

## BOOK REVIEW

“SQUEEZE-OUTS” OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES. By F. Hodge O’Neal. Chicago, Ill.: Callaghan & Co., 1975. Pp. xiv, 732. \$37.50.

*Reviewed by Joseph W. Bishop, Jr.\**

Some years ago I purchased a few shares of stock of a Cleveland machine tool manufacturer, named Cyril Bath Company after its majority stockholder, who owned about sixty percent of the voting shares. Most of the remainder was owned by the public and traded over the counter. Bath Company was reputed to be very prosperous and likely to become even more so: more, its *padrone* was known as a guardian and sustaining angel of the Reform Democrats in those parts. It seemed an ideal opportunity for Ethical Investment.

The results of my little flutter were both disappointing and puzzling. Although the Company seemed to be doing a brisk business, its annual reports invariably showed a small loss, or an even smaller profit. The total distributions to public stockholders over a period of about five years consisted of: (a) a five percent stock dividend; (b) one cash dividend of a nickel per share; (c) two Christmas cards; and (d) an annual postage stamp, intended to be used to return a signed proxy. (I pocketed the stamp, for the proxy solicitation did not even disclose the names of the nominees for whom my proxy was to be cast, much less the information about their compensation, ownership of Bath’s securities, transactions with the Company, or other invasions of privacy required by the prying Securities and Exchange Commission in the case of corporations with 500 or more stockholders.) The market price of the stock gradually sank to about half what I had paid for it and a still smaller fraction of the price at which it had originally been sold to the public.

Enlightenment dawned when I read the opinion of a federal district court in a suit brought by another minority stockholder.<sup>1</sup> I was the

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THE FOLLOWING CITATION WILL BE USED IN THIS BOOK REVIEW:

F. O’NEAL, “SQUEEZE-OUTS” OF MINORITY SHAREHOLDERS: EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1975) [hereinafter cited as O’NEAL].

1. *Britt v. Cyril Bath Co.*, 290 F. Supp. 934 (N.D. Ohio 1968), *rev’d*, 417 F.2d 433 (6th Cir. 1969).

victim of a squeeze-out—what Professor Hodge O'Neal, the greatest expert on the subject and the author of the present comprehensive and authoritative treatise,<sup>2</sup> terms a "squeeze." <sup>3</sup> The circumstances were somewhat atypical, for the Bath Company had nearly three hundred public stockholders and thus was not, strictly speaking, a close corporation, but the technique—essentially the withholding from the minority stockholders of both dividends and information—is an old standby of squeezors, which Professor O'Neal exhaustively describes and analyzes.<sup>4</sup> The complaint in substance alleged that the controlling stockholder had manipulated license agreements with the corporation in such a way as to eliminate profits, thus lowering the market price; that the defendants had caused the corporation to purchase large quantities of its own stock at the artificially depressed price; and that these and other material facts, including the existence of the license agreements, had been withheld from the public investors.

This particular squeeze-out was atypical in another way, in that it was a good deal less than completely successful. Three factors combined to rescue at least those public investors who had not yet been squeezed out: a tough public investor with a large (ten percent) minority interest and a good lawyer; the existence of section 10(b) of the Securities and Exchange Act of 1934<sup>5</sup> and the SEC's rule 10b-5<sup>6</sup> thereunder; and an irritated law professor. The Sixth Circuit held that the minority stockholder's allegations stated a cause of action under the statute and rule.<sup>7</sup> The irritated professor's contribution, aside from an *amicus* brief in the Circuit Court of Appeals, was a suggestion that the plaintiff donate one share apiece to 250 volunteers from the students, staff, and faculty of the Yale Law School, thereby raising the number of stockholders above the 500 level and subjecting the corporation to the disclosure requirements of the 1934 Act.<sup>8</sup> We wondered whether it would occur to the squeezor's attorneys to stage a reverse split, or "glue-up," reducing the single shares to fractional shares which could be called for cash,<sup>9</sup> and whether we would be able to enjoin such a maneuver. But this intriguing question, and the 10(b) suit itself, were mooted by a tender offer from a conglomerate to purchase all the shares of all stockholders for cash in an amount more than double the market price.

