A Pound of Cure: Remedies for Minority Shareholders Without an Exit Strategy

By Ladd Hirsch and Jason Fulton

In most states, it is relatively easy to start a new business, and people who start private companies generally want to keep things simple. State statutes help by requiring minimal paperwork, minimal capital requirements, and little red tape. But how to handle the departure of one or more owners who desire to exit the business—one of the key long-term issues for any company—is often overlooked when a new company is formed, particularly when it is started by a group of friends or family. Unfortunately, there is no requirement that people forming a new business decide at the time of formation how to deal with the financial issues that arise when a minority shareholder wants to leave the business and be cashed out.

This article considers what remedies *may* be available to minority shareholders who want to cash out of the business but who did not secure a redemption agreement or any other contractual buyout right, either at the time of their investment or prior to their decision to cash out. Minority shareholders in this position may find that no remedy of any kind is available or, at best, that the available remedies are limited to some type of equitable relief depending on the ability to establish that the majority shareholders engaged in improper, oppressive conduct.

The Closely Held Corporation

Large public corporations dominate the financial news, but the private, closely held company is the business form of choice for many new businesses. While investors in large public corporations are typically passive investors who have no role of any kind in the business, in closely held corporations the investors are often active participants who serve as directors, officers, and employees. While investors in large public companies can sell their shares at any time and for any reason in the public market, investors in closely held companies lack a ready market for their shares. As a result, shareholders in private, closely held corporations often find that it is much easier to get into (and become an owner of) the business than it is to get out of it (and sell their minority, noncontrolling interest).

In many, if not most, instances, the owners of closely held companies do not enter into shareholder agreements or redemption provisions that ensure that minority interest owners can monetize or liquidate their ownership interest in the business. Indeed, one of the important negatives associated with ownership of a minority interest in a closely held company is the lack of a defined exit process for minority shareholders.

Another complexity and potential problem area for a closely held corporation is that the typical rule of majority control still applies. Shareholders elect the board of directors, thereby giving the majority shareholder the ability to control the board. The board, in turn, selects the officers and decides the officers' compensation and whether the company should declare any dividends or distributions to its owners. Using the power of the board of directors, a majority shareholder can deny a minority shareholder the right to participate in the business and the right to receive financial benefits from the business. In most cases, the successful functioning of a closely held corporation depends on the relationship of trust between the shareholders. When trust ends, problems follow.

The Business Tort of Minority Shareholder Oppression

When a majority shareholder uses the power of his or her controlling interest to deny a minority shareholder the right to participate in, or enjoy financial returns from, the closely held company, the minority shareholder may file a lawsuit claiming shareholder oppression. This claim is based in tort, but there is no one set of definitive actions that give rise to the claim. Instead, the minority shareholder must establish that the majority shareholder engaged in oppressive actions of the following types (and this is not an exhaustive list):

- terminating the minority shareholder's employment;
- removing the minority shareholder from the board of directors;
- removing the minority shareholder from management;
- refusing to declare dividends when the company is profitable;
- denying the minority shareholder access to information;
- siphoning off earnings to the majority shareholder through de facto dividends or excessive compensation;
- entering into favorable contracts with affiliates of the majority shareholder;
- engaging in recapitalizations or mergers designed to reduce or eliminate the minority shareholder's interest;

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- usurping corporate opportunities;
- using corporate assets for personal benefit;
- making loans to family members.

A typical pattern of behavior by the majority shareholder that fits this tort, often referred to as a "squeeze-out" or "freeze-out," includes terminating the minority shareholder's employment, removing the minority shareholder from the board of directors or from management, refusing to provide financial information, and refusing to declare dividends or declaring de facto dividends where the majority shareholder takes a disproportionate share of profits, and the pattern culminates in an offer from the majority shareholder to buy the minority shareholder's interest at an unfairly low price. Through this scheme, the majority shareholder effectively freezes the minority shareholder out of the business, leaving the minority shareholder with no benefit from his or her ownership in the entity and no recourse other than to file a lawsuit alleging shareholder oppression.

