation is enforceable against the contracting parties and the corporation."
26. E.g., Arizona Western Ins. Co. v. L. L. Constantin & Co., 247 F.2d 388 (3d Cir. 1957) (charter provision); Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939) (by-law); Morrison v. St. Anthony Hotel, 295 S.W.2d 246 (Tex. Civ. App. 1956) (shareholders' agreement, the terms of which were incorporated into the charter and were also stated on share certificates).
dividends should be declared and paid at the rate of $3,000 per share per annum. 27

Thought must be given, however, to the fact that an agreement or charter or by-law provision which deprives the directors of their customary discretion to decide whether to declare dividends (and, if so, the size of the dividends to be declared), might drain off the corporation's working capital or deprive it of power to accumulate earnings to meet needed expansions or anticipated contingencies. Perhaps this objection can be met by giving the directors power to withhold reasonable amounts for working capital and contingencies. A more serious objection to a provision for mandatory dividends is that it might be extremely costly tax-wise: the directors might be required to declare and pay dividends at a most inappropriate and disadvantageous time from the tax viewpoint.

F. Long-Term Employment Contracts Between Shareholder and Corporation

Not uncommonly, persons organizing a small business corporation invest practically all of their money and assets in the enterprise. They may expect to devote their full time to the business and to earn their livelihood largely by working for it. Therefore, minority shareholders need assurance that they will be retained in the company's employ.

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 long-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.

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 the minority shareholder's compensation, he 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 including in the contract provisions for severance pay or liquidated damages in the event the corporation breaches the contract, or provisions obligating the corporation to

27. Lydia E. Pinkham Medicine Co. v. Gove, supra note 26. This case and other disputes and attempted squeeze-outs which occurred among the owners of the company manufacturing the Lydia Pinkham medicine are discussed in a lively book by Jean Burton. See Burton, Lydia Pinkham is Her Name (1949).
purchase his stock or give him a lifetime pension in the event it discharges him or fails to renew his contract.

The protection afforded a minority shareholder by a long-term employment contract, however, is tenuous and incomplete. In the first place, the validity of long-term employment contracts is still somewhat uncertain in some jurisdictions. Furthermore, the courts generally will not specifically enforce an employment contract; and of course damages usually will not be an adequate remedy to a minority shareholder who has invested everything he has in the company and is depending on employment by it for his livelihood. Finally, those in control of a company can make a shareholder-employee's life miserable by refusing to co-operate with him and by taking various steps to make his work unpleasant or unrewarding, such as effecting changes in his duties and in the locale to which he is assigned.

G. CHARTER OR BY-LAW PROVISION REQUIRING HIGH VOTE FOR SHAREHOLDER AND DIRECTOR ACTION

Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter or by-laws 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 per cent of the shares outstanding is required for shareholder action, a person who holds 20 per cent 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 all 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 squeeze-out techniques which involve fundamental corporate acts.

I have also used an employment contract coupled with a formula for the corporation's repurchase of the minority shares upon termination of this contract as a device for protecting an active minority shareholder.

Letter From Donald F. Keefe to F. Hodge O'Neal, Sept. 21, 1959.


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, issuance of additional corporate stock, and decisions to purchase or not to purchase shares of the company's stock under first option arrangements. To give a minority shareholder a veto over acts of this kind, it is necessary to set up 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 in the initial board. If a shareholder is on the first board of directors and a high vote is required for shareholder action, he can prevent the election of a new board; in most states 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 between the classes being that each class votes for a different director or group of directors.

In many states high vote requirements can be provided for either in the charter, in the by-laws, or in a shareholders' agreement. Usually inclusion in the charter is the safest and most effective course to follow, but careful attention must be given to local state laws in deciding whether to use high vote requirements, how to phrase them, and what instruments to use in setting them up.31

H. CAUTIONS IN USING HIGH VOTE REQUIREMENTS

Even though high vote requirements are perhaps the most effective safeguards against squeeze-outs, the protection they give minority shareholders must be weighed against risks and disadvantages they bring for the company and majority shareholders.

