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SQUEEZING OUT MINORITY CLOSE CORPORATION SHAREHOLDERS IN NORTH DAKOTA

I. INTRODUCTION

In a large corporation where the stock is publicly held, there is no question that the majority shareholders should control the corporation. If the safeguards provided for the majority shareholders will fall back on their corporate adadequate, he has the remedy of simply selling his stock and getting out.

In a close corporation,[1] the participants probably intended at first to operate as a partnership, and later decided to incorporate only so they could have limited liability and certain tax and other advantages. Even after incorporating they often expect, as among themselves, to carry on as a partnership with all participants having a say in the management. They often disregard corporate formalities such as board of director meetings. Since the participants are in constant contact with each other in the day to day operation of the corporation there arise many disputes and often the majority shareholders will fall back on their corporate advantage of majority rule. The minority "partners" may then be out in the cold without a voice in the management of the company, perhaps without any dividends on their stock interest together with termination of their employment. The shareholder in this situation cannot withdraw his investment because there is no market for his stock.

This procedure and result is commonly termed a "squeeze-out" which may be defined as the use of the corporate control vested in the statutory majority of shareholders or the board of directors to eliminate minority shareholders

1. I O'NEAL, CLOSE CORPORATIONS: LAW AND PRACTICE 13 (1958) (hereinafter cited as O'NEAL) states that close corporations are usually characterized by: (1) substantial identity of ownership and management; (2) ownership by a small number of shareholders; (3) no general market for the stock; and (4) some limitation upon admission of shareholders.

from the enterprise, to reduce to relative insignificance their voting power or claims on corporate assets, or otherwise to deprive them of corporate income or advantages.[2]

The following discussion will point out some of the techniques used to squeeze out minority shareholders and some of the protective devices available through proper drafting.

II. METHODS USED IN SQUEEZE-OUTS

A. Withholding Dividends and Termination of Employment.

One of the most commonly used squeeze-out methods is the withholding of dividends. A minority shareholder, in financial trouble or counting on dividends as his sole means of support, will in most cases be forced to sell his interest to the majority shareholders at a price below the fair value of the interest. The majority shareholders escape the hardships of no dividends by holding corporate offices and thereby receiving large salaries.

It is very difficult for a minority shareholder to compel the directors to declare dividends, the main difficulty being the overcoming of the business judgment rule which gives the directors wide discretion in the management of the corporation.[3]

Protection could be given the minority shareholders through an agreement among the participants or a charter or by-law provision which would make the declaration of dividends mandatory in certain specified situations (perhaps when net income is a certain amount or when retained earnings reach a certain level).[4] The use of this provision could, however, prove damaging to the corporation since provisions which take away the discretion of the directors in paying dividends might endanger the company's working capital

2. II O'NEAL 105.
3. See generally on minority shareholders' power to compel dividends, Scholder, **Dividends and the Minority Stockholder in a Closely-Held Corporation,** 14 N.Y.U. Intra. L. Rev. 140 (1959); Note, 64 Harv. L. Rev. 299 (1950); Note, 10 Rutgers L. Rev. 723 (1956).
4. Shareholder agreements (if all the shareholders are parties) and charter and by-law provisions providing for mandatory dividends have been sustained in the following cases: Arizona Western Ins. Co. v. L. L. Constantin & Co., 247 F.2d 388 (3d Cir. 1957) (Charter provisions); Lydia E. Pinkham Medicine Co. v. Gove, 303 Mass. 1, 20 N.E.2d 482 (1939) (by-laws); Marlino v. West Coast Macaroni Mfg. Co., 90 Cal. App. 2d 106, 202 P.2d 748 (1949) (shareholder agreement).

position or may not allow the corporation to meet future expansion needs through the use of retained earnings.

Another squeeze-out technique commonly used in conjunction with the withholding of dividends is the termination of employment of the minority shareholder. A person acquiring a substantial minority interest in a close corporation usually plans to serve as a responsible employee on a full time basis. However, in North Dakota directors can remove an officer or employee of the company whenever in their judgment the best interests of the corporation will be served.[5] This action in conjunction with the withholding of dividends would make his investment in the corporation virtually worthless, and under these conditions it would be unlikely that he could find a buyer for his interest at a fair price.