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2. O'NEAL.

3. *Id.* at v.

4. *E.g., id.* §§ 3.02, 3.04, 3.09, 3.10, 3.12.

5. 15 U.S.C. § 78j(b) (1970).

6. 17 C.F.R. § 240.10b-5 (1975).

7. *Britt v. Cyril Bath Co.*, 417 F.2d 433 (6th Cir. 1969).

8. *See* Securities and Exchange Act of 1934, 15 U.S.C. § 78l(g)(1)(B) (1970).

9. Professor O'Neal has not overlooked this device. *See* O'NEAL § 5.32.

The decision to make the offer to everyone, instead of merely buying Mr. Bath's control block (at a premium) and continuing the squeeze, may well have been motivated by the company's legal troubles. At any rate, the remaining minority stockholders (except for a few of the student donees who decided to frame their certificates as souvenirs) got out with more or less whole skins, and some of them with a profit. I strongly suspect that Mr. Bath got a long-term and lucrative employment contract, and thus did rather better than the public investors, but it would have been hard to show that such a contract amounted to a concealed premium and harder to persuade a court that he was not entitled to a premium for control.<sup>10</sup> The moral of the tale is, I suppose, that I would probably have caught on quicker if Professor O'Neal's book had been available at the time.

Usually, however, the squeeze-out problem arises in the close corporation—*i.e.* a corporation with no "public" stockholders.<sup>11</sup> (The recent tendency of some publicly held corporations to "go private" poses a special variety of the problem.<sup>12</sup>) There is no generally accepted definition of "close," beyond the very general one that the number of stockholders is fairly small. (The business itself may be very large, like the Ford Motor Company, the A & P, or Campbell Soup, before they went public.) Delaware, which is among the increasing number of states which make special statutory provision for close corporations (a development for which Professor O'Neal deserves much of the credit), sets the maximum at thirty,<sup>13</sup> and the new California Code sets the maximum at ten,<sup>14</sup> as does Subchapter S of the Internal Revenue Code,<sup>15</sup> which gives such corporations the option of being taxed as partnerships—*i.e.* the corporation itself pays no income tax, but its

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10. *See id.* §§ 4.04-.05.

11. *See generally id.* §§ 1.01, 9.07.

12. *See generally* Note, *Going Private*, 84 YALE L.J. 903 (1975). Typically, a close corporation makes a public issue at a time when stock prices are high. Thereafter the market price of the stock declines to a level below its intrinsic value—not necessarily because of the controlling stockholders' manipulations—and the corporation makes a tender offer in cash or debentures, at a price somewhat above the current market. The public shareholders are under considerable pressure to tender their stock, because if most of the fellows tender, the stock will be delisted and may become hard to sell, even over the counter. Professor O'Neal seems to share the view of Commissioner A. A. Sommer, Jr. of the SEC that "when a corporation chooses to tap public sources of money, it makes a commitment that, absent the most compelling business justifications, management and those in control will do nothing to interfere with the liquidity of the public investment or the protection afforded the public by the federal securities laws." O'NEAL § 5.32, at 364.

13. DEL. CODE ANN. tit. 8, § 342(a)(1) (1974).

14. Ch. 682, § 158, [1975] Cal. Laws 1800, 1805.

15. INT. REV. CODE OF 1954, §§ 1371-79.

income is taxed currently to the stockholders, in proportion to their holdings. (Subchapter S may set the stage for a peculiarly painful squeezing, in which the victim is compelled to pay tax on income which the controlling stockholders, who typically draw substantial salaries from the corporation, refuse to distribute as dividends.<sup>16</sup>)

As a rough generalization, a close corporation is one in which all the stockholders know each other by sight and, more often than not, are related by blood or marriage. It is notorious that no feuds are so venomous as those within families, and the close corporation is often a Petri dish for the cultivation of every known strain of human vindictiveness, greed, and chicanery. It has been said that God made the country, man made the city, and the Devil made the small town.<sup>17</sup> God has little to do with the creation of corporations, public or close, but the Devil certainly seems to take an interest in the workings of family corporations. Balzac or Trollope would have found this book a rich source of material.

