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Minority Interests in Small Business Entities

John W. Hancock*

While the subject matter of this article calls for the examination of certain aspects of “small business entities,” the focus here will be almost exclusively upon partnerships and corporations. While other types of entities, particularly the business trust and the business association, merit some consideration in determining the type of entity to be employed for a particular venture or purpose, their use can, in almost all cases, appropriately be precluded for one or more of the following somewhat arbitrary, but nevertheless practically sufficient reasons: (1) There is very little in the way of statute or decision law concerning other types of entities which can serve as a guide for those initiating a business enterprise; (2) Others are quite likely to be rather circumspect and even reluctant in dealing with other unfamiliar types of business entities; and (3) Most other types of entities are not particularly advantageous vis-a-vis corporations and partnerships for the active operation of a commercial or industrial enterprise. Also, it would be appropriate before entering into the discussion proper to make the general observation that the corporate form of entity places more numerous and more difficult obstacles than does the partnership form in the way of one who would attempt to secure any real or latent minority interests of participants in the “small business entity.” It is for this reason that the problem of protecting minority interests in close corporations will require the most attention hereafter. It is also for this reason that the partnership type of entity deserves more favorably weighted consideration in starting new enterprises. Later, reference will be made to various methods of structuring a corporation to effect a partnership kind of relation among the shareholder participants. Conversely, reference will also be made to means of arranging a partnership and the partners’ affairs to effect several of the more desirable attributes of corporate structure.

Historical Background

The rights of owners of minority interests in “small business entities” or, more comprehensively and pointedly stated, the fundamental intra-entity rights and duties of participants in any business entity, have been so well established at common law that they require but little comment here. Whether it is the basic rights and duties among partners or those among shareholders which are being examined, any abstract consideration of this subject can only conclude that there is a very strict

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fiduciary duty running between such participants. A partner “cannot, directly or indirectly (emphasis added), use partnership assets for his own benefit,” and “cannot carry on the business of the partnership for his private advantage.”1 Concerning the exercise of corporate control, it has been said, “The majority has the right to control; but when it does so, it occupies a fiduciary relation toward the minority, as much so as the corporation itself or its officers and directors.”2 Therefore, the exercise of control in such a way which unreasonably favors those exercising control or which unfairly affects the interests of other participants would be an actionable breach of a fiduciary duty.3 This is so even though the particular means by which or manner in which control is exercised is proper per se and even though the exercise be void of fraud or mismanagement.4

The casebooks are filled with examples of how those in control of a business entity, almost exclusively a small, close corporation, have been able to “freeze out” effectively those not in control, the minority.5 We may be certain that there have been many fold more instances which never have become the subject of litigation. How can this happen when the common law imposes on those exercising control or authority a fairly well defined fiduciary obligation toward those other participants in the entity whose interests may be affected?6 The answer, succinctly stated, is that this is the result of the invoking of the “business judgement” rule7 (or a variation of it) which permits those in authority or control wide, discretionary latitude in the exercise thereof. The “business judgement” rule, when considered in the abstract, is quite reasonable and even commendable in view of the unreasonable interference and harassment which it seeks to prevent. Yet, while it would be rather unreasonable to characterize the “business judgement” rule as the antithesis of the fiduciary obligation principles described above, its general tenor is to permit greater tolerance of conduct and action whereas that of the latter is to limit or control such activity. It might therefore be said that any study of the rights and remedies of minority shareholders is, in effect, the study

1 Latta v. Kilbourn, 150 U.S. 524, 541 (1893).
4 Southern Pacific Co. v. Bogert, supra note 2; Seagrave Corp. v. Mount, 212 F. 2nd 389 (6th Cir. 1954).
6 Latta v. Kilbourn, supra note 1; Southern Pacific Co. v. Bogert, supra note 2.
7 Henn, op. cit. supra note 3, 364-65; O'Neal, Oppugnancy and Oppression in Close Corporations, 1 Bost. Coll. Ind'l. & Comm'l. L. Rev. 1, 4-5 (1959).
of the resolution of these two concepts with respect to their application to concrete situations.

