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Expulsion or Oppression of Business Associates--"Squeeze-Outs" in Small Enterprises (Book Review)

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BOOK REVIEWS

EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES—*"Squeeze-Outs" in Small Enterprises.* Prepared by Duke University under the Small Business Administration Management Research Grant Program. F. Hodge O'Neal, project director, Jordan Derwin, research associate. Durham, North Carolina: Duke University Press, 1961. Pp. 263. $10.00.

In a world in which "bigger" is often confused with "better," it is not surprising that small business frequently encounters rough sledding. The small businessman may lack the research facilities to compete satisfactorily in newly developing fields; he may find it difficult to convince government contractors of his ability; he may be vulnerable to various types of pressures from much larger business organizations and from labor unions; and, despite the greater availability of tax incentives for investment in his enterprise, he may experience difficulty in obtaining satisfactory financing at reasonable costs. Among the reasons why investors may draw back from purchasing stock in a small business is the well-known risk of a "squeeze-out"—the use of strategic position, management powers, or legal device by some owners in a business enterprise to eliminate other owners or to deprive them unfairly of income or advantages.

Because "squeeze-outs" have slowed the flow of funds to small business and have occasionally led to the disruption or collapse of existing small businesses, the Small Business Administration aided in sponsoring a study of this phenomenon by Professor O'Neal and Mr. Derwin. Their well-written book now being reviewed furnishes ample evidence that the SBA has garnered a high yield from its investment in the study. Moreover, the book appears at an especially propitious moment, since changes in the tax laws appear to have spurred a trend to incorporate small enterprises—and thereby render them more susceptible to "squeeze-outs."

The authors' research, accomplished both by examination of the decided cases and by interview and correspondence with persons who had squeezed out or been squeezed out, revealed a plethora of techniques for eliminating unwanted minority shareholders. In addition to activity bordering on larceny of corporate assets, these techniques included: (1) withholding of dividends; (2) dropping minority shareholders from the corporation's board of directors and terminating their employment or office-holding with the enterprise; (3) draining off prospective profits and depleting surplus by excessive remuneration of majority shareholders for services rendered the enterprises; (4) issuing new stock under circumstances which preclude minority shareholders from acquiring the newly-issued securities; (5) modifying the rights of minority stockholders by charter amendment, merger, or some other fundamental corporate action; (6) blocking access to corporate records and information concerning its affairs; and (7) entering into business arrangements which disproportionately benefit the majority stockholders (as by leasing property from them at an excessive rental or purchasing overpriced services or supplies from some other organization owned or controlled by them).

Special situations have produced resort to rather unusual squeeze plays. For instance, majority shareholders-directors in low income tax brackets may tell a minority shareholder in a very high bracket that they will declare large dividends immediately unless he sells them his shares. Majority shareholders may use their position and information to divert business to a competing enterprise wholly owned by them, or they may seek to force the business into liquidation or bankruptcy with a view to acquiring it solely for themselves at a forced sale.

Recognizing the causes of "squeeze-outs" is a first step in preventing their use. According to the authors, the causes are often to be found in basic conflicts of interest, protracted dissension and policy disagreements, or demonstrated inability on the part of some of the owners to carry a fair share of the load in operating the business. Not infrequently the trouble will start when one of the original participants in the business retires, dies, or sells his interest to a less active owner. The widow, executor, or testamentary trustee of an original owner may prove an unsatisfactory participant in the enterprise. Jealousy and resentment may develop—and perhaps with peculiar acuteness in a family business—when one owner proves himself far more resourceful than the other. Sometimes the founder of the business outlives his usefulness and seeks to impose outmoded views and methods upon other persons interested in the business. Issuance of stock to employees under an incentive plan may introduce a dissident element into the corporate picture. Indeed, there have been occasions where the holders of qualifying shares, in states whose laws sometimes necessitate the use of such shares, were a source of conflict. Acquisitions by some of the firm's shareholders of interests either in competing business or businesses which have dealings with it (for instance, a business which is its supplier or its customer) may provide the setting for a "squeeze-out."

Not only unscrupulous majority stockholders but also obstreperous minority stockholders frequent the corporate scene.

Sometimes the minority owners are seeking to extort an inflated price for their securities. And sometimes it is they who seek to produce a forced sale of the business so that they can purchase it. Moreover, there have been instances when complaints by minority stockholders were more attributable to their own paranoia, incompetency, and jealousy than to a real "squeeze-out."