A minority shareholder can protect himself against termination of employment by means of a long term employment contract between the shareholder and the corporation, being sure to provide that his salary will be increased in proportion to other designated officers. The validity of such a contract is uncertain in some jurisdictions[6], however, the modern trend is to recognize such a contract.[7] Even when recognized the courts would not specifically enforce an employment contract[8] and damages would not be an adequate remedy.[9]

As an added protection the employee could use in addition a shareholders' agreement, because this agreement is specifically enforceable in many jurisdictions, especially when all shareholders are parties to the agreement.[10] Also the possi-

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5. N.D. Cent. Code § 10-19-50 (1961).
6. General Paint Corp. v. Kramer, 57 F.2d 698 (10th Cir.), **cert. denied,** 287 U.S. 605 (1932); Borland v. John F. Sass Printing Co., 95 Colo. 53, 32 P.2d 827 (1934); Carney v. New York Life Ins. Co., 162 N.Y. 453, 57 N.E. 78 (1900); Annots., 135 A.L.R. 646 (1941), 35 A.L.R. 1432 (1925).
7. **E.g.,** Hansen v. Columbia Breweries, Inc., 12 Wash. 2d 554, 122 P.2d 489 (1942); Littell v. Evening Star Newspaper Co., 120 F.2d 36 (D.C. Cir. 1941). For an excellent discussion of employment contracts see I O'NEAL 333-369.
8. Schultz v. Manufacturers & Traders Trust Co., 128 F.2d 889 (8th Cir. 1942); Lyon v. Goss, 19 Cal. 2d 659, 123 P.2d 11 (1942). See WILLISTON, CONTRACTS § 1423 A (rev. ed. 1937). See also RESTATEMENT, CONTRACTS § 379 (1932).
9. N.D. Cent. Code § 10-19-50 (1961) provides that an officer can be removed by the board, but such removal shall be without prejudice to the contract rights of the person removed. This indicates that the only remedy for breach of an employment contract in North Dakota would be an action for damages. See Model Bus. Corp. Act. Annot. § 45, 4.
10. Katcher v. Ohsman, 26 N.J. Super 28, 97 A.2d 180 (1953); Clark v. Dodge, 269 N.Y. 410, 199 N.E. 641 (1939); See also Annot., 45 A.L.R.2d 799, 802 (1956) and I O'NEAL 301; See **infra** section III(A).

bility of personal liability would keep a majority shareholder from causing a breach of the employment contract.

B. Merger Or Issuance Of New Stock

In North Dakota two or more corporations can combine into a single corporation by following a prescribed procedure, even though less than all shareholders approve.[11] In exchange for their original shares the minority shareholder may be given stock of the surviving corporation with different rights and preferences[12] and commonly with a large dilution of the minority interest. North Dakota provides for the rights of dissenting shareholders in such actions by giving an option to demand the fair value of their stock.[13]

Another method commonly used to dilute the minority interest is by issuing new stock. North Dakota gives all shareholders a pre-emptive right to purchase their pro rata share of the new stock.[14] If the pre-emptive right is not given he can sue the corporation for damages,[15] enjoin the stock issue[16] or obtain an order permitting him to subscribe.[17] It should be pointed out that the pre-emptive right is subject to being withheld in the articles of incorporation[18] on unissued, treasury, or additional shares and this appears to be commonly done.[19]

Even when the pre-emptive right protection is present, the new stock issue could be timed by the majority to come when the minority was in financial trouble and would be unable to purchase their pro rata share of the new issue. As a practical matter, if the majority were acting in an oppressive manner the minority shareholders would be forced to buy their protection by investing more money in this bad situation, or as an alternative being virtually eliminated from the corpo-

11. N.D. Cent. Code §§ 10-20-01 and 10-20-03 (1961).
12. Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952) is an excellent illustration of this squeeze-out method.
13. N.D. Cent. Code § 10-20-08 (1961).
14. N.D. Cent. Code § 10-19-24 (1961).
15. Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090 (1906).
16. Electric Co. of America v. Edison Elec. Illuminating Co., 200 Pa. 516, 50 Atl. 164 (1901).
17. Hammond v. Edison Illuminating Co., 131 Mich. 79, 90 N.W. 1040 (1902).
18. N.D. Cent. Code §§ 10-19-24, 10-19-53(8) and 10-19-58(16) (1961).
19. See DODD AND BAKER, CASES AND MATERIALS ON CORPORATIONS, 928 (2d ed. 1951); Rohrlich, **Suits in Equity by Minority Stockholders as a Means of Corporate Control,** 81 U. Pa. L. Rev. 692, 702 (1933).

ration through stock dilution.[20] There is an important judicially created exception that the pre-emptive right does not apply to shares issued in exchange for property.[21]