Liability for Oppressive Conduct under Statutes and Case Law

Most states provide a cause of action for shareholder oppression, which is typically based on rights granted to shareholders in a corporate dissolution statute or on theories of a fiduciary duty that exists between shareholders. For example, Texas, California, and New York all allow shareholders to sue for dissolution of the corporation when the majority shareholder has engaged in oppression or other bad conduct.[1] What constitutes "oppression" is usually a function of the case law in a particular state.

For example, courts in Delaware, New York, and Texas have examined allegations of oppression under two common-law theories:

- [O]ppression should be deemed to arise only when the majority's conduct substantially defeats the expectations that objectively viewed were both reasonable under the circumstances and were central to the minority shareholder's decision to join the venture.
- [Oppressive conduct refers to] burdensome, harsh and wrongful conduct, a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members, or a visible departure from the standards of fair dealing and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.[2]

By contrast, California follows a statutory approach to each of the two common-law alternatives. Section 1800(b)(4) of the California Corporate Code permits a shareholder in a closely held corporation, or any shareholder group owning more than one-third of the shares of a corporation that is not closely held, to file suit for dissolution if those in control have engaged in "persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders."[3] Because this right is available to shareholders in all corporations, California law does not consider the minority shareholder's expectations in applying this section and focuses only on the conduct of the majority.[4] However, Section 1800 (b)(5) of the California Corporate Code focuses on the minority shareholder's interests and expectations. It gives a minority shareholder in a closely held corporation the right to seek dissolution if "reasonably necessary for the protection of the rights or interests of the complaining shareholder or shareholders."[5]

The wide variety of factual circumstances giving rise to a claim and the variations in the legal standard make it difficult to predict whether a particular court in a particular state will find oppression under a given set of circumstances. Minority shareholders tend to have more success by showing that the majority has engaged in many oppressive acts. But even when the shareholder can show oppressive actions, obtaining the right remedy can be an equal challenge.

Remedies for Shareholder Oppression

The most common statutory remedy for shareholder oppression is dissolution of the corporation. But many courts resist dissolving a profitable corporation. Instead, they have invoked their equitable powers to permit them to respond broadly to shareholder oppression claims—holding that if they are empowered to enact the harsh remedy of dissolution, then they are also empowered to order other, less drastic equitable remedies.[6] Using their equitable powers, courts state that they will tailor the remedy to fit the specific factual situation presented in a particular case.[7]

Given the harshness of the dissolution remedy and the reluctance of courts to apply it, a far more common remedy for shareholder oppression is a court-ordered buyout of the minority shareholder's interest by the majority shareholder(s). Courts order buyouts under their general equitable powers as a remedy that is less harsh than dissolution and also pursuant to specific statutory schemes authorizing buyouts. For example, courts in Alaska, Iowa, Minnesota, New Jersey, New Mexico, New York, Oregon, and Texas, among others, have all ordered a corporation or majority shareholder to buy out a minority shareholder's interest.[8]

Issues Regarding the Buyout Remedy

A central issue in any buyout case is the standard of value to be applied. Should the shares be valued at "fair value" or "fair market value"?[9] Public company data are more readily available to valuation experts, and these experts generate valuations of private closely held companies using data from comparable public companies.[10] Private companies and public companies have important differences, however, and valuation experts and courts have therefore developed techniques to adjust for those differences.

The fair market value is "the price at which property would

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REMEDIES OTHER THAN BUYOUTS AVAILABLE TO MINORITY SHAREHOLDERS

There are many potential remedies available to minority shareholders other than dissolutions and buyouts, although these two options are the most common. Some states seek to encourage the creative judicial resolution of shareholder oppression claims by codifying equitable options. For example, South Carolina's statute includes nine separate equitable options other than a buyout or dissolution.[i] Illinois's statute identifies 11 alternatives.[ii] California law simply instructs its courts to do equity.[iii] In states lacking specific statutory authority, courts have nonetheless picked up the mantle of equitable creativity in addressing shareholder oppression.

