MINORITY SHAREHOLDERS AND OPPRESSION IN CLOSE CORPORATIONS:

CONTRACTING AS AN EFFECTIVE PROTECTION DEVICE

by

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(Under the direction of Prof. Charles O'Kelley)

ABSTRACT

Minority shareholders have been facing problems generated by oppressive behavior of majority shareholders since people started to incorporate. Due to unique characteristics of close corporations, those problems acquire a different dimension when this kind of enterprise is involved. The absence of market for its shares, the nature of the relationship among its partners, and the expectations of the participants on the business create an environment in which oppression develops extremely easily. Along with the help courts and legislators have been providing through increasingly flexible decisions and statutes, practice has shown that there is much to be done by the minority shareholders themselves. Indeed, by making use of proper contractual devices (what may be easily achieved with the help of impartial and diligent lawyers), shareholders can reach rather satisfactory levels of protection against oppression.

INDEX WORDS: Corporate law, Corporations, Close Corporations, Minority, Oppression, Protection, Shareholders, Shareholders' agreements

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DEDICATION

To Otavio,

dear husband and biggest friend,

whom I very much admire

and to whom I thank for all the support, incentive and love, which I shall never forget.

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CHAPTER 1

INTRODUCTION

The battle of minority shareholders of close corporations against oppression by majority shareholders is not recent. Indeed, problems arising from the discretion of the majority have existed since people started to incorporate under the corporate form.

This work will focus on arrangements which under existing laws can be set up in advance (when participants are entering an enterprise or before friction has developed) to avoid dissension and protect shareholders against squeeze-outs and other forms of oppression. However, before taking that path and in order to clarify the potential consequences of oppression in close corporations, two chapters will be spent in outlining the specific characteristics of such corporations and in defining and exemplifying oppression in its many ways.

Chapter Two will thus concentrate on the particularities of close corporations. As it will be shown, "closely held" corporations differ from "publicly held" ones in a few aspects, from which the most relevant is perhaps the lack of liquidity to its shares, which are not generally traded in the securities market.[1] Other important characteristics that will be pointed out further on are, for instance, the fact that shareholders of close corporations have greater expectations of participation in the venture than participants of publicly held

[1] As it will be demonstrated throughout this work, definitions of the term "close corporations" vary according to the aspects taken into consideration. As a consequence of the broadness of the concept, the majority of incorporated enterprises in the United States today can be considered close corporations.

corporations, and also that the relationship among those shareholders is usually very close, if not intimate.

Other point to be discussed is the legislative recognition of the peculiarities mentioned above. Actually, none of the legislation applicable to close corporations is self-contained or exclusive. The general corporations law remains applicable and is only supplemented by close corporations legislation.

Finally, the development of judicial attitude on the matter will be briefly analyzed. Courts – just as the legislators – are increasingly willing to recognize the specific needs of close corporations, and as a result of this behavior shareholders' agreements modifying traditional corporate norms have been also increasingly accepted.

Chapter Three will focus on the analysis of oppression. It will start by characterizing the typical "oppression scenario", which is basically the one where a participant to a close corporation decides to eliminate or reduce the influence of one or more partners, and then causes of oppression will be pointed out. Reasons for oppressive behavior by majority shareholders may be various, going from greediness to perfectly rational business decisions based on the performance and conduct of the co-participant. Along with the basic concept of oppression, a look will be taken on the steps that led to its modern judicial definition, according to which oppression would be dependent on the specific factual setting of the case. Efforts have been made, however, in the direction that a "standard" of oppression is reached.

The very modern oppression concept is thus based on a "reasonable expectations" standard, which departs from the bargain struck by the parties without requiring any fault to have happened. According to this concept, oppression would take place whenever reasonable expectations were frustrated. In the last part of the Chapter there will be a brief description of the most common oppression techniques, which can be basically categorized in two groups: the ones that lead to a cash-out of the unwanted shareholders (usually related to mergers or share exchanges), and those where while the shareholders lose every influence and return on investments, they are not bought out (they stay "locked in"). This last category involves a situation which is very common to close corporations.

Chapter Four will then concentrate on the use of contractual devices for the protection of minority shareholders' rights. It will initiate, however, by also mentioning the other two available sources of protection against oppression, which are, besides the contractual one, the legal and the judicial sources.

While legislative protection, by its own nature, requires the shareholders of close corporations to "shape" their needs to pre-existing legal rules (which sometimes do not fit their specific needs), judicial protection provides those shareholders with a certain expectation that fairness will be applied (although there is no actual guarantee that courts will decide in a specific way).

After a brief description of these two sources, a deeper analysis of the contractual source of protection will be made. The use, by shareholders, of private agreements for trying to establish a desired level of protection has proven to be an increasingly effective (although still rare) way of avoiding oppression.

These private agreements are of various kinds and may have two distinct functions: they may work in the sense of preventing or in the sense of remedying oppression, depending on the time those measures are actually taken. It will be shown that shareholders usually miss the opportunity of contractually preventing oppression. In fact, as the expectations of the partners of the future corporation are based on trust and confidence, their ability to contract is already restricted by the time of incorporation. Leaving the use of the power to contract for a second moment – when only remedying is possible – may make the use of protective clauses not totally effective.

A view will then be taken on the many kinds of agreements and provisions which might be used to reach different levels of protection in different scenarios, such as charter and bylaws provisions, shareholders' agreements, buy out agreements, compulsory dividends agreements, employment contracts, arbitration agreements etc.

The chapter will close with a few considerations on the achievement of effectiveness when contracting with the purpose of protection. These considerations concern basically the importance of each participant having an independent attorney (a simple fact that may seem unnecessary and expensive but which may produce significant results in a friction scenario) and the need of making full use of the shareholder's right to inspect corporate books and records (as a way to check the corporation's actual conditions and find out other important information).

Finally, recommendations will be made in the Conclusion Chapter that could be put into practice by shareholders to enhance the level of protection they can have in a close corporation. The goal of this work is to demonstrate that it depends heavily on the shareholders themselves to have a higher or a lower level of protection in their enterprise. In a country like the United States, where besides the law people can count on the Courts' judgment of fairness to protect their interests, contracting may be used as a rather simple way of tailoring protective devices to each specific case. When used carefully – that means, with the help of an impartial attorney and when shareholders act reasonably instead of emotionally – this device may be indeed very effective and may provide minority shareholders with highly satisfactory levels of protection.

CHAPTER 2

CLOSE CORPORATIONS

Although it has been defined in various ways, the term “dose corporation” has usually been adopted to distinguish and set apart the corporation with only a few shareholders from the “public-issue” or “publicly held” corporation.

A more popular definition states that a close corporation is a corporation “whose shares are not generally traded in the securities market”[2], what means that its stock is neither listed on any stock exchange nor traded on an over-the-counter market[3]. In other words, the close corporation has no market for its shares.

According to one of the few judicial definitions, it would be a “corporation in which the stock is held in few hands, or in few families, and wherein it is not at all, or only rarely, dealt in by buying or selling”.[4] The two aspects involved in this judicial definition – the small number of shareholders and the lack of a “buy and sell” activity for its shares - are perhaps the more relevant ones.

Indeed, close corporations were also defined as “a corporation whose shares, or at least voting shares, are held by a single shareholder or by a closely-knit group of

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[2] F. HODGE O’NEAL, “SQUEEZE-OUTS” OF MINORITY SHAREHOLDERS – EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1975) [hereinafter O’NEAL, OPPRESSION] (Prof. O’Neal is the leading authority in close corporations and his work on this subject will often be the base of this thesis, as it is of basically every article concerning close corporations or shareholder oppression).