Another method to dilute the minority interest would be to remove the minority shareholders as officers and then issue shares to the remaining officers or employees. The pre-emptive right does not apply to this stock issue if two-thirds of all shares entitled to vote approve.[22]

C. Alteration Of Voting Rights

North Dakota makes cumulative voting mandatory,[23] and also permits classification of directors for staggered terms.[24]

Cumulative voting means that each voting shareholder is entitled to votes equal to the number of his shares multiplied by the number of directors to be elected and he may then cast all these votes for a single director or distribute them among more than one candidate. Under ordinary conditions this requirement would insure the minority of representation on the board of directors. However, by staggering the terms of the directors the majority can reduce the number of directors to be elected each year and thus render cumulative voting ineffective. This classification system has been approved by most courts, stating that the constitutional provision guarantees only that cumulative voting will be available, not that it will be effective.[25]

D. Other Squeeze-out Techniques

The above discussion mentions only a few of the many squeeze-out methods. Other techniques used by majority shareholders in accomplishing a squeeze-out are the following:

The majority may drain off the corporation earnings by paying high rent for property leased from majority shareholders or by paying high salaries and bonuses to the majority shareholder-officers and perhaps their relatives; they may

20. See Bennett v. Breuil Petroleum Corp., 34 Del. Ch. 6, 99 A.2d 236 (1953).
21. Thom v. Baltimore Trust Co., 158 Md. 352, 148 Atl. 234 (1930), 39 Yale L.J. 905 (1930).
22. N.D. Cent. Code § 10-19-24 (1961).
23. N.D. Const. Art. VII § 135 and N.D. Cent. Code § 10-19-33 (1961).
24. N.D. Cent. Code § 10-19-38 (1961).
25. **E.g.,** Janney v. Philadelphia Transp. Co., 387 Pa. 282, 128 A.2d 76 (1956). **But see** Wolfson v. Avery, 6 Ill. 2d 78, 126 N.E.2d 701 (1955).

cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested;[26] they may organize a new company in which the minority will have no interest, transfer the corporation's assets or business to it, and then dissolve the old corporation; or they may transfer the business to a company incorporated in a state where climate is favorable to a squeeze-out.[27]

III. MINORITY PROTECTION ARRANGEMENTS

Participants in a close corporation can approximate the control advantages of a partnership through the use of certain minority protection arrangements.

A. Voting Agreements And Trusts

One method would be by use of the shareholders' pooling agreement. This agreement is one in which the parties vote their stock in the election of directors and in other matters as mutually agreed upon by them. Such agreements have generally not met with favor in the courts because they violate statutes requiring that the board of directors manage the corporation.[28] An 1895 North Dakota case, *Gage v. Fisher*,[29] held that a stockholders' contract by which another controlled the way in which the stockholder voted his stock was illegal and void as violative of public policy. The opinion stated that stockholders' agreements to vote stock together are not illegal, in the sense that the law regards a vote cast pursuant thereto as void or voidable, yet it might be contrary to public policy for a court of equity to decree specific performance of such a contract, especially where the sole object of the person seeking to enforce the contract was to secure control of the corporation.[30] The *Gage* case seems to indicate a

26. N.D. Cent. Code § 10-20-11 (1961) provides that a dissenting shareholder can demand the fair value of his shares where substantially all of the property and assets are being sold, when not in the usual and regular course of its business or in connection with the dissolution and liquidation of the corporation.
27. These methods and many more are discussed in O'NEAL AND DERWIN, EXPULSION OR OPPRESSION OF BUSINESS ASSOCIATES (1961).
28. N.D. Cent. Code § 10-19-36 (1961).
29. 5 N.D. 297, 65 N.W. 809 (1895).
30. The court stated in Gage v. Fisher, **supra** note 29, at 811, "But it is also true that many of these schemes to obtain the control of a corporation are conceived and carried on in a spirit inimical to the interests of the minority stockholders, and not infrequently for the purpose of so

general dislike of voting agreements and a fear that the courts might not be able to separate agreements with a proper purpose from those with improper objectives and thus might unwittingly lend their aid to dishonest litigants.[31]

A later North Dakota case[32] held that a shareholder in an unincorporated association could not validly agree to use his voting powers so as to benefit another party at the expense of the association of which he was a member.