A brief reference to the nation's economic history will help us to understand why the resolution of these two concepts may have proven to be so difficult. Industrial development in the latter part of the nineteenth century was furthered substantially by the pooling of capital and by the centralization of management for which the corporation was ideally suited. Also, the insularity from the other participants which the corporate arrangement and its concomitant "business judgment" rule afforded for those in control of the venture's affairs, was both highly valued and probably necessary under the then existing circumstances. Thrust as these industrial and commercial developments were upon us and bound up as they were in our nation's well being, courts at that time were probably quite reluctant, and perhaps understandably so, to give effect to time-honored fiduciary principles, which should have been allowed to govern any intra-entity relationships under judicial examination, to the detriment of the widely proclaimed "business judgment" rule except in very extreme or very obvious instances. Fortunately for most, the trend in succeeding years has been to bring the "business judgment" rule more into its proper perspective. With the proliferation of corporations many small entrepreneurs came to favor that type of entity for their own business ventures, initially because of its limited liability feature and later because of possible Federal income tax advantages. However, the latitude and shelter afforded by the "business judgment" rule was certainly not lost on those same small corporate entrepreneurs when they found an occasion to "freeze out" an unwanted shareholder.

**Interests and Expectations**

Safeguarding minority interests in a small business entity should be related to the expectations of the various minority participants, and it can be fairly said that the expectations of close corporation shareholders are almost identical to those of general and limited partners in the common, garden-variety kind of partnership, and in practice these shareholders are likely to regard each other more as partners than as shareholders by reason of the close and personal association which exists. Both partners and close corporation shareholders usually have a vital interest in their respective small business entities as the source of their

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8 Dodd, For Whom Are Corporate Managers Trustees, 45 Harv. L. Rev. 1145, 1162 (1932).

9 Gibson, Selecting the Form of Entity for a Small Business, 18 Bus. Law. 100, 104 (1962).


employment and as their major capital investment. Also, partners and close corporation shareholders almost without exception desire to limit participation in their entities to those of their own choosing. Finally, pervading these and all other expectations and objectives is the keystone element of mutual trust and dependence among partners and shareholders. Let us for a moment compare these expectations with the expectation (note the singular) of the shareholder in a giant commercial or industrial enterprise. The latter can be summarily described as having made an investment of passive concern committed without any intended recourse to a management group probably unknown by the shareholder and perhaps intelligibly based upon already established indicia of its suitability for investment purposes. Significantly, the expectations of those involved in a small business entity are most commonly (1) multi-faceted, (2) the active concern of the party, and (3) based primarily upon the anticipated future reliability of others involved with the participant. Based on these major differences the interests of a minority owner of a small business entity require something totally different in the way of organizational planning than would be devised for a major corporate enterprise.

Selection of Form for a Small Business Entity

Planning for the protection of the various interests and the securing of the expectations of the members of a business, including the interests and expectations of those who may constitute a minority, requires at first the selection of the form of entity which will best satisfy these and other needs. Although a summary conclusion has already been stated to the effect that the partnership form of entity is to be preferred to the corporate form for the limited objective of protecting various minority interests, it is quite obvious that the protection of these interests is but one of the many factors to be given consideration in determining the type of entity to be employed for a particular undertaking. Indeed, other factors may very well be entitled to much greater weight in making this decision and the factor here considered and discussed will seldom be the determining factor. Several of the other factors to be considered are (1) the incidence of local, state, and Federal taxes, (2) the need for limiting the liability of the participants, (3) the general nature and scope of the business, (4) various statutory sanctions and bars, and (5) the need for continuity and transferability of interests.