Professor O'Neal very logically starts by describing the causes of squeeze-outs<sup>18</sup>—avarice, family quarrels, disagreements over business policy, lack of business talent of some stockholders and an excess of it in others: the motivations are human and therefore almost infinite. Instead of confining himself to the reported decisions of the courts, which often give a dry and uninformative version of the facts, he has made an extensive canvass of practicing lawyers, whose experiences and insights (often necessarily anonymous) give the book a special utility.<sup>19</sup> Some causes, of course, are so common as to be almost normal—certainly common enough so that advance provision can be made by the founders of the business. After two or three generations, some branches of the family will lack heirs who have the desire and capacity to participate actively in the business. But some of them may need dividends, and all of them want them. The active stockholders, who control the board of directors and hold the corporate jobs, regard their cousins and in-laws as parasites and have no incentive to put themselves into higher tax brackets by declaring dividends. Their obvious temptation is to squeeze out

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16. See O'NEAL §§ 3.04, 6.07.

17. East Anglian Daily Times, May 20, 1922 ("God made the country; man the town; the devil the little country town."); see W. COWPER, THE TASK bk. 1, at 40 (1785) ("God made the country, and man made the town."); M. VARRONIS, RERUM RUSTICARUM LIBRI TRES 113 (G. Goetz ed. 1912) ("divina natura dedit agros, ars humana aedificavit urbes").

18. O'NEAL ch.2.

19. His sources include not only lawyers and businessmen, but also Ann Landers whose column once gave very sensible business advice in a typical family business row. *Id.* § 2.11, at 32 n.3.

the inactive minority shareholders, and, when they or their heirs are ready to get out of the business, sell the stock, with the appreciation in its value being taxed at capital gains rates or (if the stock is not sold until after death) not taxed at all. (In fairness, however, the book notes that there are situations in which a minority stockholder makes himself so obnoxious, and interferes so disastrously with the conduct of the business, that his elimination is thoroughly justified, provided that he receives a fair price for his shares.)<sup>20</sup> Professor O'Neal devotes four lengthy chapters<sup>21</sup> to a catalogue and description of literally dozens of squeeze-out techniques. Some are truly fiendish, such as the amendment of the charter, permitted in some states, to make stock assessable: an assessment can compel the minority to choose between getting out and making an additional investment on which there is no hope of return.<sup>22</sup> Or the majority may dilute the interest of the minority to the vanishing point by issuing to themselves large quantities of new stock; even if the minority have a preemptive right to purchase their pro rata shares of the new issue (which is often not the case), they will have trouble raising the cash. The simplest and favorite technique is splendidly exemplified by the justly famous case of *Johnson v. Mansfield Hardwood Lumber Co.*<sup>23</sup> Two members of the family, A and B, owned fifty-six percent of the Lumber Company's stock and ran the business as President and Vice President, at generous salaries. The other stockholders were a singularly helpless lot—widows, invalids, and the like. A and B informed the other shareholders that an extensive reforestation program would preclude the payment of dividends for many years to come. A and B were not, however, insensitive to the plight of the inactive shareholders; they caused the corporation to purchase the minority shares at \$350-400, which corresponded to the book value of the assets, \$1 million. The offer was gratefully accepted. What A and B failed to mention was that they had "struck oil"<sup>24</sup> beneath the forest and

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20. See *id.* § 2.11.

21. *Id.* chs. 3-6.

22. *Id.* § 5.05, at 224-25.

23. 159 F. Supp. 104 (W.D. La. 1958), *aff'd*, 263 F.2d 748 (5th Cir.), *cert. denied*, 361 U.S. 885 (1959). It is mentioned in O'NEAL §§ 3.04-05, although its full beauty is not brought out.