These decisions shed uncertainty on shareholder agreements in North Dakota, certainly with respect to controlling voting of stock, although the prevailing view in most states is to uphold such agreements if formed for a proper purpose.[33]

To insure that voting agreements will be carried out without bringing an action for specific performance, the shareholders could relinquish their power to vote their own shares and confer that power in the form of an irrevocable proxy upon one or more of their group or upon some person not a party to the agreement. A proxy to be irrevocable must be coupled with an interest.[34] The "interest" which the proxy holder must have to make the proxy irrevocable is either (1) a charge, lien or some property right in the shares themselves, or (2) a security interest given to protect the proxy holder for money advanced or obligations incurred.[35]

To avoid the uncertainty of the pooling agreement, it would seem wiser to allocate control through a voting trust as provided for in North Dakota by statute.[36] A voting trust is achieved by a transfer of shares of stock to voting trustees by a group of shareholders pursuant to a trust agreement so as to vest legal title to the shares in the trustees. The trustees then vote the shares according to conditions set forth in the written trust agreement. The voting trust is legally the most effective control device outside the corporate framework, yet its disadvantages may still make it undesireable.[37]

managing the affairs of the corporation as to force them to sell their holdings at practically such a figure as the majority stockholders should dictate."

31. I O'NEAL 301.
32. Luedke v. Oleen, 72 N.D. 1, 4 N.W.2d 201 (1942).
33. I O'NEAL 242.
34. LATTIN, CORPORATIONS 321 (1959).
35. I O'NEAL 319.
36. N.D. Cent. Code § 10-19-35 (1961).
37. See I O'NEAL 312. One of the main disadvantages in North Dakota is that the duration of the trust is limited to ten years and requires that a copy of the trust agreement be deposited with the corporation, thus

B. High Voting Or Quorum Requirements

Probably the simplest and most desireable device for providing partner-like control in a close corporation is by requiring unanimity, or voting requirements so high as to approach unanimity for action by stockholders and directors. This in effect gives each minority "partner" a veto power over actions by the corporation.

High voting requirements are sanctioned by statute in North Dakota both as to action by directors[38] and stockholders.[39] However, in view of the wording of the North Dakota statute there is some doubt that a requirement of unanimity, as distinguished from a high percentage requirement, is valid.[40]

Another method of achieving veto over corporate action, whether at the director or the shareholder level, is through the use of high quorum requirements for shareholder and director meetings.[41] If high attendance is required to constitute a quorum, a shareholder or director by staying away from a meeting could prevent corporate action from being taken. To make this method effective there must be a requirement that notices of meetings state the business that is to be transacted.

To insure that high vote or high quorum requirements will not be amended by a two-thirds vote, similar high vote requirements should be provided for in the articles of incorporation for any amendment.[42]

C. Other Protection Devices

One method of assuring that all participants will have representation on the board of directors is to set up two or more classes of stock and provide that each class is to vote for and elect a specified number of the directors, however, this method will prevent any possibility of using sub-chapter

making the terms of the agreement available to all shareholders. Because the shares are transferred to the trustee the stockholder may give up certain rights of a stockholder such as examination of the corporation books.

38. N.D. Cent. Code § 10-19-41 (1961).
39. N.D. Cent. Code § 10-19-34 (1961).
40. I O'NEAL 209 and 215.
41. N.D. Cent. Code § 10-19-41 (1961).
42. N.D. Cent. Code § 10-19-59 (1961).

S, since a corporation desiring to be taxed as a partnership can have only one class of stock.[43]

Participants in a close corporation will likely wish protection against a possible transfer of stock to strangers with whom they do not care to be associated.[44] The most popular and useful device is the first-option restriction which imposes a requirement that before stock of a shareholder is transferred to an outsider an offer must first be made to sell the stock to the corporation or to the other shareholders or to both. Such a restriction may be a private agreement among the shareholders or may appear in the articles of incorporation or the by-laws. In drafting this restriction it is important to provide a method for fixing the transfer price.[45]

The most ideal protective safeguard of all is to give the minority shareholders the option to sell their shares to the corporation at any time for a determinable price. This would give the minority shareholder a market for his stock so he could withdraw his investment when the majority were acting in an oppressive manner. The main difficulty here would be to provide the corporation with a means of paying for the stock. If the corporation could not pay for the stock the minority shareholder could use the option to harass the majority.

D. Dissolution And Arbitration

The close corporation is particularly susceptible to deadlock because of the minority control arrangements which may give a minority interest greater voting power or even a veto power. If minority control devices are used there must be some provision for a deadlock situation where the shareholders or directors cannot agree and therefore management of the corporation cannot continue. There are two major remedies; dissolution and arbitration.

