The Small Corporation and the Proposed Arkansas Corporation Code

By F. Hodge O'Neal*

The type of corporation that most Arkansas lawyers deal with is the so-called "close" or "closely-held" corporation. This is a corporation with a relatively few shareholders, a corporation whose shares are not listed on an exchange or actively dealt in by brokers. This article discusses the special problems of this type of corporation and the impact the Proposed Arkansas Business Corporation Code[1] will have on those problems.

Distinctive Characteristics and Needs of Close Corporations

To understand fully the distinctive problems of the close corporation, it is necessary to examine carefully the characteristics and needs of this type of business organization. In a close corporation the shareholders usually live in the same geographical area, know each other well, and are acquainted with each other's business skills The shareholders typically are active in the business as directors and officers or as key personnel. They quite commonly think of themselves as "partners" and want the power that partners have to choose their future business associates. Employment by the corporation is often the sole or principal source of income of some or all of the shareholders. Thus, the typical shareholder in a close corporation is not simply an investor; he wants the rights of a co-owners and a voice in management and control.

As a stock in a close corporation does not have an established market, valuation of shares for estate tax and other purposes is difficult. Furthermore, a shareholder who becomes dissatisfied with the way the corporation is being managed may find that he cannot dispose of his shares and get out of the company without suffering sharp financial loss. Another characteristic of a close corporation is that tax considerations often control business policies, particularly dividend policies.

One reason why lawyers advising businessmen in a close corporation have encountered difficult problems is that legislators and judges in the past have not realized that the close corporation differs radically in its characteristics and needs from the big public-issue corporation. As a general proposition, legislatures have applied to the close corporation the same statutory rules they have applied to the public-issue corporation; similarly, the courts, in laying down rules for governing business organizations have not distinguished between the rules applicable to a corporate giant such as General

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Motors and the rules applicable to the incorporated "hot dog" stand.

Even the form books have been geared to the public-issue corporation and have not taken into account the needs of the closely-held enterprise. How does a book of corporation forms usually come into being? A teacher or an employee of a publishing company writes the law departments of large corporations, saying: "Send me your articles of incorporation, your by-laws, and other corporation documents." He then examines the documents obtained in this way and selects what he considers the best of them for inclusion in the form book. Consequently, the form book is likely to contain forms that are splendid for the large corporations for which they were drafted, but very ill-adapted to a small corporation.

If the Proposed Code is adopted, some of the close corporation problems that exist under present Arkansas law will be alleviated. Nevertheless, many problems will remain for the lawyer who is organizing a close corporation or advising businessmen who are already operating a closely-held business in the corporate form. When I say this I do not intend to criticize the Proposed Code. Under any corporation statute in this country, the lawyer is faced with complex problems in trying to set up a legal framework that will protect minority shareholders and at the same time leave sufficient flexibility in the corporate organization to meet future contingencies and to take advantage of unexpected opportunities that may arise.[2]

RESTRICTIONS ON THE TRANSFER OF SHARES AND ARRANGEMENTS FOR BUY-OUTS

Free transferability of shares—one of the normal attributes of the corporate form of business—is usually not desirable in a closely-held enterprise. The participants do not want the shares to be freely transferable. As has already been indicated, the participants want to be in a position to choose their future business associates. The participants are in constant and intimate contact. They are commonly part of a business team. One may be a chemist, one a salesman, and one an executive who manages the corporation's internal operations and its financial affairs. They want to be sure that anyone who comes into the enterprise will be congenial and will provide skills that will contribute to the success of the business. In particular, the participants may not want to find themselves in a position where they will have to accept as an associate the widow or son of a deceased shareholder. Furthermore, the participants do not want competitors to be able to buy into the corporation and gain access to corporate books.

If the participants are well-advised, they will not want a person to become a shareholder who is not going to take an active part in the business. Inactive shareholders are undesirable because their interests usually conflict with those of the active shareholders. For

[2]See generally, O'NEAL & DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUTS" IN SMALL ENTERPRISES (1961).

example, active shareholders, in order to minimize taxation, usually withdraw most of the earnings of the corporation in the form of salaries rather than dividends; on the other hand, the inactive shareholders, not being employed by the corporation, want to keep salaries low and dividends high.