24. A and B employed this metaphor in attempting to rationalize their actions to the complaining former minority shareholders. 159 F. Supp. at 117. The defendants claimed that after the squeeze-out they had discovered that the company's timberlands possessed values which were previously unsuspected. It was, they argued, as if the company had discovered oil on its property after the stock purchases. In fact, the defendants had themselves created the "oil" in anticipation of the squeeze-out by purchasing much of the company's milling requirement from outside sources. The company's timberland was left uncut, thereby greatly enhancing its future sale value. *Id.* at 111.

that they had already been offered \$5 million for their own shares. Having acquired 100 percent of the stock, they sold the assets for a price which yielded \$2,000 per share. This was too crude even for the common law, and A and B were compelled to choose between rescission and paying the minority the difference between \$350 and \$2,000 per share. The district court spoke of "fraud," "grasping greed," and "moral bankruptcy;" the Fifth Circuit, though it softened the pejoratives, affirmed.

But in all too many cases the oppressed stockholder's remedies under state law have proved inadequate.<sup>25</sup> Enforcement of the stockholder's right under state law to inspect the corporate books and records is slow, costly, and uncertain. Courts are reluctant to find that failure to declare dividends is in "bad faith" and to order a pay-out, even in cases where it is fairly obvious that a squeeze-out is in progress.<sup>26</sup> Professor O'Neal concludes that that protean remedy for maltreated investors, section 10(b) of the 1934 Act, may well be the squeezee's best chance.<sup>27</sup> In one case, a federal district court in Georgia held that the majority shareholders' utilization of a state "short merger" statute (which permits the owners of a large majority, such as eighty-five or ninety percent, of the stock to merge the company into a new corporation, all of whose stock they own, giving the minority the fair cash value of their shares rather than stock in the new company to eliminate a minority shareholder) violated section 10(b), even though there had been no deceit or nondisclosure, and the cash price was fair.<sup>28</sup> This seems to me a very questionable extension of the antifraud provisions of section 10(b), but it demonstrates that some federal courts are as ready to devise new uses of section 10(b) for the protection of stockholders in close corporations as they are to do so for the benefit of public investors.

But despite the better protection against squeeze-outs and other forms of oppression which is offered by the federal securities laws, it is probably still true that the best protection for minority stockholders of close corporations lies in preventive medicine. Professor O'Neal makes many valuable suggestions for charter and contract provisions which can save present and future minority or inactive stockholders from the varie-

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25. See, e.g., O'NEAL §§ 3.03, 3.05, 3.08 & ch. 7 *passim*.

26. See, e.g., *Gottfried v. Gottfried*, 73 N.Y.S.2d 692 (Sup. Ct. 1947); O'NEAL §§ 3.04-.05.

27. See O'NEAL § 7.09.

28. *Bryan v. Brock & Bevins Co.*, 343 F. Supp. 1062 (N.D. Ga. 1972). The Fifth Circuit affirmed, but only on the ground that Georgia law did not permit the use of the statute for the sole purpose of effecting a squeeze-out. 490 F.2d 563 (5th Cir. 1974). see O'NEAL § 7.09, at 469-70.

ties of corporate karate he has earlier described.<sup>29</sup> For example, a founder mindful of the welfare of all his descendants may create two classes of stock, leaving common stock to those who are active in the business and cumulative preferred (nonvoting, except that if no dividends are paid for X years, the preferred may elect a majority of the directors) to those who are not.<sup>30</sup> Additionally, as he has often (and with some success) done before, the author urges various statutory reforms, calculated to protect even those minority stockholders whose progenitors lacked the foresight to consult a competent lawyer.

All in all, Professor O'Neal's book is scholarly, exhaustive, and even (to the student of human rascality) entertaining. It deserves a place in the library of any lawyer whose clients include close corporations, or minority stockholders vulnerable to oppression. That is to say, most lawyers.

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29. See O'NEAL ch. 8 *passim*.

30. *Id.* § 2.03, at 16.