It becomes necessary at this point to state why, in the opinion of the writer at least, a partnership is to be preferred to a corporation from the isolated standpoint of safeguarding various minority interests and expectations. For a "minority partner," the Uniform Partnership Act, which

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12 Gibson, op. cit. supra note 9.
has been adopted as statute law in almost all of the states, serves as both a sword and a shield. First, the Act states in express and certain terms the fiduciary relation of each of the partners to the partnership and makes him accountable therefor. Second, the act directly or indirectly proscribes the exercise of control in certain ways which might tend to injure or to exclude those in the minority by altering or abrogating the expressly stated or legally implied provisions of the partnership agreement. For instance, no partner is entitled to any remuneration except that which might have been provided in the partnership agreement, and that same partnership agreement cannot be altered to provide for increased or decreased salaries without the assent of all of the partners. The continued maintenance of this absolute protection obtains in all instances except where it has been intelligibly and expressly waived in the original partnership agreement or any amendment thereto. Also, each partner has, again with the exception of those instances involving the waiver or surrender thereof, equal rights in the management of the business, the right to limit the admission of others to the partnership, and perhaps most important of all, the right to have his defined equity interest in the partnership protected against dilution or impairment by the other partners. Third, in the event of any dissension among the partners resulting from an attempt to exclude a partner from the management of the firm's affairs, or in any way which the partner deems injurious to his own interests, or for any other reason however arbitrary, the partner has the right to cause a dissolution even though the partnership agreement might expressly attempt to bar such a course of action for all intents and purposes. Also, upon causing any such dissolution, the partner is entitled to have his interest in the partnership paid over to him in due course in a manner which is specifically set forth and subject only in the case of wrongful dissolution to certain restrictions and allowances for damages caused to the other partners. In essence, the formation of a partnership under the Uniform Partnership Act can, in the partnership agreement, provide for the irrevocable fixing of the individual partner's expectations as to salary and as to the maintenance of

13 Uniform Partnership Act, Sec. 21.
14 Uniform Partnership Act, Sec. 18(h).
15 Uniform Partnership Act, Sec. 18(f).
16 Uniform Partnership Act, Sec. 18(h).
17 Uniform Partnership Act, Sec. 18.
18 Uniform Partnership Act, Sec. 18(e).
19 Uniform Partnership Act, Sec. 18(g).
20 Uniform Partnership Act, Sec. 26, 18(a), 18(h).
21 Uniform Partnership Act, Sec. 31(1) (b).
22 Uniform Partnership Act, Sec. 31(2); Crane, Partnership, 400-404 (1952).
23 Uniform Partnership Act, Sec. 38.
the principal of his investment and the return thereon unless the power to amend the partnership agreement is expressly granted otherwise. Even if no provision is made concerning remuneration or return on investment, each partner nevertheless finds himself in the same relative position to his associates with respect to their ultimate rights to the assets of the partnership which he originally contemplated at the time of formation of the firm. However, of all the various factors which can properly be considered, there are two, the necessity or desire to limit individual liability and Federal income tax consequences, which are most often deemed to be of paramount importance. Where the limitation of a member's liability to the capital invested is desirable (e.g. where the personal wealth of any participant is substantial or the degree of risk involved in the contemplated enterprise may be great), the election of the corporate form of doing business is indicated. The structure of the rate schedules of Federal personal and corporation income taxes also tends to favor the employment of the corporation in many situations.\(^{24}\) This generally results from the comparative facility with which corporate income can be accumulated as capital at tax rates which are extremely favorable. Now concerning the weighing of these two major factors in the choice of the type of entity to be made for the venture, there are several considerations, both legal and practical, which should be undertaken and which might lead to the use of the partnership as the vehicle which offers the best combination of realizable attributes. Concerning the relation of the incidence of Federal income taxes to the choice of the type of business entity, most attorneys are undoubtedly quite familiar with the provisions of Subchapter S of the Internal Revenue Code\(^{25}\) and have probably considered its election on several occasions. However, statistics indicate\(^{26}\) that very little advantage has been taken of Subchapter R of the Internal Revenue Code\(^{27}\) which permits partnerships meeting certain criteria to elect to be taxed as a corporation. The use of the partnership form of entity supplemented by the partnership's availing itself of Subchapter R may be indicated in many instances where most or all factors other than those related to Federal income taxes suggest the use of a partnership, but where the corporate tax consequences would otherwise tip the balance in favor of that form of doing business. As mentioned above, the desire of one or all of the participants to limit their liability to their investment in the entity is often of major importance. However, this particular feature of the incorporated enterprise all too often proves to be illusory. Individual liability may be imposed upon

\(^{24}\) Gibson, op. cit. supra note 9, 104.