Since the enactment in 1958 of Subchapter S of the Internal Revenue Code,[3] which permits close corporations meeting certain requirements to elect a tax status roughly similar to that of a partnership, there is an additional reason for placing restrictions on the transfer of shares. Among the requirements for eligibility to elect the Subchapter S status are the following: (1) the corporation must not have more than ten shareholders, and (2) the shareholders must be individuals or estates. If shares are transferred to a corporation or to a trust or if a shareholder divides up his shares and transfers them to a number of persons so as to create more than ten holders of shares in the company, the corporation loses its privilege to elect. Furthermore, even if the shares are transferred to an eligible shareholder, his consent to the continuance of the election of Subchapter S status must be obtained. Therefore, if shareholders plan to cause the corporation to elect Subchapter S status, it is wise to place restrictions on the transferability of stock in order to prevent the shares from being transferred to an ineligible holder, to a holder who will not consent, or to a number of shareholders so as to increase the total number of holders to more than ten.

There are many different kinds of restrictions that the lawyer might consider placing on the transferability of shares. Among these are the following: (1) absolute prohibitions against the transfer of shares; (2) consent restraints, *i.e.*, restrictions requiring for transfers the consent of the directors or of the other shareholders or of a designated percentage of one of those groups; (3) provisions limiting transfers to specified classes of persons; (4) "first option" provisions, *i.e.*, provisions giving the corporation or the other shareholders "first right" to buy the shares of a holder who decides to sell; (5) options empowering the corporation, its officers or directors, or the other shareholders to purchase the shares of a holder on the happening of specified events, *e.g.*, his death, incapacity, or leaving the employ of the corporation; (6) buy-out arrangements for the transfer of a deceased holder's shares to the corporation or the other shareholders at a specified price or at a price to be determined by formula; (7) provisions for the redemption ("call") of common stock at the option of the corporation or its board of directors.

Courts sustain restrictions that they characterize as "reasonable." Absolute restrictions unlimited in time on the alienability of shares have almost invariably been held invalid. Factors which courts have considered in determining whether restrictions are reasonable include the following: (1) the size of the corporation; (2) the de-

[3]INT. REV. CODE OF 1954, §§ 1371—77. [Subchapter S corporations are also discussed in Trammell, *Organizing the Corporation with an Eye to the Tax Future*, 17 ARK. L. REV. 425—(1964).

gree of restraint on the power to alienate; (3) the length of time the restriction is to remain in effect; (4) the method to be used in determining the transfer price of the shares; (5) the likelihood of the restriction's contributing to the attainment of corporate objectives; (6) the possibility that a hostile shareholder would injure the corporation; and (7) the likelihood that the restriction will promote the best interests of the enterprise as a whole.

Enough cases have now been decided to give the lawyer reasonable guidance on what kinds of restrictions will be sustained. The consent restraint is widely used in England and is unquestionably valid there. In this country, the earlier cases declared the consent restraint to be invalid as an unreasonable restriction of alienability. Some of the more recent cases have sustained such restraints.[4]

Buy-and-sell agreements and other buy-out arrangements have usually been held valid. Not only have the courts consistently held that buy-out arrangements are not testamentary,[5] but they also grant specific performance of buy-out arrangements,[6] particularly if the stock involved is stock in a closely-held corporation.

Courts in almost all jurisdictions now uphold first option provisions, at least if the provisions are of the typical type and do not contain unusual and peculiarly restrictive terms.[7] Redeemable *common* stock is valid in some jurisdictions but of questionable validity in others.[8]

The lawyer must use caution in determining whether to place the transfer restriction in the articles of incorporation, in the by-laws, in a separate shareholders' agreement, or in more than one of those documents. Careful attention must be given to the corporation statute and the case law in answering this question, because a provision in one document may have statutory case law support in a particular jurisdiction while the identical provision in another document might be of questionable validity. In any event, irrespective of where else the restrictions are placed, it is necessary in every jurisdiction to state the restrictions on the share certificates themselves or at least to note or make some reference to the restrictions on the share certificates.[9]

The Proposed Code is one of the few corporation acts in the country that contains a section on share restrictions. Section 26 of the Proposed Code reads as follows:

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[4]See, *e.g.*, Penthouse Properties, Inc. v. 1158 Fifth Avenue, Inc., 256 App. Div. 685, 11 N.Y.S.2d 417 (1st Dep't 1939) (contract required consent of corporation for transfer).

