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Shareholder 'Squeeze Out' Can Carry Serious Consequences

Frank's manufacturing business, a corporation his father had formed and of which he was the sole shareholder, had grown substantially over the prior five years. His uniquely designed widgets were flying out the door, but Frank knew that to take his business to the next level he needed to optimize his Web site and make it more interactive for his customers. Enter Sam. College-educated in marketing and computer science, Sam had just finished a two-year stint with a business consulting firm. In the first 18 months of his employment, electronic sales increased handsomely and this appeared to be just the beginning.

Flush with enthusiasm and eternally optimistic, Frank announced that Sam was being appointed vice-president of Sales, thus becoming a corporate officer. Sensing his own importance, Sam asked for more. He wanted an opportunity to buy, on an installment basis, up to 10 percent of the company, and he wanted to be a corporate director. Frank obliged.

However, as a shareholder, board member and officer, Sam's attitude began to change. He became more insistent about his views and began to meddle in manufacturing operations and personnel matters. Frank was furious. First, he fired Sam, ending his role as an employee. He changed the locks to ensure that Sam had no access to the office. Although the corporation had traditionally made quarterly distributions to shareholders, that practice stopped immediately after Sam was fired. When Sam asked for information on the financial performance of the company, Frank initially ignored him, and then gave him only general information about sales and earnings. Finally, in a move that was not justified by any increased job responsibilities, Frank tripled his own salary. Enraged, Sam retaliated by temporarily disabling the company's Web site, disrupting hundreds of transactions. Then, at the annual shareholders' meeting, four months after his firing, Sam was voted out as a director.

This type of shareholder "squeeze out" and resulting retaliation happens far more frequently than one might expect. There are vast numbers of court decisions detailing the tactics used by one shareholder against another and the effort by judges to determine what duties each actor owes to the other. Generally, both sides have acted badly.

Frank may have been completely justified in firing Sam, but ending Sam's employment does not impair his rights as a minority shareholder. As a controlling shareholder (having a majority of the voting shares), Frank has a fiduciary obligation to the corporation and to minority shareholders such as Sam. That obligation requires that Frank conduct himself with an eye toward Sam's interests as a shareholder. If he feels that Sam's involvement is harmful to the company, he can certainly end that involvement, but in doing so he cannot deprive Sam of the anticipated rewards of shareholder status.

Quite simply, a concerted effort to "squeeze out" a minority shareholder by depriving him or her of information and other reasonable benefits of share ownership can cause serious consequences for the controlling shareholder. As noted by the United States Federal District Court in deciding a case originating in Erie,

> "[A]ny attempt to 'squeeze out' a minority shareholder must be viewed as a breach of ... fiduciary duty. The reasons for excluding an obstreperous shareholder may often appear compelling to the majority, and the conduct which eventually leads to a 'squeeze out' may not have been undertaken with such intent. Yet such conduct is injurious when the result is the exclusion of minority shareholders without adequate recompense and it is particularly harmful when carried out with malevolence or indifference. The law recognizes a right to recovery under such circumstances."

Orchard v. Covelli, 590 F. Supp 1548, 1557 (W.D. Pa. 1984).

Should he seek relief in the courts, it is likely that Sam would find the judge sympathetic to his cause. In such cases, judges have wide discretion in shaping a remedy that will accomplish equity, such as money damages or a forced buyout of Sam's ownership interest by Frank or the company.

But Frank and the company are not without their own counter-arguments. Sam's action in disrupting the company Web site is wrong no matter what his status may be as a shareholder or employee. The fact that he was still a director of the company makes his conduct even more egregious. As long as Sam holds a position of director, he must conduct himself with the interests of the corporation in mind. There is little doubt that a judge's view of Sam's case would be affected by Sam's damaging conduct, i.e. his lack of "clean hands."

Ultimately, scenarios such as this are best avoided by carefully considering the need to transfer stock ownership to an employee. However, if such a transfer of stock is deemed necessary, it is essential to devise (in writing) a fair and efficient way to unwind the relationship if it sours.

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