[3] Forinash v. Daugherty, 697 S.W.2d 294, 303 (Mo. Ct. App. 1985)(quoting Phelps v. Watson-Stillman Co., 365 Mo. 1124, 1127, 293 S.W.2d 429, 431 (1956))

[4] Brooks v. Willcuts, 78 F2d 270, 273 (CA 8th, 1935); Galler v. Galler, 32 Ill2d 16, 27, 203 NE2d 577, 583 (1965)

shareholders. Generally, there are no public investors and its shareholders are active in the conduct of the business…”.[5]

As seen, the width and consequent vagueness of the concept do not allow us to determine a fixed definition to the term “dose corporation”. In fact, to narrow down its definition based only on the lack of market aspect would mean to ignore some important characteristics inherent to close corporations.

Following the decision in one of the first cases where the rights of minority shareholders in close corporations were recognized, by which the Supreme Court of Massachusetts “deemed a close corporation to be typified by (1) a small number of stockholders; (2) no ready market for the corporate stock; and (3) substantial majority participation in the management, direction and operations of the corporation”[6], commentators started to expand its concept in order to insert aspects not considered up to that time.

The following wave of definitions included, thus, characteristics such as (1) the shareholders are few; (2) they usually live in the same geographical area and know each other well; (3) management and ownership are substantially identical (most shareholders participate actively in the business, usually serving as directors or officers or sometimes fulfilling other managerial functions; there is a small number of managers); (4) shareholders treat each other as partners; and (5) there is no market for the shares (little or no trading of shares at all takes place).[7]

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[5] BLACK'S LAW DICTIONARY (6th ed. 1990)

[6] Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505 (1975)

[7] F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3rd ed. 1988) [hereinafter O'NEAL, CLOSE CORPORATIONS], at §1.02, 1.08.

After a long time without any legal definition, and having its concept based merely on courts and scholars thoughts, the term “dose corporation” was finally object of legislative analysis, that led to the adoption of close corporations statutes. One of the first rules on this matter was the “model statutory close corporation supplement of 1982”, which provides that “corporations having fifty or fewer shareholders may become statutory close corporations”[8]. Numerical restrictions are present in some state statutes as well, as in Delaware, where the limit for a corporation to be legally considered a “dose corporation” is thirty shareholders. In California, for instance, the limit is thirty five shareholders at any moment in time, while in Arizona this number goes down to ten shareholders at the moment of incorporation.

Uniformity is not present either when it regards the way those corporations are known and called. There are in fact different terms which have been generally used, each of them with a particular meaning depending on its focus. “Closed” and “dose”, for instance, emphasize the willingness to keep outsiders out of the corporation by not allowing them to become investors. “Closely held”, on its turn, focuses on the small number of shareholders and their special relationship.[9]

Once inside the universe of close corporations, two distinct types of companies will arise: the so called “archetypical” dose corporation (the small company where shareholders have familial or other personal relations) and the “non- archetypical” one.[10]

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[8] Model Stat. Close Corp. Supp. §3(b)
[9] O'NEAL, CLOSE CORPORATIONS, *supra* note 7 at § 1.04
[10] *See* Charles O'Kelley, Jr., Commentary, *Filling Gaps in the Close Corporations Contract: a Transaction Cost Analysis*, 87 Nw. U. L. Rev. 216, 238 (1992) (using the distinction between archetypical and non archetypical close corporations to analyze their needs in adaptability, opportunism and thus their needs for stability and limited liability or for the partnership law relationship) [hereinafter O'Kelley, Filling Gaps]

Despite not constituting a determinative factor, the size of those companies also vary enormously. In fact, while most of the close corporations in the United States are small enterprises, some of them are giants worth millions of dollars.[11]

As shown, the aspects which might be used to define a close corporation are various and differ in their focus. However, it is our opinion that one single aspect – the lack of market – strongly differentiates that kind of corporation from the publicly held ones, and thus this is the aspect that will be considered throughout this work (unless the context clearly indicates a different meaning).

A Relevant Particularities

Closely held corporations differ from publicly held ones in fundamental aspects, which are less legal but rather related to the business environment.[12]

In fact, when ownership and control are concerned, the traditional corporate norms that are applicable to publicly held corporations do not apply. Close corporations are more intimate enterprises, in which the separation of function that corporate form permits (with distinct roles for shareholders, officers and directors) usually lacks. In other words, there is usually only a small number of participants actively involved in the business, with no rigid division between those contributing money capital and those putting in human capital.

As a consequence of management and ownership not being usually split, there is virtually no agency cost problems. Nevertheless, another representation problem arises as

[11] O'NEAL, CLOSE CORPORATIONS, *supra* note 7 at §1.03

the majority does not have to take the minority's interest into account. Thus, despite the minimized agency cost risks, some scholars believe that minority shareholders in close corporations face unique risks of oppression. [13]

Regarding relationships and expectations, close corporations also have very particular characteristics. Business relations often overlap family or other close personal ties.[14] Indeed, these corporations are usually formed by friends or relatives.

The corporation thus arises in a context of close relationships, trust and optimism about the future. The partners rarely consult lawyers or bargain for protective mechanisms[15]. In fact, even when feeling that there is some risk involved, partners usually avoid to contract in a preventive way, as they fear that by acting like this they could be scaring other investors or somehow maculating the good relationships and common optimism that are present when business is starting.[16]

It is thus precisely in the context where agreements are most needed for protection that none is drawn.[17] From a contractual point of view, close corporation contracts will therefore be vague and full of gaps.[18]

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[12] CHARLES R. T. O'KELLEY & ROBERT B. THOMPSON, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS, (3rd ed. 1999) [hereinafter O'KELLEY, CORPORATIONS], p.453

[13] Fama & Jensen, *Separation of Ownership and Control*, 26 J. L. & Econ. 301 (1983); Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 Va. L. Rev. 1, 5-6 (1977) [hereinafter Hetherington, *Illiquidity*].

[14] O'KELLEY, CORPORATIONS, *supra* note 12 at 453

[15] *See also* Charles W. Murdock, *The Evolution of Effective Remedies for Minority Shareholders an Its Impact Upon Valuation of Minority Shares*, 65 Notre Dame L. Rev. 425, 426 (1990)

[16] Hetherington, *Needs of Close Corporations*, *supra* note 13 at 17-18

[17] *See* Terry O'Neill, *Self Interest and Concern in the Owner-Managed Firm: a Suggested Approach to Dissolution and Fiduciary Obligation in Close Corporations*, 22 Seton Hall L. Rev. 659 (1992); *See also* O'Kelley, *Filling Gaps, upra* note 10 at 247 (There are other reasons why parties to a close corporation do not contract, as (1) the cost of contracting might exceed the potential benefits; (2) investors do not act in a fully rational way; and (3) a rational investor might predict that courts will exercise their equitable gap-filling authority and provide optimal governance rules and structures).

[18] O'Kelley, *Filling Gaps, supra* note 10 at 216.