[5]See, *e.g.*, Chase Nat. Bank v. Manufacturers Trust Co., 265 App. Div. 406, 39 N.Y.S.2d 370 (1st Dep't 1943).

[6]See, *e.g.*, Johnson v. Johnson, 87 Colo. 207, 286 Pac. 109 (1930); Bohnsack v. Detroit Trust Co., 292 Mich. 167, 290 N.W. 367 (1940); Lindsay's Estate, 210 Pa. 224, 59 Atl. 1074 (1904). See also, O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE, §§ 7.10 and 7.27.

[7]See Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812 (1957).

[8]See Lewis v. H. P. Hoon & Sons, Inc., 331 Mass. 670, 121 N.E.2d 850 (1954); PROPOSED CODE §§ 16, 17.

[9]See UNIFORM STOCK TRANSFER ACT § 15, and UNIFORM COMMERCIAL CODE § 8-204 and Comment 2.

A. A corporation may provide, in respect to any of its shares which are to be issued, that the future transfer (whether *inter vivos*, by inheritance or testamentary gift), hypothecation or other disposition of such shares shall be subject to restrictions, (including purchase options) that do not unreasonably restrain alienation—which restrictions, among other things, may require a prior offering to the corporation or to one or more of its shareholders, at a fair price, before the shares may be otherwise transferred or hypothecated. The same restrictions may be placed by the corporation upon previously issued and outstanding shares but only with the consent of the holders thereof.

B. No such restrictions shall be valid unless the authority therefor is prescribed in the articles of incorporation or bylaws; and, in addition to the foregoing, such restrictions on transfer shall not be valid (except as against a person with actual notice of them) unless they are conspicuously noted on each certificate covering the shares affected by such restrictions.

C. Nothing in this section is intended to prevent the holder or holders of any or all shares of a corporation from subjecting their shares, by their own personal contract or agreement, to restrictions (including stock options) that do not unreasonably restrain alienation; but any such restrictions on transfer shall not be valid (except as against a person with actual notice of them) unless they are conspicuously noted on each certificate covering the shares affected by such restrictions.

A number of provisions of this statutory section are worthy of special attention. Note, for instance, that the statute states that a restriction may require "a prior offering to the corporation or to one or more of its shareholders, *at a fair price*, before the shares may be otherwise transferred or hypothecated." This means that fixing the transfer price at par — a common method of setting the price at which shares may be transferred under the option—may result in the first option provision's being held invalid in Arkansas. A leading New York case, *Allen v. Biltmore Tissue Corp.*,[10] held that a first option restriction is valid even though the price to be paid by the corporation exercising the option is fixed at the price the selling shareholder originally paid for his shares. Query whether this would be "a fair price" within the meaning of the Arkansas statute if the shares have appreciated markedly in value. In order to be certain that first option provisions are not declared invalid because the price at which the shares are to be transferred is unfair, some provision may have to be made for adjusting the price from time to time as the shares change in value.

Note that the Proposed Code section indicates that authority for restrictions on the transfer of shares may be put in the articles of incorporation or in the by-laws, or that restrictions may be imposed (as provided by Subparagraph C of the Code section) in a shareholders' agreement. Note too that Subparagraph B of the Proposed Code section indicates that the restrictions must be conspicuously noted on the share certificates to be effective against persons without notice of them.

The Code section makes clear that first option provisions are valid. The validity of consent restraints is subject to a great deal

[10] 2 N.Y.2d 534, 141 N.E.2d 812 (1957).

more doubt. That question is left open and will have to be decided by the courts.

In recent years most of the litigation on share restrictions has involved the interpretation of restrictions rather than the validity of restrictions. This fact indicates that lawyers are not doing a good job of drafting. The lawyer must be extremely careful to use language that is specific and unambiguous. For instance, in a first option provision, he must be careful to state exactly when the option comes into play, what events give the corporation or the other shareholders an option to buy, and when the option terminates. It is nearly always clear from a first option provision that the option to buy comes into effect when a shareholder decides to sell. But does the option apply to the following situations: a decision by one shareholder to sell to another shareholder, a decision by a shareholder to transfer his shares to a voting trust, or a decision by a person to whom the shares are transferred to transfer the shares again?