The list of other potential remedies for shareholder oppression includes at least the following:

- altering or setting aside an action of the corporation, its shareholders, or directors;
- cancelling a provision in the articles of incorporation or bylaws;
- ordering payment of dividends;
- appointing a custodian to manage the business;
- appointing provisional directors;
- appointing an individual to be an officer or director;
- removing a director or officer from office;
- ordering an accounting;
- awarding damages;
- reinstating the minority as an employee;
- requiring repayment of sums wrongly siphoned from the corporation;
- limiting the salary of the majority or defining certain amounts of compensation as a constructive dividend;
- ordering issued stock to be cancelled or redeemed;
- permitting the minority to purchase additional shares.[iv]

Endnotes

i. S.C. Code § 33-18-410 (West 2010).

ii. 805 Ill. Comp. Stat. 5/12.56 (West 2010).

iii. Cal. Corp. Code § 1804 (West 2010) ("After hearing the court may decree a winding up and dissolution of the corporation if cause therefore is shown or, with or without winding up and dissolution, may make such orders and decrees and issue such injunctions in the case as justice and equity require.").

iv. *See, e.g.*, Brodie v. Jordan, 857 N.E.2d 1076, 1082 (Mass. 2006) (discussing prospective injunctive relief to allow minority to participate in the business, including reinstatement of employment and/or back pay); Hirsch v. Cahn Elec. Co., 694 So. 2d 636, 643 (La. Ct. App. 1997) (ordering return of $200,000 in excessive compensation and payment of a dividend); Brenner v. Berkowitz, 634 A.2d 1019, 1033 (N.J. 1993) (discussing alternatives to dissolution); Balvik v. Sylvester, 411 N.W.2d 383, 388–89 (N.D. 1987) (same); Masinter v. Webco Co., 262 S.E.2d 433, 441 & n.12 (W. Va. 1980) (same); Baker v. Commercial Body Builders, Inc., 507 P.2d 387, 395–96 (Or. 1973) (same); *see also* 805 Ill. Comp. Stat. 5/12.56 (West 2010); S.C. Code § 33-18-410 (West 2010); Model Statutory Close Corporation Supplement (1993).

change hands between a willing buyer and a willing seller when neither party is under an obligation to act."[11] A fair market value will usually discount a minority interest in a close corporation for lack of marketability and lack of control.[12] The discount for lack of control simply reflects a reduction in price for the inability to control the corporation's actions because the buyer is buying less than a controlling interest in the company. But many courts refuse to include a lack-of-control discount in a buyout valuation because it would "deprive minority shareholders of their proportionate interest in a going concern"[13] and would undermine the remedial goal of protecting "minority shareholders from being forced to sell at unfair values imposed by those dominating the corporation while allowing the majority to proceed with its desired corporate action."[14]

The discount for lack of marketability, however, is more debatable, and courts will consider adjusting the valuation to reflect the fact that close corporation shares lack liquidity.[15] While majority shareholders argue in favor of applying discounts and using a fair market value standard to determine the value of the minority shareholder's interest, minority shareholders seek buyouts at fair value, a valuation that includes no discounts and in which the minority shareholder receives a full, proportionate share of the entire enterprise value based on the percentage of ownership.[16]

As an alternative to a court-imposed equitable award, some states offer the majority shareholder the option to buy the minority owner's shares as an alternative to dissolution. For example, California permits the corporation or the shareholder with more than a 50 percent ownership interest to avoid dissolution by buying the dissenters' stock for "fair value." If the parties cannot agree on a fair value, the court can order evidence submitted to a panel of three disinterested appraisers selected by the court. The court enters a decree based on its review of and affirmation of the valuation of the appraisers. The decree gives the corporation, or, if it declines, the majority shareholder, the right to avoid dissolution by purchasing the minority's shares for the price stated in the decree.[17]

Conclusion

The fact patterns that give rise to claims for shareholder oppression are as limitless as the human capacity for greed and fraud. Fortunately, the judicial system has responded

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with equal creativity. Recognizing the limited protections for minority shareholders in a typical corporation under majority rule, legislatures and courts have developed flexible remedies that are designed to address the problems unique to each case. Whether representing majority or minority shareholders, attorneys would do well to think creatively about a resolution that will effectively preserve maximum value for their clients and take advantage of the tools available to them. ■

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Endnotes

1. Tex. Bus. Orgs. Code §§ 11.404(a)(1)(C), 11.405 (West 2008), Cal. Corp. Code § 1800(a) and (b) (West 2010), N.Y. Bus. Corp. Law § 1104-a(a)(1) (West 2010).