The "expectations" aspect is also very relevant to differ close corporations from the publicly held ones. Indeed, shareholders of close corporations have greater expectations than those of public companies, whose basic expectations are increasing share value and some dividends.[19]

As close corporation shareholders usually invest a substantial part of their assets, as well as their time and skills in the company, they expect to get in return employment, salary or a dividend as well as a key managerial position.[20]

Another relevant aspect relates to the fact that there is no liquidity to the shares of close corporations, as there is no market where shares can be negotiated. Thus, those in control are not subject to the "check" that markets sometimes provide when a larger corporation is involved[21].

The minority remains consequently in a "unique" position when facing majority oppression, because unlike shareholders in public corporations the minority in close corporations is not protected by the exit option offered by the securities market.[22] The lack of liquidity affects minority investors in many ways, one of the most relevant being the difficulty in valuing their shares caused by the absence of market (transfers, even when allowed, are not easily achieved).

Finally, it is necessary to include as a particularity inherent to close corporations its similarity to partnerships, that led to what is said to be a "partnership analogy". The idea of applying partnership rules to close corporations arose since most characteristics of both close corporations and partnerships are common. Similarities go from the close

[19] O'NEAL, CLOSE CORPORATIONS, *supra* note 7 at §1.08.
[20] Robert B. Thompson, *The Shareholder's Cause of Action for Oppression*, 48 Bus. Law. 702 (1993) [hereinafter Thompson, *Shareholder's Cause*]
[21] O'KELLEY, CORPORATIONS *supra* note 12, p. 453

relationship among the partners to the expectations that those partners have. This analogy is in fact a useful tool for analyzing close corporation problems.

B Legislative Recognition of Close Corporations Particularities

Unlike major corporations – who lobby to effect changes in corporate law, close corporations are not represented by any organization.[23] As a consequence, none of the legislation applicable to close corporations is self-contained or exclusive. In fact, general corporations law remains applicable and is only supplemented by close corporations legislation.[24] Some states, however, have statutes that are considered to be especially accommodating for close corporations; this is the case of California, Delaware, Florida, Maine, Maryland, New York and South Carolina.[25]

As to the legal definition of close corporations, most states have adopted the criteria of requiring, for eligibility, that a corporation have fewer than 50 shareholders at the time of incorporation[26] (what does not mean that if the number of shareholders later exceeds 50 the corporation will lose its statute).

Flexibility and absence of formalism characterize the new close corporations legislation [27]. An example of such flexibility is that according to many statutes the board of directors[28] or the annual shareholder meeting[29] can be eliminated.

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[22] Hetherington, *Needs of Close Corporations*, *supra* note 13 at 20.
[23] *Idem* at 1-4
[24] Forrest B. Weinberg, *The Close Corporation Under Ohio Law*, 35 Clev. St. L. Rev. 165, 172 (1986)
[25] HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS, 178 (3rd ed. 1983)
[26] Model Stat. Close Corp. Supp. § 3(b)
[27] FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 234 (1991) [hereinafter EASTERBROOK, CORPORATE LAW]
[28] E.g. Md. Code Ann., Corps. & Ass'ns § 4-302

Statutes as flexible as, for instance, the Revised Model Business Corporation Act (hereinafter RMBCA), allow the achievement or certain desired legal results by the use of sophisticated shareholders' agreements.

On the other hand, the "supplement", despite not changing in a significant way the results obtainable under the RMBCA, provides certainty and flexibility; it also lowers the transaction costs, since less drafting is required.[30]

C Last Developments in Judicial Attitude

Also the courts have learned to recognize the specific needs of close corporations. They are, indeed, increasingly willing to recognize shareholders' agreements modifying traditional corporate norms.

Nowadays, decisions involving such agreements are guided by cases such as *Clark v. Dodge*[31] and *Galler v. Galler*[32], that express a new approach by the courts if compared to the one of *McQuade v. Stoneham*.[33] Courts' attitude (in what it regards the freedom to contract) is supported by most of the new statutes.

The example that better illustrates the change in the general judicial attitude (perhaps for constituting the most impressive change over the last years) relates to the

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[29] E.g. Model Stat. Close Corp. Supp. §23(b), Del. Code Ann. tit. 8 §351 (all corporate powers can be given to shareholders)

[30] Model Stat. Close Corp. Supp. (introductory comment); Frank H. Easterbrook & Daniel r. Fischel, *Close Corporations and Agency Costs*, 38 Stan. L. Rev. 283 (1986) [hereinafter Easterbrook, *Agency Cost*].

[31] 269 N.Y. 410, 199 N.E. 641 (1936) (in which the court allowed a minority shareholder to enforce an agreement granting him the right to stay in office and receive one fourth of the net income as salary or dividend so long as he remained "faithful, efficient and competent").

[32] 32 Ill.2d 16, 203 N.E.2d 577 (1964) (validating all agreements in close corporations when absent prejudice to third parties and when not in direct contravention to a statute. An agreement providing for salary and dividend payment was upheld)

[33] 263 N.Y. 323, 189 N.E. 234 (1934) (invalidating an agreement among shareholders to use the best effort to vote for each other as directors and officers).

remedies issue. Indeed, while the courts originally viewed dissolution as a drastic remedy (granting it, as a consequence, very rarely), this remedy is being increasingly applied by courts[34], along with other equitable solutions which were developed over the years (such as orders to compel dividends, appointment of custodians or provisional directors, imposed buy outs etc.). The judiciary plays in fact an important role when it comes to remedies, as statutes provide courts with broad discretion in choosing the appropriate solution to be applied to each case.[35]

The balance of courts decisions is positive. Indeed, their flexibility in enforcing shareholders' agreements and their scrutiny in applying higher standards of fiduciary duty, among other factors, have created a healthier environment in which minority shareholders fear less to be deprived of any return on investment.

[34] Easterbrook, *Agency Cost*, *supra* note 30 at 286
[35] O'NEAL, CLOSE CORPORATIONS, *supra* note 7 at § 1.20

CHAPTER 3

OPPRESSION TO MINORITY SHAREHOLDERS

Under a simplified definition, an "oppression scenario" is usually the one where a participant to a close corporation decides to eliminate or reduce the influence of one or more partners.[36] This "elimination" or "influence reduction" may take place in different ways, depending on their purpose and on their actual ground (which might be a fair or an unfair one).

As pointed out in O'Neal's book on oppression, *"the losses which a minority shareholder suffers in a squeeze-out are sometimes catastrophic. He may be deprived of any effective voice in the making of business decisions. Not only that, he may be locked out of the company's premises"*,[37] among other restrictions.

A Causes of Oppression

The reasons for oppressive behavior by majority shareholders may be various, going from greediness to perfectly rational business decisions based on the performance and conduct of the co-venturer. Indeed, many are the business situations out of which squeeze plays typically arise.[38]

[36] O'NEAL, OPPRESSION, *supra* note 2 at § 2
[37] *Idem* at § 1.01

As described by O'Neal, some examples of grounds for oppression are, among many others, the greed and the desire for power, personality clashes, marital discord and family quarrels, conflicts of interest and disagreement over policies, inactivity of minority shareholder, death of founder or other key shareholder, aged founder who "hangs on" etc. [39]

Other scenario in which oppression is facilitated is the one generated by the failure of businessmen to obtain legal advice and the failure of lawyers, when consulted, to foresee squeeze-out[40] problems which might arise and to use in the solution of those problems timely and effective planning, drafting and other preventive law techniques.[41] Particular attention will be given to this aspect of oppression in Chapter Four, *infra*.