The authors' study points a way to some possible modifications of corporation laws in many American jurisdictions. In this respect there is perhaps something to be learned from the experience in England and Scotland under Section 210 of the Companies Act of 1948 which gives the courts broad discretion to deal with "squeeze-out" situations. The authors also suggest certain changes in the judicial approach to the close corporation—such as a more selective application of the business judgment rule and a more discriminating choice of remedies in the event of oppression of certain stockholders. Undoubtedly, the lucid analysis in this book, together with some of the case histories it recites, will aid in producing the desired change in the judicial climate.

As matters now stand, however, the primary reliance for avoiding "squeeze-outs" must be on the skill and perspicacity of the lawyer who provides the legal framework for a newly-organized small business—whether corporation or partnership. Such an attorney, after looking for potential causes of a "squeeze-out," may decide to utilize some one of a variety of legal devices discussed by the authors. The most frequently employed device for protecting minority shareholders in a small corporation is a written agreement among all the shareholders. This agreement might include the following provisions: (1) certain designated stockholders or their nominees shall constitute the board of directors, which shall not be subject to expansion or contraction without consent of all the shareholders; (2) designated shareholders are to be employed in certain key positions by the corporation at specified salaries, and termination of their employment at the instance of other owners of the business shall render the latter personally liable; (3) salaries of officers and key employees are only to be changed by unanimous shareholder consent; (4) each shareholder shall have a veto power as to specified corporate decisions; (5) dividends shall be declared under specified circumstances, *e. g.,* when the surplus, as computed by certain prescribed methods, exceeds a certain figure; (6) the corporation or other shareholders shall have a right of first refusal if a shareholder wishes to transfer his stock; (7) disputes among the participants must be submitted to arbitration for settlement, with perhaps a provision that injunctive relief shall be available to compel performance of the agreement to arbitrate.

Other devices which may be useful in avoiding "squeeze-outs" in corporations include: (a) arrangements under which the corporation has the right to, or perhaps is required to, purchase the shares of a deceased shareholder; (b) long-term employment contracts between the corporation and minority shareholders; and (c) charter or bylaw provisions requiring unanimity or a high vote for shareholder and director action, so that minority holders will have a veto over corporate decisions. In a partnership, the opportunities for "squeeze-outs" are considerably less abundant than in a corporation, since any partner can compel dissolution and an accounting. Nonetheless, it is important for the partnership agreement to define carefully all the rights, powers, and obligations of the partners, so that the temptations to try a squeeze play will be diminished.

The authors recognize that a corporation can be overprotected against the danger of a squeeze play by the majority. Indeed, the granting of too many veto powers to minority stockholders can destroy the flexibility and adaptability which sometimes is one of the great assets of a small business. Moreover, an unscrupulous minority stockholder can use his veto powers to extort unreasonable concessions from the majority.

The lawyer who organizes a new small enterprise bears a heavy responsibility in balancing, against the dangers of excessive corporate rigidity, the need to provide each owner suitable protection that he will not be robbed of his right to participate in any future profits from the business. The lawyer's task is all the more difficult because of the glow of optimism which usually pervades the establishment of a new business and blinds the owners to the risks of future dissension. The legal adviser must not destroy this optimism, which provides a necessary impetus towards business success; but he must not ignore the possibility that—either in success or failure—the new business may generate a pressure for some of its owners to "squeeze-out" the others. Even if the attorney prepares documents which he considers to be a correct response to the problems he foresees for the new enterprise, he must then cope with the danger of a court's determining that the owners of the business subsequently waived or modified some of the terms of the arrangements whereunder the business was organized.

One of the disadvantages sometimes ascribed to small businesses is that they are not able to afford the especially skilled and specialized legal counsel which abounds on Wall Street. And allegedly the Main Street lawyer often does not foresee and guard against the "squeeze-out" hazards. By reason of the publication of this excellent and readable book, no lawyer—whether on Main Street or Wall Street—should have any excuse for not providing suitable guidance to small entrepreneurs in coping with the "squeeze-out" hazard. Indeed, this book is so clearly written that some attorneys may wish to recommend it to their small businessmen clients who need to be convinced that "squeeze-outs" can happen in their enterprises—and, of course, that they should compensate the attorney for his services in preventing a squeeze play. In short, any attorney who has a corporate client can well afford to purchase this excellent study by Professor O'Neal and Mr. Derwin.

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