31. See O'NEAL, op. cit. supra note 16, ch. IV.
Here are some points to keep in mind. First, a shareholder with a veto may use his veto power to extort unfair concessions from his associates as a condition to giving his approval to desired corporate action. Second, veto arrangements deprive a corporation of flexibility which it may need to adjust to new situations. Third, high vote requirements greatly increase the chance of deadlock and corporate paralysis and raise the difficult question of what arrangements can be set up to break deadlocks when they develop.

To minimize the disadvantages in the use of veto arrangements, the scope of the veto can be limited to areas in which it is felt protection is most needed by the minority shareholders—perhaps to fundamental corporate action and to decisions on the employment and discharge of key employees and the fixing of their compensation. The risk of deadlock of course grows as the number of shareholders increases. If a corporation is to have more than four or five shareholders, it may be unwise to give a single shareholder power to veto corporate action. In a corporation with seven shareholders and a seven-man board, for instance, it might be preferable to set the vote for shareholder and director action in a way which requires concurrence of two shareholders or directors to effect a veto.

I. Providing a Veto by Tailoring the Corporation's Share Structure

In a two-man company or one with two factions of shareholders, the share structure can be tailored to provide a veto to each shareholder even though high vote requirements are not used. If a company has only one class of shares and the shares are held by the two shareholders on a fifty-fifty basis, a new board of directors obviously cannot be elected nor other shareholder action taken unless both shareholders concur.

32. That a shareholder's attitude toward high vote requirements is likely to depend on the percentage of the shares he holds is illustrated by the following extract from a letter from a California lawyer who has had a great deal of experience with such requirements:

"With respect to the usage of charter and bylaw provisions requiring high votes for shareholders' and directors' actions, I have been involved in the drafting thereof in all three situations, that is, where one of our companies holds a minority interest and individuals hold the majority, where we are a 50-50 'partner' with another individual or company, and where we hold a majority and one or more individuals hold the balance of the stock. Pragmatically, I have drafted upon the basis that we should have a veto when we are the minority, as much leverage as possible when the deal is 50-50, and as much latitude as possible when we are the majority stockholder."

Letter to F. Hodge O'Neal, Sept. 28, 1959 (name of writer withheld to preserve anonymity).

33. For a discussion of arrangements for resolving deadlocks in close corporations, see O'NEAL, op. cit. supra note 16, ch. IX (1958).
Where contributions to the corporation are unequal or for other reasons one shareholder is to have a greater proprietary interest (i.e., a greater interest in dividends and in assets on dissolution) than the other, two classes of shares—one with voting power and one nonvoting—can be used, with the voting stock divided equally between the two participants and the nonvoting stock distributed in a way to achieve the desired division of proprietary rights.

Another approach is to classify both the shares and the directorate; two classes of stock could be used, with the classes having identical rights except that Class A stock would elect the two Class A directors of the four-man board and the Class B stock would elect the two Class B directors. The two classes of stock need not have the same number of shares.

J. Providing a Veto over Officer Action

As the principal corporate offices will usually be held by majority shareholders or by persons responsive to their wishes, a minority shareholder will want to be in a position to prevent any action by those officers which would be prejudicial to his interests. To decrease the chance of unfavorable officer action, the by-laws might define the duties and powers of the officers in narrow terms and prohibit the delegation of any important work of the board of directors to officers or committees.