1 Principles of Corporate Law Affecting the Fight Against Oppression

Although close corporations have proven to be enterprises different from public companies, the general principles of corporate law ignore their peculiarities. Good examples of this "resistance" are the majority rule and the business judgment rule, under which the use of the wide range of oppression techniques are considered legal, and consequently difficult to be challenged.

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[38] *Idem* at § 2.01
[39] *Idem*
[40] According to O'Neal, the term "squeeze-out" means the use by some of the owners or participants in a business enterprise of strategic position, inside information, or powers of control, or the utilization of some legal device or technique, to eliminate from the enterprise one or more of its owners or participants. The term "freeze-out" is often used as a synonym for "squeeze-out". *See* O'NEAL, OPPRESSION *supra* note 2 at § 1.01.
[41] *Idem* at § 2.01

As to the majority rule, it is a basic corporate norm according to which those possessing the majority of the shares of a company elect its board of directors (wholly or at least partially, in the case of cumulative voting being determined in a contractual provision), which is invested with "all corporate powers". A majority vote is usually sufficient to have a decision taken by the board, and the scheme is clear: unless the minority has bargained for some protection and restrictions of the power of the majority, thy will not be heard.[42]

Under an impartial point of view, this rule can not be deemed unfair, since the majority not only invested more than others but also bear higher risks, and thus should be able to control these risks. The only concern is that when it regards to close corporations, there are no market forces present to supervise the centralized control.[43]

The business judgment rule, on its side, is an evidentiary presumption that directors act in accordance with their duty of care,[44] which is a process duty and not a qualitative one. In other words, if the board takes an informed decision, this decision will be protected. The judge-made rules regarding this matter assure non-interference by the courts on the issue and thus partially immunize management from liability.[45] The classic argument supporting the rule is that it is not the function of the judge to review business judgment, as he lacks business expertise.

[42] O'NEAL, OPPRESSION, *supra* note 2 § 1.03
[43] O'NEAL, CORPORATIONS, *supra* note 7 at §1.15
[44] Smith v. Van Gorkem, 488 A.2d 858, 872 (Del. 1985)
[45] Henn, *supra* note 25 at 661-663

The protection afforded by the business judgment rule is not, however, unlimited. It has been set out in cases like *Aronson v. Lewis*[46] that it should apply only to <u>disinterested</u> directors who make <u>informed</u> decisions. Indeed, fraud, lack of reasonable care and self dealing are not protected.[47]

Justification to the rule lies on the belief that it reassures capable managers (although this aspect is not so relevant in close corporations as it may be in public companies), encourages risk taking and deters risk of abuse of derivative litigation (this threat is also not so serious in close corporations, as shareholders are often managers as well).

As seen, the rule is not capable of covering the complex relationships that exist in close corporations.[48] The major problem involved is, in other words, that the rule is based on assumptions that are not present in close corporations.

For instance, external factors of control that regulate management conduct and abuse of the rule (like the securities market and the securities market regulations) do not play a role in close corporations.[49] The rule constitutes in fact a mechanism that enhances shareholder passivity, which is only useful in public companies (where the active role is confined to the managers).

The best solution to the business judgment rule dilemna is perhaps to narrow down the protection afforded by the rule in close corporations, causing it to remain useful in the many situations where business decisions do not in fact affect minority shareholders' expectations.

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[46] 473 A.2d 805, 812 (Del. 1984)
[47] J.C. Bruno, *"Reasonable Expectations": a Primer on an Oppressive Standard* (part 2 of 2), 71 Mich. B.J. 566, 570 (1992)

After all, protection of legitimate business judgment is essential for allowing a corporation to be managed efficiently and profitably, with risks being taken by the majority when necessary.[50] Flexibly interpreting the rule when close corporations are regarded assures protection for non-oppressive business decisions and at the same time permits courts intervention so as to protect minorities.

B Legal Definition of "Oppression"

"Oppression" is the generic term that encompasses all the "oppression techniques" to be discussed later on in this Chapter. The term may be said to be a recognition by the legislatures of the rights of the minority.[51] It is, however, useless to consider "oppression" isolated, as it is in fact intimately linked to the forms of relief it makes available.[52] Indeed, most statutes nowadays list "oppression" as a ground for dissolution.

The term (as a ground for relief) was first included in Illinois and Pennsylvania in 1933 and in the MBCA in 1946.[53] After that, thirty one states included oppression in their statutes and six have similar language.[54] Four states use the words "unfairly prejudicial" instead of "oppressive" [55] (both terms are considered to be closely related).

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[48] Ralph A. Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporations*, 60 Notre Dame L. Rev. 483-484 (1985)
[49] O'Neill, *supra* note 17 at 681; Peeples, *supra* at 485-486
[50] Murdock, *supra* note 15 at 429
[51] Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67:1 Minnesota L. Rev. 1, 39 (1982)
[52] Thompson, *Shareholder's Cause*, *supra* note 20 at 718
[53] *Id.* at 709
[54] *Id.* at 709 n. 70
[55] *Id.* (states as Alaska, California, Minnesota and North Dakota)

Although the "oppressive terminology" has been adopted by many statutes, most have declined to really define the term. The official comment to the "supplement" expressly indicates that no attempt is made to statutorily define oppression, so as to leave these "elastic terms" to judicial interpretation according to specific circumstances. [56] The states of Minnesota and North Dakota have expressly adopted the "reasonable expectations" standard to interpret "oppression" in their legislation. [57]

"Oppression" or other similar terms like "unfairly prejudicial" can also be limited towards the persons to whom they apply. Most statutes do not list exhaustively in what capacity a shareholder must be oppressed, but only provide a general "right of a shareholder to request dissolution". Nevertheless, "oppression" is generally viewed as including oppression towards "shareholders in their capacities as directors, officers or employees". [58]

There is no doubt that a generic term for a scheme of oppression techniques must be created by legislatures. Whether the best term or expression is "oppression", "unfairly prejudicial" or some other makes no big difference. The point is the standard that will be used to interpret and define oppression.

C Modern Judicial Definition of "Oppression"

The evolution of the interpretation of "oppression" by courts has taken place in parallel with the increasing understanding and acceptance by the judiciary and

[56] Model Stat. Close Corp. Supp. § 40 (official comment 2)
[57] Minn. Stat. Ann. 302A.751; ND Cent Code § 10-191-115
[58] Thompson, *Shareholder's Cause*, *supra* note 20 at 714

legislatures of the special characteristics of close corporations.[59] The description of "oppression" is usually dependent on the specific factual setting of the case, [60] but there has been an increasing search for a "standard" of oppression.

Earlier decisions interpreting oppression were very restrictive because courts feared they would be allowing abuse by the minority[61], and thus oppression was only recognized in extraordinary circumstances (as it would basically be linked to dissolution).

After this first approach there was a "second wave of decisions" which used a fault based pattern[62] according to which oppression was understood as a departure from the notions of fair play and fair dealing (conduct would have to be found to be "burdensome, harsh and wrongful"). [63] However, the definitions of those standards (of fair dealing and fair play) showed up to be very complex, complicating somehow the standardization of "oppression" by courts.