\(^{27}\) Int. Rev. Code of 1954, Sec. 1361.
the shareholders for a corporation's debts where the corporation has been found to have been "too thinly capitalized" in relation to what its undertakings and obligations had become, and such a deficiency may be found to have existed even though the corporation has met all of the statutory requirements with respect to the maintenance of capital.\(^{28}\) Also, it frequently happens that a small corporation can secure necessary financing and credit only when the officers or major shareholders personally obligate themselves as co-signers of the corporation's promissory obligations and consequently this particular corporate attribute is of no avail. Of interest to some practitioners may be the possibility, admittedly quite limited in actual practice, of partners being able to limit their liability arising out of a particular contract or undertaking by providing in express terms that the obligee or promisee may look only to the partnership estate for fulfillment or satisfaction.\(^{29}\) But, because of the almost total lack of decision law or other treatment of this topic, this device should be employed only in the most appropriate circumstances and then only with great care being taken to define the partnership estate and to make it subject to no unauthorized impairment by the partners.

**Need for Planning**

Although involvement either as a general or a limited partner is to be preferred to participation as a minority shareholder for the isolated objective of protecting one's interests and expectations in a small business entity, other factors suggesting the use of a corporation will often seem more compelling and a corporation will be formed. The common law principles and statutory requirements of fiduciary obligation to which officers, directors, and majority shareholders exercising control are subject, should serve to deter those parties from attempting many of the more obvious and deliberately inimical acts which directly injure minority owners, and at the same time should afford a legal or equitable remedy for those shareholders affected. However, as the means employed to defeat the interests of the minority shareholders become less obvious and the manner in which these means are employed become more subtle, the minority shareholder is less likely to avail himself of any ultimate remedy to protect his basic shareholder rights and interests much less his reasonable expectations as an active participant in a small business entity.\(^{30}\) In order to secure the necessary protection against invasion or encroachment in this last described penumbral area, various methods


\(^{29}\) Marion Machine Foundry & Supply Co. v. R. T. Harris Interests, 26 S.W. 2nd 449 (Tex. App. 1930); 68 C.J.S. 634-636 (1950).

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and devices have been employed with varying degrees of success. Shareholders' agreements, voting trust agreements, long term employment contracts, high vote requirements, and the use of several classes of stock with varying rights and privileges are some of the more common methods and devices, and of these perhaps the most common is the shareholders' agreement.

**Shareholder's Agreements**

The shareholder's agreement is the device which singly is the most adaptable for the purpose of securing the small business shareholder's unique expectations, especially those having to do with employment and salary, a reasonable return on his investment as initially contemplated, and choosing who his associates shall be, and such agreements have been successfully used and tested for these purposes. Shareholder's agreements can also be devised with the primary objective in mind of allowing the minor shareholder or shareholders to so control or limit the action of the officers, board of directors, or majority shareholders by virtue of their strategically arranged status that they can assure the continued enjoyment of their originally expected privileges as "member shareholders." This latter type of agreement which, in effect, gives the minority a veto over the power of the majority, also serves the purpose of preventing the majority group from diluting or "squeezing out" the interests of the minority shareholders by various methods involving corporate reorganizations or recapitalizations which, if resourcefully and cleverly done, can avoid the limitations and bars of the corporation statutes designed to prevent such wrongs. Shareholder's agreements then would seem to be a most ideal and practical way of assuring any "would be" or "ab initio" minority shareholder of realizing his expectations in whole or in part. But in practice, majority shareholders or their controlled directors and officers all too often have been able to disregard the covenants of these agreements and to incur no legal or equitable penalties or judgments in so doing. These consequences have been the result of a number of very strict judicial attitudes which had their bases in our economic history as did the judicial attitudes toward the "business judgment" rule. It would be well to know and appreciate why these attitudes developed and why they have persisted if we are to base the well-being of our clients on something which may be susceptible to being negated