Another approach that can be taken is to require the concurrence of two or more officers for certain important action. It is fairly common, for instance, to require the signature of two officers (e.g., the president and treasurer) on corporate checks and other negotiable paper. Under such an arrangement, if the minority shareholder holds the office of treasurer he is of course in a position, by withholding his signature, to prevent the borrowing of money or the expenditure of corporate funds.\footnote{See Berdane Furs, Inc. v. First Pennsylvania Banking & Trust Co., 190 Pa. Super. 639, 155 A.2d 465 (1959), where the corporation opened a commercial checking account and filed with the bank a certified copy of a resolution of its board which provided—
that until otherwise ordered, said Bank be and hereby is authorized to make payments from said account upon and according to the check, draft, note or order of this . . . Corporation . . . when signed by President and Treasurer . . . without inquiry as to the circumstances of their issue or the disposition of their proceeds . . . .
\textit{Id.} at 640, 155 A.2d at 466. The court in the \textit{Berdane Furs} case, however, held that the corporation by a course of dealing (repeatedly issuing negotiable paper over the signature of just one of the authorized officers) had estopped itself from setting up against the bank noncompliance with the resolution.}
K. Special Charter and By-Law Provisions

Special charter or by-law provisions (other than high vote requirements for shareholder and director action) can often be used to diminish the risk of squeeze-outs. For instance, a clause can be inserted in the charter to broaden and strengthen shareholders' pre-emptive rights. A provision of that kind provides some protection to minority shareholders against dilution of their voting power or their proportionate interest in the corporation by the issuance of additional shares to majority shareholders. To give a minority shareholder any real protection, pre-emptive rights must be made applicable to stock issued for property, to stock issued in payment of a debt, and to the reissuance of stock purchased by the corporation and held as treasury shares.

The hand of a minority shareholder who is fighting against a squeeze-play is considerably strengthened by a charter or by-law provision which gives a shareholder an unqualified right to examine personally or by representative all corporate books, contracts, accounts, correspondence, memoranda and other records, and to copy those documents and records. A provision of this kind avoids whatever questions and delays might otherwise arise out of uncertainty as to the scope of a shareholder's common-law or statutory inspection rights. However, if an inspecting shareholder behaves unreasonably or if he seeks information for improper purposes, such a provision can be a real thorn in the side of even the most honest and conscientious management. Consideration might also be given to a clause which would require the president or some specified corporate officer to report periodically to the shareholders on company affairs or to render (on request) full information on any designated corporate matter to a shareholder, to the legal representative of a deceased shareholder, or to the representative of a shareholder under legal disability. 5

To guard against the siphoning off of corporate profits, in the form of exorbitant compensation to majority shareholder-employees, a person entering a small business as a minority shareholder might well insist on a charter or by-law provision which fixes a maximum limit on compensation of corporate officers. The vague equitable limitations on the compensation of corporate officers do not furnish an effective safeguard against excessive executive compensation. A fixed limit on compensation might avoid expensive and risky litigation.

Another provision which might be considered is one which would require an outside firm to examine the company's assets

and business periodically and place a value on its shares.\textsuperscript{36} If this were done, an objective evaluation of the company's shares would be available on which to base negotiations for a buy-out, whenever a dispute developed or a participant decided to leave the business. Consequently, long, drawn-out negotiations in which each party comes to believe that the other is behaving arbitrarily and unreasonably—the type of frustrating situation that breeds attempts at squeeze-out—can be avoided. A disadvantage of this kind of provision is, of course, the cost of the periodic appraisals.

Whenever provisions are inserted in the charter or by-laws with a view to protecting minority shareholders (including high vote requirements for shareholder and director action), precautions must be taken to prevent an amendment of the charter or by-laws to eliminate the protective clauses. In other words, clauses designed to safeguard the rights of minority shareholders must be "backstopped" by high vote requirements for charter and by-law amendment, or by some other device to prevent majority shareholders from first removing the protective clauses from the charter or by-laws and then effectuating the squeeze-out.

\textsuperscript{36} In Standard Int'l Corp. v. McDonald Printing Co., 159 N.E.2d 822, 824 (Hamilton County, Ohio, Ct. C.P. 1959), one of the witnesses testified that when the question of valuation of the company's stock came up, in regard to valuation if one of the shareholders should die, it was decided to have Moody's place a periodic valuation on the stock.