The modern concept of oppression – embraced by most of the US states - is based on the "reasonable expectations" standard, which departs from the bargain struck by the parties and does not require any fault. The idea is to find the hypothetical bargain between the parties such as to allow courts to fill in the gaps of the contract.[64] Broadly interpreting, there would be "oppression" whenever reasonable expectations were frustrated.[65]

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[59] *Id.* at 711
[60] Peeples, *supra* note 48 at 488
[61] Thompson, *supra* at 709-711
[62] Sandra K. Miller, *Should the Definition of Oppressive Conduct by Majority Shareholders Exclude a Consideration of Ethical Conduct and Business Purpose?*, 97 Dick. L. Rev. 227, 236 (1993)
[63] Skiera v. Skiera Bros., Inc. 629 P.2d 214, 221 (Mont. 1981)
[64] Michael E. DeBow, *Oppression of Minority Shareholders: Contract, no Tort*, 54 Ala. Law 128 (1993)
[65] Topper v. Park Sheraton Pharmacy, 433 N.Y.S. 2d 359 (N.Y. Sup. Court 1980)

This "reasonable expectations" doctrine has also been adopted by some courts as a standard for equitable jurisdiction independently from the standard for "oppression", as it happens in North Carolina and in California.

D The Essence of the "Reasonable Expectations" Aspect

When close corporations are concerned, we can say that the expectations shareholders would reasonably have would be, for instance, expectations of active involvement, employment and return on investment.

The development of the "reasonable expectations" standard was initiated by New York courts in the late seventies. In *Topper v. Park Sheraton Pharmacy*[66] the Supreme Court of that state held that the discharge of a minority shareholder from his employment for cause and of his officer position was oppressive. The fact that the shareholder was discharged for cause or as a result of legitimate business judgment was actually irrelevant for that court, which based its decision on the severe damage of the minority shareholder's expectations, characterized as oppression.

The decision in *Topper* constituted, for many, an excessively wide step, as it did not allow a legitimate business purpose to be used as a valid defense[67]. In fact, allowing the "reasonable expectations" standard to be applied under such a broad concept showed up to be somehow troublesome, as it transformed the risk of abuse by the minority into a serious threat.

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[66] *Idem*
[67] Bruno, *supra* note 47 at 435

Another example of broad interpretation of "reasonable expectations" by courts can be found in *Pedro v. Pedro*,[68] where the court decided in favor of a sympathetic plaintiff stating that "reasonable expectations" can include an implied agreement to provide lifetime employment (what constitutes a total contradiction to the "employment at will" doctrine).

Problems like the one mentioned above (relating the broadness of the "reasonable expectations" standard) led courts to try to narrow down such standard by imposing some limits. As a result, these days a plaintiff must usually prove that (1) he had reasonable expectations; (2) those expectations are substantial; (3) those expectations were known or assumed by the other partners; (4) the frustration of those expectations does not result of plaintiff's fault and is in large part beyond his control; and finally (5) those expectations were present along the entire history of the participants' relationship, i.e., from inception of the enterprise through the development thereafter.[69]

Examples that well illustrate the tendency of courts to narrow down the standard are found in *In Re Kemp & Beatly, Inc.*,[70] where expectations were limited as the court provided it would not grant relief for frustrated expectations of a minority shareholder acting in bad faith, and also in *Burack v. Burack*,[71] where it was stated by the court that "oppression should be deemed to arise only when the majority's conduct substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and central to the petitioners decision to join the venture".

[68] 489 N.W.2d 798, 803 (Minn. Court App. 1992)
[69] Meiselman v. Meiselman, 307 S.E.2d 551 (N.C. 1983)
[70] 473 N.E.2d 1173 (N.Y. 1984)
[71] 524 N.Y.S.2d 457 (N.Y. App. Div. 1988)

Along with the new standard developed by courts, some scholars also came up with relevant considerations to be observed. In this sense, when "reasonable expectations" are concerned, relief, for instance, should be shaped in accordance to the following "rules": (1) expectations need not be evidenced by a written instrument (they may be gleaned either from written documents or from conduct) and the burden of proof lies on the plaintiff; (2) expectations must be important to investor's participation and must be substantially defeated; (3) expectations must be known to the other parties; (4) "relevant" expectations are those at inception of the enterprise and those that develop thereafter. Courts should not, furthermore, grant relief for failure to achieve expectations within a reasonable time period (it suffices if the majority shows that there is a significant probability that expectations will be fulfilled).[72]

Despite the efforts to narrow it down, the "reasonable expectations" standard is still broad. While those efforts should continue in order not to put at stake corporate stability of investment, the concept must remain broad to the extent that it should be able to meet the peculiar needs of minorities in close corporations (which was, after all, the reason why it was initially developed).

E Oppression Techniques

Controlling shareholders can use a wide variety of techniques to squeeze out or oppress minority shareholders. In fact, 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

[72] Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 Wash. U.L.Q. 215, 228 (1988) [hereinafter Thompson, *Dissolution*]

determine the outcome of shareholders' votes on other matters, have tremendous power to use a great variety of devices or modes of operation to benefit themselves at the expense of minority shareholders.[73]

Those techniques can be categorized in two major groups according to their practical effect: in one group are the techniques that lead to a cash-out of the unwanted shareholders (which are usually related to mergers or share exchanges, like for instance merger consolidations, compulsory share exchanges etc.) and in the other group are the techniques by which while the shareholders lose every influence and return on investments, they are not bought out.

This last situation (where a shareholder although "squeezed-out" or "frozen-out" stays "locked-in") is more likely to happen in a close corporation scenario, as in a public corporation, though maybe unwilling, the shareholder who feels oppressed can always sell his shares for a fair value and get out of the company, never being "locked-in"; in close corporations this "easy exit" is not available.

Frequent oppression techniques of both categories are, for instance, the withholding of dividends, the elimination from the board of directors and from company's employment of the oppressed shareholder, high compensation to majority, denial of access to books and records and other sources of information, misappropriation of corporate assets for personal use or by a company controlled by the majority, fraudulent or unfair contracts, usurpation of corporate opportunities, charter amendments, reduction of capital, recapitalization, mergers and consolidations, among others[74].

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[73] O'NEAL, OPPRESSION, *supra* note 2 at § 3.02
[74] Prof. O'NEAL presents and discusses an extensive and detailed list of squeeze-out techniques in his treatise on oppression. *See* O'NEAL, OPPRESSION *supra* note 2

However, although squeeze-out techniques are usually divided into separate categories to facilitate their analysis, the fact is that in practice squeezers usually combine several techniques in a coordinated plan or effort to eliminate or oppress minority shareholders.[75] Oppressors usually utilize many – sometimes even most – of the techniques to be discussed in this work.

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[75] O'NEAL, OPPRESSION, *supra* note 2 at § 3.01

CHAPTER 4

PROTECTING MINORITY SHAREHOLDERS' RIGHTS:

CONTRACTUAL DEVICES

As pointed out in Prof. O'Kelley's book on Corporations, *"jointly owned firms (as well as long-term contractual relationships) arise when individuals making a mutual team-specific investment prefer to place constraints on the opportunistic risks inherent in remaining totally autonomous from one another. In other words, creating a jointly owned firm (like entering into a long-term contract) involves a specification of each owner's rights and duties (or, in contractual terms, an allocation of risks)."*[76]

Within this context, it may be said that minority shareholders of close corporations have three available sources of protection against oppression: legal, judicial, and contractual.

Legislative protection, by its own nature, requires the shareholders to "shape" their needs to pre-existing legal rules, which sometimes do not fit their specific needs. With no prejudice of the "pure" contractual source of protection, "state corporation law can also be viewed as a contract, containing standard form internal governance rules, that are provided to prospective investors by the state."[77]

Under such a view, one should expect that actual users of corporate form will seek to tailor the corporate "contract" to meet their particular governance needs.