31 Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1936); but see Meck, Employment of Corporate Executives by Majority Shareholders, 47 Yale L. J. 1079 (1938).


by these attitudes or their underlying rationale. Voting trusts were a favorite device of a number of predatory industrialists of the late nineteenth century and were used primarily to form a pool of the controlling stock of most or all of the corporations in a particular industry.\(^\text{34}\) For these companies, this not only had the salutary effect of deterring cutthroat competition but also permitted the industry as a whole to deal with the public as a monopoly. Voting trusts were also used in some instances for the purpose of insuring absolute and continued control by a majority group with the end in mind of operating the corporate enterprise for their own exclusive interests. While the voting trust was undoubtedly used in some other instances to insure continued control for ethical reasons, this type of arrangement understandably came to be treated with a great deal of disfavor by the courts which developed the rationale that the voting trust was unlawful because it severed the voting power of stock from the beneficial interest in it.\(^\text{35}\) This seems to have been a rather superficial and legalistic approach but one which, in that era and under those circumstances, was sufficient. Shareholder's agreements were found to be an alternative which technically did not sever voting control of stock from beneficial interests. However, courts did not lose sight of the fact that, if shareholder's agreements were to be given effect, they equitably severed voting control of stock from the beneficial interest therein, and such agreements were often found to be a mere variation of the disfavored voting trust.\(^\text{36}\) A more tenable rationale could be found to deny legal and equitable effect to shareholder agreements where they not only set forth who should be elected as directors, but also provided how the corporation's affairs were to be managed with respect to certain specifics. These latter covenants were additionally found to be against public policy, which was alleged to be that a corporation was to be managed by its board of directors who were responsible individually and collectively to all of the shareholders, creditors, and the public, and, being thus obligated, they were bound to exercise their discretionary judgment in the management of the corporation's affairs, unfettered by any commitments except those general dictates of common and statute law.\(^\text{37}\) This reasoning was criticized and discarded in the leading case of Clark vs. Dodge\(^\text{38}\) from which case we can develop two more or less requisite standards to be observed in attempting to draft a valid share-

\(^{34}\) United States v. E. C. Knight Co., 156 U.S. 1 (1895).

\(^{35}\) Shepaug Voting Trust Cases, 60 Conn. 553, 24 A. 32 (1890); 19 Am. Jur. 2nd 191-93 (1965).

\(^{36}\) 45 A.L.R. 2nd 821; O'Neal, Protecting Shareholders’ Control Agreements Attack, 14 Bus. Law 184, 185 (1950).

\(^{37}\) O'Neal, op. cit. supra note 36, 188.

\(^{38}\) Supra note 31.
holders' agreement. There the agreement between the two sole shareholders provided, among other things, that the plaintiff minority shareholder was to be employed as general manager of the corporation so long as he faithfully, efficiently, and competently performed his duties and that as compensation, he was to receive one-fourth of the net profits of the corporation as defined. Upon his discharge, not for cause, he sought specific performance of the contract and its validity was thereupon brought into question by the defendant majority shareholder. It was held that since the contract required the employment of the plaintiff only so long as he proved to be faithful, efficient, and competent, it "impinged" only slightly on the discretion of the directors and resulted in no injury to the shareholders, creditors, or to the public. Further, it was implied that the performance of the contract was sanctioned by all of the shareholders, including the defendant, and that by their assent they should be estopped from objecting to any inferred imposition on the judgment and discretion of the directors. Reasoning inductively from this decision, we may fairly conclude that a shareholders' agreement should impose upon the directors' prerogatives only to the extent necessary to secure the results desired (generally the party's expectations of employment and return on investment), and should include all of the shareholders as signatories if this is reasonably possible. An additional caveat which arises primarily in connection with corporation charters and by-laws but which applies also to shareholders' agreements is the intolerance of some courts toward devices or arrangements which permit the control or management pattern of the corporation to deviate from the so-called corporate norm. This subject will be treated in more detail later as a part of the discussion of charter and by-law provisions. Shareholders' agreements are also commonly used to control or limit the ownership of stock in a close corporation. Such a use is an attempt to synthesize for shareholders the delectus personae of partners, and, because of the differing nature of partner and shareholder status, many legal and practical considerations are necessarily involved in planning an agreement for this purpose. "Buy and sell" and "first option" agreements are mainly the means to serve the ends of the remaining shareholders of a close corporation and are generally not planned with the objective of affording any absolute right or remedy for the aggrieved minority shareholder. They are mentioned here primarily because they help to fulfill a desire or need of close corporation shareholders, and aside from that they are not within the purview of this paper. Some further advice about the drafting of shareholders' agreements appears to be in order.

