<u>CONFRONTING THE CORPORATE "SQUEEZE-OUT"</u>

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Minority shareholders—both those who start out that way, and those who suddenly find themselves with that status—must be aware of the recurrent tale of those who hold the controlling interest in a corporation and attempt to divest the shareholding interests of the minority, without payment of fair value and without consideration of the minority's other, continuing rights under California law. Consider the following, typical example of a corporate "squeeze-out."

Bob Caulkrin and his two co-shareholders, Marty Walsh and Pete Martin, founded and built Dynamic Supply Company (DSC), a California corporation. DSC now has more than 300 employees and is on track to achieve sales revenue this year in excess of $80 million. Caulkrin, Walsh and Martin maintained plenary control of their respective areas of operation within DSC until today, when Walsh and Martin told Caulkrin to leave.

Because Walsh and Martin together own two-thirds of the stock, they control the board of directors, leaving Caulkrin feeling as though he has no alternative to allowing them to buy him out. To exacerbate the situation, Walsh and Martin offer Caulkrin less than one-fifth of what his interest in the company is worth. Caulkrin determines there must be something he can do to remedy the situation.

<u>The Classic Squeeze-Out</u>

Caulkrin's predicament is all too common. For whatever reason—be it ego, greed, or simply a difference in business philosophies—one group of shareholders, holding the controlling, majority interest, turns on the minority shareholder or shareholders and attempts to squeeze the minority out of the corporation under threat of losing the value of the minority's interest in the business.

Typically, the "squeeze out" is effectuated in a closely held corporation in which the shareholders operate the day-to-day affairs of a business, and distribute most, if not all, of the corporation's profits through salaries and bonuses to the shareholders, who serve as the executive officers of the corporation. Once the minority shareholder's position as an executive officer (*i.e.*, employee) of the corporation is terminated, the disenfranchised minority is excluded from sharing in any of the monetary rewards generated from the business of the corporation. The control group then takes full advantage of their voting power and physical control over the corporation by continuing to receive ongoing salaries and bonuses that are, at a minimum, equal to those that predated the termination of the minority's employment. The standard philosophy adopted by the control group is that the minority will ultimately realize the futility of their dilemma and accept a buyout hugely favorable to the controlling majority.

Practical and Legal Collide

Of course, the immediate, practical reality of the classical squeeze-out is that the control group captures command of the business and assets of the corporation, without any interference from the excluded minority. The control group usually is in charge of both day-to-day affairs, through their executive officer positions, and longer-range operations, through their control of the board of directors. Hence, the minority is effectively ousted from any say in the conduct of the corporation's business and affairs. This is typically compounded by a freeze on information to the expelled minority shareholder in Caulkrin's position, as soon as that shareholder is no longer in the business on a daily basis. As a consequence, the minority shareholder is powerless to protect his or her own interests.

As a matter of law, however, the fact that the controlling majority shareholders might have *power* does not afford them the *right* to exercise that power to the detriment of the minority. In California, the controlling majority has long been recognized to owe fiduciary obligations to the minority. Under *Jones v. H. F. Ahmanson & Company* (1969) 1 Cal.3d 93, and its progeny, the controlling majority must act for the benefit of all shareholders, in accordance with their proportionate equity in the corporation.

Thus, while minority shareholders in Caulkrin's position have no effective self-help remedy, their rights and interests can be enforced through litigation.

<u>Remedies Available</u>

The most obvious of the remedies available for such breaches on the part of the controlling majority include monetary damages for breach of fiduciary duties, and permanent injunctive relief to prevent further breaches. Recovery generally can be obtained for all of the harm proven to have been sustained by reason of the control group's wrongdoing. Furthermore, since the control group acts in willful disregard of the minority's known rights, the minority should have a strong claim for punitive damages. Less obvious, but often carrying much more impact, is a claim for involuntary dissolution of the corporation. *Corporations Code*, § 1800, subd. (b) enumerates the grounds for involuntary dissolution of a California corporation. Included among those bases listed is the following:

> (4) Those in control of the corporation have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward

> any shareholders or its property is being misapplied or wasted by its directors or officers.

Under California law, an action for involuntary dissolution may be maintained by a minority shareholder or shareholders owning not less than 33⅓% of the equity of the corporation, exclusive of the shareholders guilty of wrongdoing. (*Corp. Code*, § 1800, subd. (a)(2).) For example, if Caulkrin owns only 25% of DSC's equity, he would nevertheless be entitled to bring an action for involuntary dissolution, because the remaining 75% is owned by Walsh and Martin, the perpetrators of the misconduct. That is, Caulkrin owns more than 33⅓% of the equity of DSC, excluding Walsh and Martin.

The ultimate import of the involuntary dissolution action, if successful, is that the court either orders the corporation wound up and dissolved, or, pending such order and to avoid the shut down of the corporation, the control group exercises an election to buy the minority's shares at independently appraised, fair value (*Corp. Code*, § 2000).

The Litigation

The commencement of litigation in these situations only rarely brings the control group to its senses. More typically, the control group digs in its heels and attempts to prove its prowess through actions that appear to ignore the pending claims. Sometimes, the control group will even cross-complain or commence a separate lawsuit against the minority. When this happens, the claims against the minority typically are not well-founded, and eventually are exposed to be specious, contrived, or trifling.

Often in business litigation, early settlement opportunities are created through applications for provisional or pre-trial, equitable relief, such as preliminary injunctions and receiverships. Not every case affords sufficient evidence at the outset to enable the minority to present a strong application for such relief. However, there are several pre-trial maneuvers that can have the effect of significantly restricting the control group's brazen disregard for proper corporate governance. These include (but are not necessarily limited to) forcing discovery of the corporation's ongoing financial records, compelling meetings of the board of directors, and requiring members of the control group to submit to deposition.

The key to success is assembling, as quickly as possible, the evidence necessary to prove the self-dealing of the majority. When that evidence is gathered, substantial pressure is brought to bear upon the control group as the individual members recognize a heightened possibility they will be held financially accountable. Even if that awareness is not immediate, the evidence will enable the minority to seek safeguard measures from the court (*e.g.*, a preliminary injunction or receivership), or, in some instances, summary adjudication of certain of the claims advanced.

In most cases, a good deal of effort is concentrated in the control group's attempts to avoid the minority's discovery, which will obviously provide the wherewithal to prove the control group's wrongdoing. Thus, when the court begins to enforce the minority's rights to compel discovery, the opportunity for resolution often follows.

In some cases, the control group is simply convinced that it can outspend and outlast the minority. Those cases result in a kind of war of attrition in which the majority continues to litigate, seemingly oblivious to the evidence being amassed by the minority. While this protracted litigation is certainly more costly and frustrating for the minority shareholder, the eventual result—whether by late settlement or judgment following trial—is usually enhanced because of the weight and volume of evidence the minority will have assembled, thereby diminishing the control group's earlier leverage and assumed credibility.

The Lesson

A certain arrogance necessarily accompanies the conduct of majority shareholders who believe that because of their voting power, they are entitled to control a corporation for their own interests and benefits, without regard for the rights of the minority. To maximize the effectiveness of the litigation, the action almost always should be commenced expeditiously and pursued aggressively. Such an approach takes full advantage of the overconfident approach that can be anticipated from the control group, and enhances the likelihood of an early, favorable settlement.

In the final analysis, Caulkrin was correct. Minority shareholders need not accept the loss of the value of their equity in the corporation at the whim of a controlling majority. Those shareholders have effective remedies that can, and should, be pursued.