2. Davis v. Sheerin, 754 S.W.2d 375, 377–80 (Tex. App.–Houston [1st Dist.] 1988) (writ denied); Gimpel v. Bolstein, 477 N.Y.S.2d 1014, 1017–18 (N.Y. Sup. Ct. 1984); Litle v. Waters, No. 12155, 1992 WL 25758, at *7–8 (Del. Ch. Feb. 11, 1992). *See also In re* Kemp & Beatley, Inc., 473 N.E.2d 1173, 1179 (N.Y. 1984).

3. Cal. Corp. Code § 1800 (b)(4) (West 2010).

4. Bauer v. Bauer, 46 Cal. App. 4th 1106, 1113 (Cal. Ct. App. 1996).

5. Cal. Corp. Code § 1800 (b)(5) (West 2010).

6. *See* Shirmer v. Bear, 672 N.E.2d 1171, 1176 (Ill. 1996) (affirming remedy of a buyout in a freeze-out and noting that in addition to a buyout, the court possessed many other equitable powers); Brenner v. Berkowitz, 634 A.2d 1019, 1033 (N.J. 1993) (finding the power to dissolve necessarily includes less drastic remedies); *Davis*, 754 S.W.2d at 380 (same); *In re Kemp & Beatley*, 473 N.E.2d at 1179 (a court has other remedies but can still order dissolution).

7. *Davis*, 754 S.W.2d at 380.

8. Alaska Plastics, Inc. v. Coppock, 621 P.2d 270, 275 (Alaska 1980); Sauer v. Moffitt, 363 N.W.2d 269, 275 (Iowa Ct. App. 1984); Pooley v. Mankato Iron & Metal, Inc., 513 N.W.2d 834, 836 (Minn. Ct. App. 1994); McCauley v. Tom McCauley & Son, Inc., 104 N.M. 523, 537 (N.M. Ct. App. 1986); Lund v. Krass Snow & Schmutter, P.C., N.Y.S.2d, 2009 N.Y. slip op. 03996, 2009 WL 1406312 (N.Y. App. Div. 1st Dep't, May 21, 2009) (affirming trial court judgment ordering a buyout of the minority shareholder, plus post-judgment interest); Delaney v. Georgia-Pacific Corp., 278 Or. 305, 325 (Or. 1977); *Davis*, 754 S.W.2d at 380 (affirming trial court buyout order).

9. *See* Douglas K. Moll, *Shareholder Oppression and "Fair Value": Of Discounts, Dates, and Dastartdly Deeds in the Close Corporation*, 54 Duke L.J. 293 (Nov. 2004); Balsamides v. Protameen Chems., Inc., 734 A.2d 721, 734–35 (N.J. 1999).

10. *See generally* Shannon P. Pratt, Valuing a Business: The Analysis and Appraisal of Closely Held Companies 261–309 (5th ed. 2008) (outlining valuation methodologies for closely held companies by comparison to public companies).

11. Pueblo Bancorporation v. Lindoe, Inc., 63 P.3d 353, 362 (Colo. 2003).

12. *See* Pratt, *supra* note 10, at 397–459; Douglas K. Moll & Robert A. Ragazzo, The Law of Closely Held Corporations § 8.02[B][3] (2009).

13. *In re* Friedman, 661 N.E.2d 972, 976–77 (N.Y. 1995).

14. *Id. See also Balsamides*, 734 A.2d at 734–35.

15. *Pueblo Bancorporation*, 63 P.3d at 357 n.2; Advanced Commc'n Design, Inc. v. Follett, 615 N.W.2d 285, 291 (Minn. 2000).

16. *See* Moll, *Shareholder Oppression and "Fair Value," supra* note 9.

17. Cal. Corp. Code § 2000 (West 2010).

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