In North Dakota the minority would always be able to block a voluntary dissolution if certain control devices were in effect. A voluntary dissolution by consent of shareholders

43. Int. Rev. Code of 1954, § 1371(a)(4).
44. See generally, O'Neal, **Restrictions on Transfer of Stock in Closely Held Corporations: Planning and Drafting**, 65 Harv. L. Rev. 773 (1952); Cataldo, **Stock Transfer Restrictions and the Closed Corporation**, 37 Va. L. Rev. 229 (1951).
45. See II O'NEAL 37 for a discussion of price determination methods.

requires consent of all of the shareholders.[46] Voluntary dissolution by act of the corporation would give some hope for dissolution.[47] This method, however, requires that the directors pass a resolution recommending the corporation be dissolved and directing a stockholder vote. The minority could block this resolution if a high vote requirement were present for director action. If the resolution is passed there must then be an affirmative vote of two-thirds of the outstanding shares of the corporation. The minority could block this if they controlled over one-third of the outstanding shares.

North Dakota does include deadlock as a grounds for compulsory dissolution at the instance of less than a majority interest if the minority can convince the district court of its necessity.[48] Another solution for the deadlock problem would be to provide statutory authorization for the participants to make their own arrangements for dissolution because of deadlock. Two other logical solutions have been suggested, although neither has been tested in court. One is that the shareholders should contract that if for a stated time their disagreement causes corporate deadlock all shareholders will vote their shares for dissolution.[49] The other solution would be that an agreement be made among the shareholders to the effect that if the company is unable to take action by reason of the dissent of a minority interest, an option to purchase shall become operative in favor of the majority shareholders at a price prescribed in the contract.[50]

Arbitration would be a more desireable solution to the deadlock situation because it would preserve the corporate existence, would be less expensive, would be quicker and there would be less publicity. The arbitration clause can be inserted in the pre-incorporation agreement and in the certificate, with the exact procedure to be used, including a method for selecting the arbitrators, clearly specified.[51] However, North Dakota arbitration statutes seem to provide only for present

46. N.D. Cent. Code § 10-21-02 (1961).
47. N.D. Cent. Code § 10-21-03 (1961).
48. N.D. Cent. Code § 10-21-16 (1961).
49. See Israels, **The Sacred Cow of Corporate Existence— Problems of Deadlock and Dissolution,** 19 U. Chi. L. Rev. 778, 791 (1952).
50. Cary, **How Illinois Corporations May Enjoy Partnership Advantages: Planning for the Closely Held Firm,** 48 N.W. U. L. Rev. 427, 439 (1953).
51. See II O'NEAL 214-221; Sayre, **Development of Commercial Arbitration Law,** 37 Yale L.J. 595 (1928).

disputes and not future disputes.[52] This would not prove effective in a close corporation because arbitration, to be effective, must be agreed on in advance and must provide for future disputes.

IV. CONCLUSION

Undoubtedly the majority of North Dakota corporations are close corporations. For this reason it seems peculiar that North Dakota's corporation law would be drafted primarily for large publicly held corporations with no specific reference to or statute for close corporations.

If proper drafting techniques are used, however, the competent attorney can protect minority shareholders and provide a partnership type relationship in North Dakota. The greatest deficiency in the North Dakota law is that it does not provide an adequate means of arbitration or a deadlock solution short of dissolution for the close corporation.

North Carolina[53] and New York[54] have led in the field in close corporation law with special statutes for close corporations. There have been numerous law review articles advocating separate corporation statutes for the two types of corporations and the arguments set forth are very persuasive.[55]

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52. N.D. Cent. Code § 32-29-01 (1961). See Ham, **The Close Corporation Under Kentucky Law,** 50 Ky. L.J. 125, 182 (1961) where it states that language in Kentucky's arbitration statute (which is similar to North Dakota's) has generally been interpreted as applying to the submission of disputes which have already arisen. See also STURGIS, COMMERCIAL ARBITRATIONS AND AWARDS 88 (1930).

53. N.C. Gen. Stat. §§ 55-1 to 55-175 (Supp. 1955).

54. N.Y. Bus. Corp. Law (McKinney 1961). The principal section designed to liberalize the New York law in regard to close corporations is section 620.

55. Oppenheim, **The Close Corporation in California—Necessity of Separate Treatment,** 12 Hastings L.J. 227 (1961); **A Plea for Separate Statutory Treatment of the Close Corporation,** 33 N.Y.U.L. Rev. 700 (1958); Winer, **Proposing a New York "Close Corporation Law",** 28 Cornell L.Q. 313 (1943).