[76] O'KELLEY, CORPORATIONS, *supra* note 12, p. 458
[77] *Idem*

Consequently, if prospective investors in a closely held corporation find the majoritarian-directorial bias of corporate law (and the attendant risk of majority opportunism) undesirable, it may be value-enhancing for them to "contract around" such bias.

In the early years of this century, however, state corporation codes cast the unwanted rules in immutable form.[78] Official support for greater "freedom of contract" can be traced back to the Uniform Business Corporation Act (UBCA), adopted by the National Conference of Commissioners on Uniform State Laws in 1928.[79] In its preface, greater contractual freedom is described as one of the drafters' principal goals: *"the attempt has been made to avoid unalterable statutory regulation of matters of intra-corporate management and to give to the incorporated group as much freedom in this regard as seems consistent with sound policy. To this end, the Act prescribes certain rules which shall apply in the absence of contrary provisions in the articles of incorporation or in the by-laws."*

The role of the courts in this scenario is not unimportant at all. Despite the formal immutability of the rules mentioned above, it remained for the judiciary to determine the extent to which shareholders could contractually specify their wishes (as to salary, dividends, or corporate policies, for instance) or otherwise limit or "sterilize" the directors' discretion to decide such matters by majority.[80] As to this last aspect, courts have been reaffirming the immutability of majority rule by directors through various decisions, as indicated in cases like *Clark v. Dodge*[81] and *Benintendi v. Kenton Hotel,*

[78] *Idem*
[79] *Id*., p. 476
[80] *Id*., pp. 458-459
[81] 269 N.Y. 410, 199 N.E. 641 (1936)

Inc..[82] As seen, courts provide shareholders with a certain expectation that fairness will be after all applied, although unpredictability will always be present.

The third source of protection – the contractual one – is where the focus of this work is placed. The power of minority shareholders of making use of private agreements in order to try to establish a desired level of protection can be a precious tool. Indeed, such agreements are certainly the most economic alternative to conflict resolution;[83] when well drafted, they not only allow smooth conflict resolution but also deter and forbid oppressive conduct. Their efficiency also derives from the possibility of tailoring them to the specific needs of each close corporation.

Despite constituting an efficient way of preventing oppression, shareholders' agreements, even when well drafted, can not anticipate and resolve every form of oppression[84], as the imagination of oppressive shareholders and the variety of techniques can never be fully covered. That is why lawyers play a very important role when protection to shareholders is concerned.

The arrangements to be discussed later on *"are those which can be serviceable under existing law"*[85] and constitute measures that may be taken at the time business is being organized (before any oppressive conduct has occurred) or even in an oppression scenario, where friction has already shown its signs but has not yet developed.

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[82] 294 N.Y. 112, 60 N.Ed.2d 829 (1945)
[83] Hunter J. Brownlee, Comment, *The Shareholders Agreement: A Contractual Alternative to Oppression as a Ground for Dissolution*, 24 Stetson L. Rev. 267 (1994)
[84] Hetherington, *Illiquidity*, *supra* note 13 at 36
[85] O'NEAL, OPPRESSION, *supra* note 2 at § 8.01

A Dual Function of Contracting: Preventing or Remedying Oppression

When contracting before any oppression takes place (i.e., in a preventive way), shareholders may avoid harsher results.

However, due to the fact that the expectations of the partners of the future corporation are based on trust and confidence, in real life the "preventive" conduct rarely takes place, as shareholders' ability to contract is already restricted at that time. In fact, demonstrating little confidence to the majority could even get to the point of queering the whole deal.[86]

On the other hand, if parties do not insert protective clauses from the beginning, by the time oppression occurs contracting (at this point already a remedy) might not be totally effective in the sense of avoiding losses to the minority.

The arrangements to be discussed in the following pages are those which give affirmative protection to minority shareholders against squeeze plays, the most prominent among them being shareholders' agreements, long-term employment contracts, and charter or bylaw provisions requiring high votes for shareholder and director action.[87] They do not constitute, however, an exhaustive list of such devices.

1 Charter and Bylaws Provisions

The insertion of protective provisions in corporate charters and bylaws is probably the most effective way of protecting a minority shareholder against a squeeze-

[86] Hetherington, *Illiquidity*, *supra* note 13 at 36-37
[87] O'NEAL, OPPRESSION, *supra* note 2 at § 8.01

out. Among those provisions the most common ones are those related to minority veto power (which guarantee participation of the minority in the decision making process), for instance a provision requiring unanimity or a high vote for shareholder and direction action, and also those by which mandatory dividends are stipulated[88].

A high vote requirement for shareholder action gives a minority shareholder a veto over the personnel of the directorate and protects him against the various squeeze-out techniques which involve fundamental corporate acts. This requirement alone, however, does not give a veto over many management or policy actions which might be used in a squeeze-play.

In fact, to protect the minority against certain types of squeeze-plays, they need 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 purchase shares of the company's stock under first-option agreements.

So, 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.[89]

There is a number of ways in which a shareholder can be assured of representation on the board of directors. It is, for instance, very usual that when a small corporation is organized each shareholder be given membership on the initial board. If

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[88] This last kind of provisions (determining mandatory dividends) will be better analyzed later on in this work.
[89] O'NEAL, OPPRESSION, *supra* note 2 at § 8.08

this happens in parallel to the requirement of high vote for shareholder action, the minority shareholder can prevent the election of a new board.

Another way of doing it is by a unanimous shareholders' agreement which designates the minority shareholder or his nominee as a director.

The classification of shares would be a third way of giving a minority shareholder representation on the board: the minority would be given all the shares of one class and then it would be provided that each class of shares would elect a designated number of directors (this procedure is very common now in small corporations).[90]

The way in which high vote requirements can be used to prevent the elimination or circumvention of cumulative voting illustrates how effective such requirements are in protecting the rights of minority shareholders.[91] The various attacks that can be made on cumulative voting can be met by a charter provision which requires unanimity or a high vote for charter amendments, a decrease in the number of directors, or the issuance of additional stock.

These requirements can usually be provided for either in the charter, in the bylaws, or in a shareholders' agreement (depending on the state). Inclusion in the charter is usually the safest and most effective way to do it, but attention should be given to local state laws when deciding whether to use high vote requirements, how to phrase them, and what instruments to use in setting them up[92].

Despite being perhaps the most effective safeguard against oppression due to the protection they provide to minority shareholders, high vote requirements must be weighed against risks and disadvantages they may bring for the company and the other

[90] *Idem*
[91] *Idem*

shareholders (like the use of the veto power to extort unfair concessions from his associates, the fact that it deprives a corporation of flexibility that it may need to adjust to new situations, and the consequent increase when it regards the chance of deadlocks). So, in order to minimize those disadvantages, the scope of the veto can be limited to areas in which it is felt protection is most needed by the minority (for instance, to fundamental corporate action and to decisions on the employment and discharge of key employees and the fixing of their salaries).[93]

There are other provisions that can also be used to diminish the risk of squeeze-outs. In this sense, a clause can be inserted in the charter to broaden and strengthen shareholders' preemptive rights. This kind of provision provides some protection to minority shareholders against dilution of their voting power or they proportionate interest in the corporation by the issuance of additional shares to majority shareholders.[94]

The periodical valuation of the company's shares by an outside firm (after proper examination of the company's assets and business) is also another provision to be considered. An objective appraisal of the company's shares would then serve as a base for negotiations for a buy-out when any kind of dispute developed or when a participant decided to leave the business. The high cost of periodical evaluations would naturally be a disadvantage of this kind of provision.[95]

The kinds of provisions mentioned above are not exhaustive. Indeed, other alternatives will certainly occur to draftsmen when a particular business situation is faced. However, certain precautions must be taken no matter the kind of provision which

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[92] *Idem*
[93] *Idem*
[94] *Idem*
[95] *Idem*

is chosen. Those precautions are intended to prevent an amendment of the charter or bylaws to eliminate the protective clauses.