Suppose the first option provision provides that when the shareholder sells he will give the other shareholders the first option to buy. Does he have to offer the shares in proportion to their existing holdings, or must he offer the same number of shares to each of the shareholders, or must he sell the shares to the other shareholders on a first come, first served basis?

Specific answers must be given to these questions in the restrictive provision if litigation is to be avoided. The courts have repeatedly said that restrictions on the transfer of stock will be strictly construed. If the draftsman does not make himself clear, it is quite likely that the restrictions will fail to achieve their intended purpose. For instance, if a restriction provides that the corporation will have a first option to buy shares of stock in the event of "any transfer," the courts are quite likely to hold that the option is not applicable to *inter vivos* gifts, donations by will, and transfers by operation of law.

One of the most difficult decisions that the draftsman has to make is selecting a method of fixing the price at which the shares will be transferred. The price-determining arrangement should be set up in advance and included in the restrictive provision.

Perhaps the most frequently used method of setting the price is fixing it at book value. This may be an unsatisfactory way of setting the price because book value is often far different from actual value. For instance, the corporation's assets may be carried on its books at a price which has historical significance only. Actual value may be many times book value. Furthermore, good will and going concern value are usually not reflected on the books at all. At the very least, a lawyer who is going to use book value should indicate whether good will is to be included in determining the book value of shares, and if so, how the value of the good will is to be calculated.

Another method of determining the transfer price is for the parties to set the price when the restrictive agreement is made, and then from time to time, say every two years, to get together and fix a new price. The difficulty that has been found with this approach is that people forget to adjust the price; or one man, seeing that the others are getting along in years and are likely to die soon, will not agree to a change in the price to reflect appreciation. As a general proposition, therefore, the fixing of the price from time to time by the parties themselves has not proved to be a satisfactory method of determining transfer price.

Other methods for setting the transfer price are as follows: (1) fixing the price at what an outsider will offer; (2) determining the price by the capitalization of earnings; and (3) selecting appraisers to decide on the value of the shares. A method of price-fixing that seems to be growing in popularity is an arrangement pursuant to which the parties themselves set the price, adjust it themselves from time to time, and agree that if they failed at the adjustment period immediately before the transfer to agree on a modification of the price they will call in appraisers to fix the value of the shares.

OPPRESSION OF MINORITY SHAREHOLDERS AND THE SQUEEZE-OUT PROBLEM

The problem of oppression and squeeze-outs is not easy to solve. Even in a family corporation dissension is fairly common. As a matter of fact, dissension and squeeze plays occur more often in family corporations than in other close corporations.

Every year thousands of small businesses are injured by dissension among the principal owners and the squeeze play which frequently grow out of such dissension. Fights among the owners of a business almost invariably lead to poor publicity, loss of confidence by suppliers and customers, and expensive litigation. Furthermore, the economy as a whole suffers because many persons who are prospective investors in small businesses have heard about the oppression of minority shareholders and about squeeze-outs, and they are afraid to invest in a close corporation. Finally, as a result of a squeeze-play, a minority shareholder may find that he has suffered the following losses: (1) he has been deprived of any voice in the control of the corporation; (2) he has been deprived of information about company affairs and decisions being made; (3) he has been deprived of employment by the company; (4) his investment has ceased to have any value because he is not receiving either dividends or salary, and he cannot get his money out of the business or even use his interest to borrow.

The techniques that can be used to eliminate a minority shareholder from a business are almost limitless in number. Back in 1960 a study was commenced at the Duke Law School with a view to enumerating and describing the various squeeze-out techniques. In the beginning it was thought that all of the squeeze-out techniques could be discovered within a few months at most and ways worked up to avoid dissension and prevent squeeze-outs. Well, the job took about two years.[11] Businessmen and their lawyers and other advisors have been most ingenious in evolving ways of eliminating undesired business associates.

The most frequently used squeeze-out technique is simply the elimination of dividends. Sometimes the approach by the majority shareholders to the minority shareholder is a blunt approach. They simply say to him, "You might as well sell out. As long as you are in the company we're not going to declare any dividends." This is not the subtle way, this is not the wise way if you are the squeezer. Quite often the approach is more subtle—the majority say to the minority, "Our machinery is old; we've got to expand; we've got to set aside money for a rainy day we see coming; you know about the increased government regulations and red tape. We can't afford to declare dividends. If you people need money now, you'd better sell out now and invest in something else. We wish we could give you dividends, but the prospects are dim for this company for the next ten years."