39 O'Neal, op. cit. supra note 36, 195, 199.
40 2 O'Neal, op. cit. supra note 11, 1-80.
41 1 O'Neal, id. at 13-16.
42 O'Neal, op. cit. supra note 36, 194, 198, 201, 202.
1. A recitation of the purposes of the agreement describing the expectations of the various shareholders and their intention to realize them should help to obtain favorable consideration of the agreement in any cause of action brought to effect one of those cited purposes.

2. It would also seem advisable to limit the term of the agreement in order to avoid judicial characterization of it as a perpetual voting trust.

3. Having the corporation bound as a party would not impair its validity and could simplify its enforcement procedurally.

4. Parties should agree to bind all transferees, and the mechanics for doing this should be established.

Charter and By-law Provisions

Frequent use has been made of the provisions of corporation charters and by-laws to "spread" the control of a corporation and, occasionally, to secure some of the expectations of the member shareholders. The "spreading" of control among the members is commonly done by establishing high vote requirements for certain or all shareholder and/or director actions.\(^{43}\) Of course, requiring a high percentage vote for any board of directors action can only serve the purpose of minority participants when this requirement is complemented by having that minority participant or someone allied with him assured of sufficient representation on the board. This certainty can be best accomplished by the undertakings of a shareholder agreement or voting trust agreement. It is now fairly well settled that the covenants of these agreements obligating the parties either as shareholders or through trustees to vote only for certain designated persons for directors are a valid exercise of a proprietary right, and in the case of voting trust agreements, there is statutory sanction in many jurisdictions for the transfer of this right. Minority interests can also be assured of representation on the board of directors where several nominally different classes of stock are employed and each of these classes, owned exclusively by a single interest, is entitled to elect one or more directors.\(^\text{44}\) However, with this type of arrangement, the right to elect the director(s) is not personal to designated parties, but passes to any transferee of the majority of the stock of any class, which result may not be the intention of the initial participants. Assuming that the desired number of directorships for each participant or interest can be assured by satisfactory and binding arrangements, there yet remains a major area of doubt concerning the common and

\(^{43}\) O'Neal, op. cit. supra note 11, 188-221.