Thus, clauses designed to safeguard the rights of minority shareholders must be "backstopped" by high vote requirements for charter and bylaw amendment or by some other device to prevent majority shareholders from eliminating the protective clauses and then effectuating the squeeze-out.[96]

2 Shareholders' Agreements

A contract among the shareholders is without any doubt the most frequently used device for giving protection to minority shareholders against squeeze-outs, and some of the causes for this frequency are perhaps the relative ease involved in the preparation of such agreements, as well as the relative low cost involved. Indeed, it was once said that *"the best protection that can be extended a client about to enter into a corporate venture is a well-drawn agreement between shareholders designed to safeguard their interests on a mutually fair basis"*.[97]

However, when drafting such agreements, a lawyer should not only be very cautious when giving form to the provisions but he should also analyze very carefully the applicable state law so as to determine whether the provisions to be inserted are legal (despite the flexibility of the legislation applicable to close corporations), as

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[96] *Idem*

[97] Elson, *Shareholders' Agreements, A Shield for Minority Shareholders of Close Corporations*, 22 Bus. Law 449, 451 (1967)

shareholders' agreements are challenged in court more often than it is realized even by lawyers.[98]

The list of provisions that might be included in a shareholders' agreement to help preventing squeeze-outs is very long. Among those provisions are those (1) designating that specified shareholders or their nominees are to constitute the board of directors; (2) guaranteeing that each shareholder is to be employed in a key position by the corporation at a specified salary; (3) prohibiting that salaries of officers and key employees be changed except by unanimous consent of the shareholders; (4) giving each shareholder or each of specified shareholders the power to veto some or all corporate decisions; (5) determining that whenever the corporation's surplus exceeds a specified sum, dividends in the amount of the excess will be paid to the shareholders; (6) prohibiting a shareholder to transfer his shares until he has first offered them to the corporation and to the other shareholders; (7) determining that disputes among the participants are to be submitted to arbitration for settlement; and so on.

Finally, drafters should turn their attention to the fact that agreements of this nature (preventive ones) are usually elaborated on the false assumption that participants will wish to continue to manage the business together, which is a doubtful assumption in case of serious dissension.

3 Buy Out Agreements

This kind of arrangements regulates withdrawal of investment under a set of given circumstances or at will[99], which happen when the majority engages in a squeeze-out or if

[98] O'NEAL, OPPRESSION, *supra* note 2 at § 8.08

corporate employment is terminated. The majority is then bound to purchase the shares of the withdrawing shareholder.

In practice, trouble usually arises in a small corporation when its shares pass into the hands of an inactive shareholder. An alternative of solution to the inactive shareholder problem is a buy-out agreement under which the shares of a holder who dies are purchased by the corporation or 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.[100]

When well drafted, these agreements provide methods of valuation of the shares to be negotiated or refer to an independent third party if no fixed price is determined. Other aspect for achieving effectiveness is that agreements of this kind should be made in advance while all the shareholders are still active in the business, as after a shareholder dies or becomes inactive, negotiations for the purchase of his shares will often be unsuccessful.[101]

Other situation in which similar agreements can be used is for instance when a partner reaches retirement age, becomes disabled, or for other reasons ceases to devote substantially full time to the operation of the business, and his shares are then purchased by the company or by the other shareholders.

A disadvantage of the use of such agreements is the financial burden they put on the corporation and its shareholders; indeed, in many situations such arrangements become impractical because of the high cost involved.

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[99] Brownlee, *supra* note 66 at 298-300 (for a description of the content of buy out agreements)
[100] O'NEAL, OPPRESSION, *supra* note 2 at § 8.03

4 Compulsory Dividends Agreements

The withholding of dividends is the most frequent squeeze-technique. In order to prevent such oppressive behavior, the minority may make use of "compulsory dividends agreements" or may include in a shareholders' agreement, in the charter or in the bylaws a provision which makes the declaration of dividends mandatory in certain circumstances.

Usually, these agreements provide that dividends are to be declared whenever the corporation's surplus exceeds a specified figure. If dividends are withhold, the agreement can also provide that the minority be able to elect a majority of directors, and then dividend policy will immediately be redressed.[102]

However, good sense must be used when drafting such agreements, as it is often fiscally wiser to distribute earnings via salary than via dividends. Another consideration that should guide those agreements is that enough flexibility should be retained such as to permit investment of earnings for corporate expansion or adaptation.

These agreements and also provisions inserted in charter and bylaws providing for mandatory dividends have been increasingly sustained by courts (usually when all shareholders are parties thereto).

[101] O'NEAL, OPPRESSION, *supra* note 2 at § 8.04
[102] Brownlee, *supra* note 66 at 304

5 Long Term Employment Contracts

This kind of device for obtaining protection was created in face of the expectations (for instance, of full time devotion to the business and of earning their livelihood largely by working for it) that a minority shareholder usually has when a close corporation is organized. The minority, thus, feels the need for assurance that they will be retained in the company's employment.

Indeed, sensible employment contracts covering long periods with defined salaries (eventually adaptable to the corporation's profitability) provide essential and valuable protection[103], the only problem being that such agreements collide with the "employment at will" doctrine, which has been reevaluated in close corporations.

Relevant is the fact that the parties to these agreements are the particular shareholder-employee and the corporation; it is not, thus, an agreement among the shareholders.[104]

Attention should be given to the fact that the majority may increase their salaries when the corporation grows and becomes prosperous, without, however, increasing the minority salary in the same proportion.

To avoid this kind of behavior, the minority shareholder should insist on inserting in his employment contract, in addition to a basic salary, a clause providing for contingent compensation (a percentage of profits, for instance) or one providing that his

[103] *Id.* at 302-304
[104] O'NEAL, OPPRESSION, *supra* note 2 at § 8.07

salary will be increased in a fixed proportion with salaries of designated corporate officers.[105]

These agreements, however, provide the minority with a kind of protection that is rather tenuous and incomplete.[106] In fact, under the legal point of view, the validity of long-term employment contracts is still somewhat uncertain in some jurisdictions. Moreover, courts do not generally specifically enforce contracts of this nature.

A last aspect to be considered is that the majority can in fact make the life of the minority shareholder-employee miserable. It may, for instance, refuse to cooperate with him and may take various other steps to make his work unpleasant or unrewarding, such as effecting changes in his duties and in the location to which he was initially assigned.[107]

6 Arbitration Agreements

Although agreements of this nature are mostly used in disputes between distinct corporations, they may also be used to solve intra corporate disputes. They are rather successful for valuation of shareholders' stock, but are less effective for deep rooted shareholders conflict.[108] The good point is that most states enforce arbitration agreements.[109]

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[105] *Idem*
[106] *Idem*
[107] *Idem*
[108] Brownlee, *supra* note 66 at 306-307
[109] Harry J. Haynsworth, *Valuation of Business Interests*, 33 Mercer L. Rev. 457 (1982)

B Relevant Considerations for Achieving Effectiveness

Most people who become minority shareholders in a close corporation when it is being organized, or who enter the business later, have a childish innocence at the outset of their involvement. They are excited about going into business for themselves, and usually anticipate success in the business and high profits. They fail, however, to recognize that in the absence of special protective arrangements almost absolute control (certainly ultimate control) is placed in the hands of holders of a majority of the corporation's voting shares.