Dividends are usually cut off when the "squeezee" needs money badly; and of course this squeeze play, the withholding of dividends, is accompanied by a removal of the shareholder from any employment with the company. He is also usually removed from the Board of Directors.

It quite often happens that salaries of majority shareholders in their capacities as officers are increased. Majority shareholders may feel that they are doing more of the work now that the minority is no longer helping. In any event, majority shareholders not uncommonly increase their own salaries. As a result, the majority shareholders live handsomely, and perhaps also their sisters and their cousins and their aunts who are company employees, while the minority shareholder starves.

There's a rule of law (in some states it is called the "Business Judgment Rule") under which the courts refuse to interfere in the internal affairs of a corporation as long as the directors are exercising their honest business judgment in making decisions. Judges are not businessmen. They usually are not qualified to determine whether dividends should be paid, whether a certain employee should be discharged, or what salary should be paid a particular employee. So, applying that Business Judgment Rule, the courts refuse to interfere. Also, the courts generally feel that majority shareholders should have the power to control; after all, this nation is a democracy, and the majority voice is the voice that is heard. The trouble is, in a two-man company for instance where one person owns 40 per cent of the stock and another man owns 60 per cent, democracy gets very monotonous: the same man is *always* on the short end of the vote.

Many squeeze-out techniques make use of contracts between the corporation and the majority shareholders or other companies they

[11] This study has been published by the Duke University Press, Durham, North Carolina, as O'NEAL & DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES: "SQUEEZE-OUTS" IN SMALL ENTERPRISES.

own. The majority shareholders are in control of the corporation; they are the directors or designate the directors; therefore they are in a position to cause the corporation to contract with the majority shareholders or companies owned by the majority shareholders. Of course, the majority shareholders supposedly are fiduciaries of the corporation, and a corporation may rescind a contract it enters into with controlling shareholders if the contract is unfair. But the fact remains that time and again a corporation enters into management contracts with other corporations which the majority shareholders own or contracts with majority shareholders or their companies for specified services at a designated rate; or the corporation lends money to the majority shareholders at no interest or at a low rate (incidentally, Section 47 of the Proposed Code prohibits loans by a corporation to its officers and directors); or the majority shareholders lend money to the corporation at very high rates of interest.

Now there are ways of unfairly treating minority shareholders and in some instances eliminating them through the use of fundamental corporate changes, such as charter amendments, mergers, dissolution, and so on. In the past, majority shareholders have often squeezed out a minority holder by dissolving the corporation and selling its business and assets to a new corporation which has been set up by the majority shareholders to receive those assets. It will also be possible under the Proposed Code (as it is under the corporation statutes in most states) to modify the rights of a preferred shareholder by charter amendment, to cut down on his dividend rates, for instance, and even to eliminate his accumulated but unpaid dividends.[12]

Merger has sometimes been used as a procedure to eliminate undesired shareholders. This was so in a Washington case, *Matteson v. Ziebarth.*[13] The facts of that case were as follows: The majority shareholders received an offer from an outsider who wanted to buy all the corporation's shares. The prospective purchaser was not willing to buy anything less than all of the shares. Minority shareholders would not sell their shares. The majority shareholders thereupon organized a new corporation in which they took all the common stock for themselves. They then arranged a merger, merging the old corporation into the new corporation. Under the merger, preferred stock in the new company was given to all the shareholders of the old company (both majority and minority share-

[12]See Proposed Code § 59 (broadly defining the power to amend articles of incorporation; subparagraphs (g), (j) and (k) appear to permit the corporation to alter the preferential rights of the preferred stock; a preferred stockholder is not given the right to have his stock appraised and purchased by the corporation. However, under Proposed Code § 60C preferred shareholders are entitled to vote as a class on amendments effecting their preferential rights: "The proposed amendment shall be adopted upon receiving the affirmative vote of the holders of at least two-thirds of the shares entitled to vote thereon, unless any class of shares is entitled to vote thereon as a class, in which event the proposed amendment shall be adopted upon receiving the affirmative vote of the holders of at least two-thirds of the shares of each class of shares entitled to vote thereon as a class and of the total shares entitled to vote thereon." See also Proposed Code § 61 (class voting on amendments).