\(^{44}\) O'Neal, op. cit. supra note 33, 553-55.
statutory legality of charter, by-law, or contract provisions for high vote or unanimity requirements, especially as they may apply to director actions. A noteworthy case signaling this danger is Benintendi vs. Kenton Hotel where a by-law requiring unanimity for any director action was found to be “almost as a matter of law, unworkable and unenforceable (sic).” A 1693 English decision was cited: “prima facie in all acts done by a corporation, the major number must bind the lesser, or else differences could never be determined.”; and the corporation statutes were found not to permit any departure from this common law rule. The implied basis for these decisions is the supposed public abhorrence of any inaction, paralysis, and consequent waste which might result from the failure of a corporation, through its directors, to make ordinary and necessary business decisions on account of any continued stalemate among the directors. Following the Benintendi decision, the legislatures of New York and many other states amended their corporation laws for the purpose of permitting corporations to establish their own vote requirements for shareholder action at variance with those otherwise supplied by statute. While the apparent intent of these enactments was to permit the use of checks and balances in the management of corporate affairs in spite of possible occurrences of stalemate and waste, there have been several decisions invalidating unanimity or extremely high vote requirements put into effect under permissive statutes. Generally, though, the dictates of the legislature will be literally observed where high vote or unanimity requirements have been authorized by remedial amendments to a state’s corporation laws. The attorney should consider not only the latitude of control arrangements permitted by statute and the judicial interpretation of them, but also the possibility of abuses which may occur where any single party or faction is given an effective veto power in corporate management. It would seem fitting and proper that the legal disposition of the exercise of a veto power in any instance should be a function of its underlying good faith or bad faith motivation and not be based on its consequences to the corporation or other shareholders. This, however, presumes both the availability of clear and convincing proof and the realistic expectation of sound equitable adjudica-
tion. In the opinion of the writer, high vote or unanimity requirements in corporate management should be regarded very circumspectly and should be employed, if at all, only as supplementary to agreements, provisions, etc., relating specifically to the real expectations of the parties as small business owners. The following reasons are offered to support this opinion: (1) Statutory and case law concerning their use is not sufficiently clear and settled; (2) Arguments advanced against their validity appear quite reasonable and might be given added weight by particular circumstances; (3) The availability of a veto power invites deadlock and abuse; and (4) This type of control arrangement does not deal directly with the real expectations of the minority shareholders. There is considerably less objection to imposing high vote or unanimity requirements on those major corporate dispositions and other defined matters which, if they are deftly handled by those in control, could dilute or defeat the interests of the minority shareholder. While unanimity or high vote requirements for these matters would also deviate from the prevailing corporate norms, they would not interfere with the ordinary operation of the business and are more practically and legally defensible. Finally, it should be mentioned that both charter53 and by-law54 provisions have been used successfully to require the payment of dividends under defined circumstances. Although shareholders’ agreements have also been found to be valid for the purpose of fulfilling this expectation,55 it would seem to be more appropriate to provide for this in the share contract (charter) or corporation rules (by-laws) because the existence of such a mandatory requirement does substantially reduce the discretionary authority of the directors in a major corporate matter.

Planning for Specific Expectations

Planning for the specific interests of a minority shareholder not only calls for an examination of the advantages and pitfalls of various devices and methods, but also requires an ultimate decision about the selection of the means to be employed in securing the individual expectations. Shareholders’ agreements and long term employment contracts are the two major alternatives for safeguarding employment and salary expectations, and, of the two, the former seems preferable for this purpose. An agreement between all shareholders can be so drawn that the office or employment promised becomes the unique consideration flowing to the shareholder by virtue of his expressed or implied desire to “keep an eye on” his investment as a shareholder, and, since the promised consideration is unique, he should be entitled to specific performance of the

55 Pheterson, op. cit. supra note 32.
The same construction of a long term employment contract would be extremely awkward. Also, the general principles of estoppel should make it difficult if not impossible for other shareholders to object to the validity of any employment and salary obligations of the corporation to which they and their assignees have assented, especially if they have received any benefits from the same agreement. They are not similarly estopped from contesting the validity of a long term employment contract. It has been previously stated that any provision for mandatory dividends would be less subject to attack as a part of the charter or by-laws than it would be as an element of a shareholders' agreement. However, since such dividend obligations have been regularly enforced whenever they arise, another factor of possible significance may be weighed in determining where the mandatory dividend clause is to be placed. It is quite possible that the shareholders collectively may desire to "waive" the receipt of a dividend during any given period for Federal income tax purposes. Having the mandatory dividend clause in the charter or by-laws would be tantamount to the constructive receipt of the dividend. Its inclusion in a shareholders' agreement would be less likely to be regarded as the constructive receipt of a dividend because therein it is patently an unexecuted and unenforced contractual obligation and only indirectly a muniment of title subject to being waived.

**What to Do in Case of Dissension or "Squeeze Out"**

A business entity involves the association of individuals and the interaction of their personalities and, not infrequently, trouble. Dissension can occur even in the most carefully planned organizations and the existence of safeguards may not deter the controlling majority from attempting to "squeeze out" the minority. When this happens, an attorney for the affected minority should feel obliged to confront the majority not merely to satisfy any procedural requirements respecting demands, but primarily with the object in mind of creating a climate where reason and fair play might be allowed to prevail. This approach should not be ignored, and where it is successful a better and less costly resolution of the problem for all is the result.