In order to avoid this concentration of power on the majority, each prospective shareholder in a proposed close corporation should ideally be represented by his own attorney.

Practice shows, however, that 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 to a single attorney. They do not realize at that time that although legal services cost money, preventive legal advice has proven to be inexpensive when compared to the cost of litigation that may result from the failure to seek out competent legal assistance.[110]

The fact is that having an attorney other than the one who serves the corporation or other participants thereof is a simple way of reaching higher levels of effectiveness when trying to contractually protect minority shareholders' interests in close corporations. Legal advisors can usually recognize many squeeze plays in their inception, while there is still time to fight successfully against them (they can decrease substantially the number of squeeze-plays by removing some of the causes of squeeze-outs and taking suitable precautionary steps to protect holders of minority interests).[111] Moreover, remedies are available against many squeeze plays if legal assistance is obtained with sufficient promptness and the lawyers engaged are resourceful in discovering and utilizing available protective measures and remedies.[112]

Another relevant aspect is the utilization of the shareholder's right to inspect corporate books and records. In almost all US states the corporation act contains provisions granting shareholders the right to inspect those books and records, and even in those states that do not have laws allowing those inspection, a shareholder will always retain his common-law inspection rights.

Such a right must be, however, for "proper purposes" and at "reasonable places and times"[113] and covers the right to investigate all books, records, bylaws, papers, contracts, ledgers, journals, books of account, minutes or other instruments that bear on the corporation's condition or on whether it is being managed properly.[114]

As to meeting the "proper purpose" requirement, a shareholder who is being oppressed usually faces no difficulty. Indeed, many are the purposes for inspection that have been held by courts to be proper, some of them being the following: (1) to ascertain the value of the corporation's shares when the corporation or other shareholder offers to buy the petitioner's shares; (2) to determine whether the company is being properly managed; (3) to get information to be used in litigation against the corporation, its directors, officers or controlling shareholders; (4) to get information (names, addresses

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[110] O'NEAL, OPPRESSION, *supra* note 2 at § 2.20
[111] *Idem*
[112] *Id.* at § 1.05
[113] O'NEAL, OPPRESSION, *supra* note 2 at § 7.03
[114] *Idem*

etc.) about other shareholders so as to attempt to get them to join in litigation) and so on.[115]

During the inspection, the shareholder is allowed to have the assistance of accountants or lawyers (whom the courts often permit to conduct the inspection for him even in his absence) and also to make copies or extracts from the material that is being inspected.[116] It is worth noting that a shareholder may be permitted to inspect corporate books and records even when being a competitor of the corporation.[117]

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115 *Idem*
116 *Idem*
117 *Idem*

CHAPTER 5

CONCLUSIONS

Practice has shown that persons organizing a business enterprise invariably have some conflicting interests. Consequently, whenever a participant is to occupy a minority position in an enterprise, his lawyer should carefully study the underlying causes of dissension and squeeze-outs described on Chapter Three *supra*. The fact is that even the most experienced practitioner might do well to review the recurring problem-situations discussed before accepting the job of protecting a client about to enter into a particular venture.[118]

Moreover, businessmen and their legal and business advisors should be aware of the facts that dissension and squeeze-outs are of common occurrence; that merely because all the participants in a business are members of one family does not assure immunity and may even increase the possibility of a squeeze play; and that steps to prevent squeeze-outs and other oppressive conduct can and should be taken at the time of formation of a business.[119]

Along with all the protective measures already listed in this work, another diligent step would be, for instance, that the lawyer, in order to avoid the dissension which usually develops after a participant in an enterprise buys an interest in a competing

[118] *Id.* at § 8.02
[119] *Id.* at § 1.05

business, persuade the participants to include in their business bargain a stipulation against any participant's acquiring an interest in a competing business.

Besides, if the enterprise is to be conducted in the corporate form, 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 would not take an active part in conducting the business or who would be somehow inclined to indulge in squeeze-plays.[120]

As to the large scale consequences of oppressive behavior by majority shareholders, it must be admitted that there is no efficient way of knowing the extent of the economic loss resulting from dissension and squeeze plays. Obviously many businesses are seriously damaged by bitter squeeze-out fights. Although statistics are not available, squeeze-outs and attempted squeeze-outs undoubtedly bring to thousands of businesses each year friction and strife, impaired efficiency of managers, heavy loss of working hours by key personnel, expensive litigation, and diminished confidence in the business and its managers by banks, suppliers, customers and employees. Friction among the participants is often vindictive and vicious, sometimes culminating in physical encounters. In some occasions the strife, litigation, and unfavorable publicity arising out of a squeeze-out get to the extreme point of destroying an enterprise.[121]

Irrespective of what statutes are enacted or what judge-made rules are evolved for the protection of minority shareholders against squeeze-plays and other oppression, participants in a business enterprise should be given a broad freedom to set up protective arrangements tailored to the particular business and to their own needs and wishes. Each

[120] *Id.* at § 8.02.
[121] *Id.* at § 1.04

business enterprise is of course unique. Legislation and judge-made rules, thus, must almost always be extremely flexible.

Indeed, one of the functions of corporate law is to provide protection for parties who are not in a position of protecting themselves. The law in this field protects insiders and outsiders, but our concern is basically with the insiders, of which the minority is the part in need for protection. Ideally this minority should bargain for protection (not merely relying on legislation), but the fact is that in most cases this bargain does not happen. That is exactly the ground why the law of close corporations has been – and must continue to be – increasingly flexible, providing default protection rules.

As to the courts, they have traditionally been reluctant to interfere in the internal affairs of corporations when dissension develops among shareholders or even when minority shareholders claim that they have suffered injustices. The two principal conceptualistic barriers to the court's granting relief to aggrieved shareholders in squeeze plays are (1) the principle of majority rule in corporate management and (2) the business judgment rule, both analyzed in Chapter Three *supra*. These principles, however, have proven to have a limited validity when it comes to close corporations.[122]

The goal of this work was first to demonstrate the scenario in which oppression may take place in a close corporation and then to point out measures that are effective to avoid the oppressive behavior by the majority. As it was demonstrated, minority shareholders of close corporation have many alternatives available when it comes to elaborating contracts that provide them with different levels of protection. Of extreme relevance is the role played by diligent attorneys, specially when representing single shareholders. However, in order to get to the point of hiring an attorney the shareholder must think and act very cautiously, without letting the excitement of the new business affect his capacity of making rational decisions. The whole point lies on understanding that good relations – not in family, not in business – may not last forever.

It is expected that this work will somehow be useful for ordinary people about to embark in the corporate business. It is already sure, however, that it helped this writer to develop a different view of the problem and of the ways of solving it. If contracting with caution was already a natural behavior in my personal and professional life, after the research that has been done it became more than ever a necessity. I hope it achieves the same level of importance in the minds of the readers.

[122] *Id.* at § 9.04

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