[13]40 Wash. 2d 286, 242 P.2d 1025 (1952).

holders) in return for their old shares. This preferred stock was redeemable. The obvious plan of the majority shareholders was to redeem the preferred stock so that they would hold all the stock in the new company. Then they would hold all the stock in a corporation with the business of the old company and they would be in a position to sell all of its shares to the outside purchaser. The court permitted the merger. Most courts probably would not approve a merger plan of this kind, but nevertheless this case shows merger is a squeeze-out technique that majority shareholders can sometimes employ.

The holdings of minority shareholders can often be diluted by the issuance of new stock to majority shareholders at a favorable price. The new stock may be issued at a time when the minority shareholders do not have money to buy their proportionate part, or an effort may be made by majority shareholders to circumvent the minority's pre-emptive rights. Section 27 of the Proposed Code provides in part as follows:

> . . . unless otherwise provided in the articles of incorporation, there shall be no preemptive right to purchase: (a) Shares or other securities which are part of the shares or securities of the corporation authorized in the original articles of incorporation and are issued, sold or optioned within two years from the date of filing of such articles of incorporation, or (b) Shares or other securities to be issued for consideration other than money, or (c) Shares issued or to be issued to satisfy conversion rights or option rights theretofore lawfully granted by the corporation.

Note that this section permits the majority shareholder to cause the corporation to sell its shares to the majority shareholders or to their relatives without any recognition of pre-emptive rights in minority shareholders if the shares are authorized in the original articles and two years have not elapsed since the filing of the articles. Furthermore, shares can be issued in return for property other than money at any time without recognizing pre-emptive rights. Finally stock options can be given to the majority shareholders, and they could later exercise those options to obtain additional stock.

Arrangements Which Avoid Squeeze-Outs

The first step the lawyer who is setting up a new corporation should take to avoid dissension and to prevent squeeze-plays is to study the underlying causes of dissensions and squeeze-outs. Many squeeze-outs are, of course, attributable to the avarice of unscrupulous men who take advantage of trusting or less able associates. Nevertheless, squeeze-outs result less often from sheer grabs for power or profit than might be supposed. Most squeeze-out cases are characterized by basic conflicts of interest, protracted policy disagreements or other dissension, or demonstrated inability of those who are squeezed out to carry a fair share of the responsibility and effort involved in operating a business.

Nor is right always with the minority owners. Quite often they are so unco-operative and unreasonable that majority owners cannot be blamed for wanting to eliminate them from the business.

Indeed, obstreperous conduct of minority owners is sometimes an attempt on their part to compel majority owners to buy their interests at exorbitant prices.

Also, minority owners sometimes conclude that they are being squeezed when their unhappiness can with more reason be attributed to other causes. They may live far from the place where the enterprise is conducted, perhaps do not understand the business or its problems, or may not be in a position to play leading roles in its operations for any number of reasons. Real squeeze plays are sometimes hard to distinguish from cases of imagined injustices grounded in frustration or unrealistic expectations.

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

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

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

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

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

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

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

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

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

The lawyer can take a number of affirmative measures at the time a business is being organized or before friction has developed to prevent oppression and to avoid squeeze plays. The most frequently used arrangements are as follow: (1) restrictions on transfer of stock and buy-out arrangements; (2) charter or by-law provisions requiring high vote for shareholder and director action; (3) shareholders' agreements; (4) long-term employment contracts between corporation and shareholder; (5) arrangements for settling disputes.

Restrictions on the transferability of stock have already been discussed. They decrease the chances of dissension by preventing shares from getting into the hands of persons who will not be active in the enterprise. Subsequent sections of this article discuss in some detail the other arrangements for avoiding squeeze-outs.

GIVING SHAREHOLDERS A VETO OVER CORPORATE DECISIONS: HIGH VOTE REQUIREMENTS FOR SHAREHOLDERS AND DIRECTOR ACTION

Perhaps the most effective way of protecting a minority shareholder against a squeeze-out is to include in the charter a provision requiring unanimity or a high vote for shareholder and director action. Such a provision is authorized by the Proposed Code.[14]