Where legal action finally becomes necessary, the preparation of the plaintiff's case must necessarily be founded on the injury sustained as a consequence of the majority's breach of duty or contract, but it should also involve the presentation of any relevant facts tending to permit an inference that the discretion vested in the control group has been grossly misused. Any arguments advanced on behalf of the minority should also allude directly to the unique status of close corporations and their shareholders and the increasing recognition being given to the manifest and implied understandings of the shareholders.

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56 Sneed, op. cit. supra note 30, 994-98.
Remedial Legislation

Any study of the history of arrangements to establish and protect valid minority interests will show that the courts in considering these arrangements have tended more recently to examine purpose and intent and to disregard legal forms and precepts. This salutary trend has been given further impetus by the legislatures of two states which have provided in their corporation laws for wide latitude in the making of intra-entity agreements. North Carolina law now states that, with respect to certain close corporations, "no written agreements to which all of the shareholders have actually assented . . . and which relates to any phase of the affairs of the corporation . . . shall be invalid as between the parties thereto . . ." A recent New York enactment reads: "A provision in the certificate of incorporation otherwise prohibited by law as improperly restrictive of the discretion or powers of the board in its management of corporate affairs shall nevertheless be valid;" and conditions this validity on unanimous formal assent of the shareholders and on any transfers being made with notice of the provision. Statutes of two states also sanction the voluntary dissolution of a corporation at the instance of any proportion of its shareholders if the charter so provides. Such a provision would entitle an individual shareholder to the same remedy which a partner has available as a matter of law and its availability might afford the minority shareholder more consideration in the "councils" of the corporation.

"Buy Out" Contracts

"Buy and sell" agreements and "first option" agreements are usually drafted and executed only with the purpose in mind of limiting the transfer of a company's stock. However, "buy out" agreements can also be drawn with the view in mind of resolving any continued dissension by committing one party or several parties to purchase the other interests at the request of any shareholder. An equitable type of "buy out" arrangement is where the initiating shareholder announces his intent, states his valuation price per unit of the equity in the corporation, and thereby obligates the other party or parties to "buy out" or "sell out" at the appraised unit price. This is used most often where there are two shareholders each with 50% of the stock, but there is no reason why this method could not be used where the stock is divided otherwise. Another possible method would be a mandatory "closed auction" requiring

57 Gen. Stats. of N.C., Sec. 55-73(b) (1963).
58 N.Y. Bus. Corp. Law, Sec. 620(b) (1963).
60 O'Neal, op. cit. supra note 11, 171-74.
61 Sports Illustrated, October 3, 1966, p. 38 for an article describing the closed auction sale of the Los Angeles Rams.
sealed bids and possibly coupled with a proviso permitting the highest bid to be over-called by a bid at an amount higher by a stated percentage of significant proportion (e.g. 20%). These "buy out" contracts should only be used where the parties involved are sufficiently sophisticated to accept the inference of ultimate disagreement and have enough financial resources to make any "buy out" commitment workable.

Summary

In meeting the problems posed by the desire to protect minority interests, the practitioner should fully weigh the advantages available to those participating in a partnership and should not be influenced by the parties' desire for personal aggrandizement as corporation owners or officers. It is the writer's opinion that the securing of minority owner's interests in a small business corporation is best accomplished by defining them as expectations and making the controlling faction obligated to observe them. Control and veto arrangements do not directly identify and deal with these expectations and can easily prove to be the foundation of deadlock, dissension, and abuse. The use of "trust provisions" in the charter is suggested as an alternative to shareholders' agreements. The latter should be regarded, however, as a tried and proper vehicle for the securing of minority interests and deserves the most favorable consideration. Mandatory dissolution and "buy out" provisions and agreements can also prove useful as an available remedy where other arrangements are not feasible or require secondary protection.