Obviously, if a favorable vote of holders of 85 per cent of the shares outstanding is required for shareholder action, a person who holds 20 per cent of the shares is in a position to prevent shareholder approval of any resolution he finds objectionable. The shareholders elect the directors, at least in the absence of a shareholders' agreement designating the directors; and, under modern corporation statutes, shareholder approval is required for fundamental corporate acts such as charter amendment, sale of all assets, merger, consolidation, or dissolution. Thus a high vote requirement for shareholder action gives a minority shareholder a veto over the personnel of

[14] Proposed Code § 35C: "Whenever, with respect to any action to be taken by the shareholders of a corporation, the articles of incorporation require the vote or concurrence of the holders of a greater proportion of the shares, or of any class or series thereof, than required by this Act with respect to such action, the provisions of the articles of incorporation shall control." Proposed Code § 40A: "The act of a majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors, unless the act of a greater number is required by this Act or by the articles or the by-laws."

the directorate and protects him against the various squeeze-out techniques which involve fundamental corporate acts.

A high vote requirement for shareholder action alone however, does not give a veto over many management or policy actions which might be used in a squeeze-play. To protect a minority shareholder against certain types of squeeze-plays, he needs to be given a veto over action within the province of the board of directors, including the hiring and discharge of employees, changes in employees' compensation, execution of contracts, lending of money, issuance of additional corporate stock, and decisions to purchase or not to purchase shares of the company's stock under first-option arrangements. To give a minority shareholder a veto over acts of this kind, it is necessary to set up a high vote requirement for director action and to couple that high vote requirement with an arrangement which assures the minority shareholder representation on the board of directors.

A shareholder can be assured of representation on the board of directors in a number of ways. Not uncommonly when a small corporation is organized each shareholder is given membership on the initial board. If a shareholder is on the first board of directors and a high vote is required for shareholder action, he can prevent the election of a new board; in most states the old board carries over until a new board is elected and qualifies. Another way of giving a minority shareholder representation on the board is by a unanimous shareholders' agreement which designates him or his nominee as a director. A third way is to classify the shares, giving the minority shareholder all the shares of one class and providing that each class of shares will elect a designated number of directors. It is quite common now in small corporations for stock to be classified between Class A, Class B and Class C stock, with the only difference between the classes being that each class elects a different director or group of directors.

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

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

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

SHAREHOLDERS' AGREEMENTS

Undoubtedly the most frequently used device for giving protection to minority shareholders against squeeze-outs is a contract among the shareholders.[15] Perhaps one reason for the frequency with which shareholders' agreements are used is the relative ease of preparing such agreements.

Among provisions which might be included in a shareholders' agreement to help forestall squeeze-outs are the following: (1) specified shareholders or their nominees are to constitute the board of directors; (2) each shareholder is to be employed in a key position by the corporation at a specified salary; (3) salaries of officers and key employees are not to be changed except by unanimous consent of the shareholders; (4) each shareholder or specified group of shareholders is to have the power to veto some or all corporate decisions; (5) whenever the corporation's surplus exceeds a specifield sum, dividends in the amount of the excess will be paid to the shareholders; (6) a shareholder will not transfer his shares until he has first offered them to the corporation and to the other shareholders; and (7) disputes among the participants are to be submitted to arbitration for settlement. The parties might also consider including in the agreement a statement that a breach of the covenants therein will result in irreparable damage, which damage is not measurable in money, and that therefore the parties agree to injunctive relief to compel compliance.

A lawyer preparing a shareholders' agreement should study the applicable state law with great care to determine whether the provisions he wants to use are legal, and he should use caution in drafting the provisions.[16] Shareholders' agreements are challenged in court much more often than the average lawyer realizes. Nevertheless, provisions of the type listed in the preceding paragraph, to the extent that they will be given effect by the courts, set up a bulwark against some of the most common squeeze-out techniques. For example, a shareholders' agreement which assures a particular shareholder that he will be employed by the corporation at a specifiel salary and that if salaries are raised his will be increased in pro-

[15] O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE §§ 5.01-5.30 (1958); Hoban, *Voting Control Methods*, 1958 U. ILL. L. FORUM 110; Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L. J. 1040 (1950); Scott, *The Close Corporation in Contemporary Business*, 13 BUS. LAW 741, 748-752 (1958).

[16] For a detailed discussion of considerations affecting the validity of shareholders' agreements and of planning and drafting precautions that can be taken to strengthen such agreements, see O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE, ch. V (1958).

portion to those of other participants of course protects him against the other shareholders' "ganging up" on him and excluding him from company employment while they siphon off corporate earnings by high compensation to themselves. Similarly, a provision requiring payment of dividends assures a shareholder that he will get some return on his investment if the business is profitable and other participants can be prevented from draining off corporate earnings.

Long-term Employment Contracts Between Shareholder and Corporation

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

A person who is taking a minority interest can to some extent protect himself against being deprived of employment with the company by insisting on a long-term employment contract. Note that what is contemplated here is not an agreement among the shareholders but a contract between the corporation and a particular shareholder-employee.

To guard against the possibility that when the corporation grows and becomes prosperous the salaries of majority shareholders will be increased without a proportionate increase in his compensation, the minority shareholder may insist that his employment contract include, in addition to a basic salary, some provision for contingent compensation (*e.g.*, a percentage of profits) or an arrangement under which his salary will be increased in a fixed proportion with salaries of designated corporate officers. Furthermore, he might insist upon the contract including provisions for severance pay or liquidated damages in the event the corporation breaches the contract, or provisions obligating the corporation to purchase his stock or give him a life-time pension in the event it discharges him or fails to renew his contract.

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

ARRANGEMENTS FOR SETTLING DISPUTES

Often a squeeze-play can be avoided by setting up in advance, by charter or by-law provision or by shareholders' agreement, an arrangement to resolve whatever policy disagreements or other disputes arise from time to time among participants in an enterprise. Three approaches seem promising. One is an arrangement by which impartial outsiders will be brought in to manage the business until tempers have cooled or the parties have resolved their differences. Another approach is to provide in advance for the arbitration of whatever disputes arise. In jurisdictions in which agreements to arbitrate future disputes (including disputes on management and policy questions) will be enforced,[17] arbitration has great potential for settling quickly and satisfactorily many of the disputes which occur in small businesses and thus avoiding the long drawn-out dissension which leads to so many squeeze-plays.[18]

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

In a two-man company where the shares are evenly divided, the two shareholders sometimes enter into an agreement which provides that either shareholder may at any time set a price which he is willing to take for his interest in the business or to give for the other's interest and that the other will then have a specified period of time to decide whether he will buy or sell at that price. No instance has been found where an arrangement of this kind has been used in a company in which one shareholder owned more than half the stock; nevertheless, no reason is apparent why the shareholders in such a company could not use this type of buy-out. The price, instead of being stated in terms of a half-interest in the business, would have to be set at so-much-per-share. A possible objection is that the price a majority shareholder would receive for his

[17]Agreements to arbitrate future disputes do not seem to be enforceable in Arkansas. See ARK. STAT. ANN. §§ 34-501 through 34-510 (1962 Repl.) (apparently statute contemplates submission of existing controversy, not an agreement to submit *future* controversies). Section 34-502 states in part: "All controversies, which might be the subject of a suit or action, may be submitted to the decision of one or more arbitrators, or to two and their umpire . . . ." See Alexander v. Fletcher, 206 Ark. 906, 175 S.W.2d 196 (1943) (arbitration statute does not repeal the common law on the same subject).

[18]For a discussion of the potentialities of arbitration for settling disputes in close corporations and of the planning and drafting precautions that make arbitration provisions more effective and less vulnerable to attack, see O'NEAL, CLOSE CORORATIONS: LAW AND PRACTICE §§ 9.08-9.25 (1958).

majority interest, if he were to become the seller, would not reflect an added element of value for power to control the corporation. Actually, however, in a small business corporation, where the participants usually consider themselves "partners" and conduct the internal affairs of the business very much as though they were partners, there is very little reason, in a buy-out arrangement among the participants, to provide for payment of a higher price per share to the majority shareholder than to the minority shareholder. In the business bargain which persons organizing a corporation reach before it is brought into existence, they usually agree (if not expressly, then by the way shares are to be allotted) on how each of them is to participate in dividends and in assets on dissolution; if participation in assets on dissolution is to be in proportion to shareholdings, the price received by a shareholder when he sells his interest might well depend simply on the number of shares he holds, without regard to whether his holdings are sufficiently large to give control of the corporation. Of course, a shareholder with a small interest might find it difficult to raise sufficient funds to buy out the larger interest of his associate, but provision could be made for the person who buys the other's interest to have the privilege of making a relatively small down payment and of paying the balance in specified installments and at designated interest rates.