"Do You Really Want a Partner? Suggestions to Avoid Litigation and Improve Inter-Owner Harmony Upon Selling Minority Interests in a Business"

by Fredric D. Tannenbaum[1]
Partner, Gould & Ratner
Chicago, Illinois

Introduction

Many private business owners sell (or grant options to sell) small minority ownership interests in their business to employees, investors, family members, friends or others. The majority owner selling these minority interests may be motivated by many reasons, a few of which are: the desire to obtain new capital, incentivize, reward or put "golden handcuffs" on employees, strive for family harmony, obtain estate planning goals, and reap the emotional feeling of power or largesse. The majority owner's goals, while certainly well intended and understandable, often focus only on these positive aspects, but seldom factor in the countervailing concerns which will be addressed in this article. This article in no way attempts to dissuade business owners from inviting minority partners. Rather, its purpose is to assist the owner in carefully weighing the risks inherent in sharing the business' profits and losses, financial and other confidential information, and opinions regarding the future direction of the business with minority owners. While many, if not most, majority and minority owners co-exist amicably, the cases of unhappy relationships and their ultimate unwinding sometimes overshadow, and certainly receive more notoriety, than the positive examples.

This article attempts to assist a majority owner in better balancing its laudatory goals in bringing in new owners with the often painful realities which newfound responsibilities to minority owners impose. A careful weighing of all of these risks, together with a heightened sensitivity to the rights of minority shareholders, will hopefully aid the business owner to better weigh the risks and rewards, as well as the benefits and burdens of having minority partners. This heightened sensitivity will hopefully lead to the majority discharging its responsibilities with greater care and propriety which, in turn, will minimize antagonisms with the minority owners and reduce the prospects for litigation and diversion of time and energy away from the business. The principles set forth in this article apply to every form of business enterprise, whether a corporation, partnership or limited liability entity, even though some principles will be more salient in certain forms.

1. Overall Fundamental Fairness/Exercise of Fiduciary Duty. A vigilant or persistent minority owner will be entitled to scrutinize carefully every action or inaction by the majority owners. These rights exist, within reasonable limits, whether the minority owner sincerely questions the majority's conduct or is trying to use its position to frustrate or hinder the majority.

In general, minority owners may assert that the majority breached its fiduciary duty, or engaged in bad faith and unfair dealing and other contractual breaches based on various fact patterns. To support those legal conclusions, minority owners will seek to weave a tapestry of facts showing the majority regularly or systematically, or at least occasionally, favored itself over the best interests of the business or the minority. The business judgment rule will often sanitize many of the majority's actions. This rule generally states that the majority's good faith decisions regarding management issues or the overall stewardship of the entity are presumed to be valid and not actionable. However, acts of self-dealing, disloyalty or self-preference shifts the burden back to the majority to prove its "fairness". While the majority may ultimately prevail on all charges, the threat of the minority's charges, as well as the attendant time, cost, embarrassment, disclosure of sensitive information and distraction from running the business may convince a practical majority owner to settle or stop certain challenged practices.

2. Affiliate Agreements. Minority owners seeking to challenge a majority owner's conduct may be entitled to carefully scrutinize all contracts, agreements and other arrangements between the business and suppliers, customers, consultants and other businesses owned or operated by the majority. The fairness of the price, comparative quality of performance and openness of the bidding for the affiliated company's goods and services are often subject to criticism. The minority owner will have the opportunity to contest production and inter-company pricing and sales decisions involving that entity. If there are licenses or leases of equipment, or overhead charges from an affiliate to the business in which the minority has a stake, they could also be questioned. Normal business decisions such as consolidating one plant with other operations, compensation practices between one business and the affiliate, sales between or among affiliate operations involving that plant are some other examples of items which a minority owner may challenge. While most of these areas may (a) as a practical matter, be waived by the minority in the purchase or stockholder documents and (b) be condoned as normal discharge of business judgment, these factors would not prevent a minority owner from launching challenges. In other words, having a minority owner may require a majority to either avoid dealing with its affiliates or obtain a well documented record of competitive bids to develop contemporaneous evidence of arms' length and fair value of the affiliate's pricing.

3. Salaries, Bonuses. Similar to issues raised under affiliate agreements, compensation arrangements with key employees, particularly those employees who are majority owners or related to majority owners, will be subject to scrutiny on the same basis. Comparable compensation structures, either compared against industry competitors or against unrelated comparable personnel within the business would help substantiate the majority's fairness and good faith.

4. Distributions of Excess Cash vs. Reinvestment. The different priorities of majority and minority owners are magnified in the area of a privately held business. The use of excess cash flow is a frequently vexatious area of dispute between minority and majority owners. Majority owners desire the untrammeled flexibility to re-invest the free cash in the business, buy additional businesses (whether or not in the same line of business as the existing business) or make distributions to owners. While the minority may share the same business philosophies as the majority and not oppose re-investment or expansion, the minority often looks to the business as a source of cash. While the majority may have access to some of this cash through other means (such as salaries, bonuses, leases, licenses etc.), the minority will often be passive and therefore rely on regular or predictable distributions. This issue often comes to a head in pass through entities, since the owners are subject to tax on the income of the entity, yet distributions

of cash to pay those taxes may not always be forthcoming. Disputes over use of excess cash flow also arise when the minority owners are past or current employees, or are venture capital investors, and desire liquidity from their investment. Minority owners typically will, at a minimum, seek a commitment of a minimum level of cash flow from the business equal to the tax liability attributable thereto. Minority owners may further seek a sliding scale of distributions as the cash flow of the business increases. For example, a partnership agreement may stipulate that there will be minimum mandatory distributions of cash flow each year equal to the entity's net income multiplied by the highest marginal federal and specific state income tax rate. Thereafter, sale proceeds from refinancing debt or the sale of a division may be required to be distributed to all owners. Sometimes, the majority will agree to distribute 5% of the cash flow above a certain number, 10% above a higher number and so on.

5. Sale of Business and Structure Thereof. The minority owner may challenge all aspects, substantive and procedural, of the ultimate sale of the business. Besides the obvious substantive areas for challenge such as the timing (either too soon or too late), and the price and payment terms, minority owners may examine other aspects of the transaction which allegedly favor the majority. Substantive areas often challenged for their alleged mischief include (a) allocations of the sale price to non-compete and consulting and similar arrangements in favor of the majority (thereby reducing the net consideration available to the minority), (b) other post-closing arrangements between the buyer and the majority (such as leases or purchase and supply contracts) and (c) the overall tax structure and financing of the transaction. The majority, for example, may desire a tax efficient disposition (such as a tax-free merger or deferred income tax payments through promissory notes) and the minority may simply desire cash notwithstanding the attendant tax bill. The minority may further posit that the majority's desire for tax efficiency resulted in a lower purchase price and therefore breached a fiduciary duty to the minority. Further, a certain portion of the aggregate consideration paid by the third party buyer may be allocated to non-compete payments paid directly to the majority. These payments may rightfully be justified by the buyer and majority since their agreement to forego competition with the buyer was truly independent consideration. The minority might view this as a sham and a thinly veiled attempt to siphon a larger percentage of the purchase price to the majority. Finally, a minority's interest in the business is often purchased by the majority or redeemed by the entity pursuant to a buy-sell or other inter-owner agreement. In the event that the business is sold soon thereafter for a higher value, the minority will often claim that the majority committed fraud by failing to disclose the existence of a buyer. This last point is sometimes addressed with "catch-up" clauses providing for an increase in the minority's buyout price if there is a subsequent sale within a certain time period. The existence of a catch-up provision, however, will not prevent a minority from asserting fraud, but should help protect the majority since this shows that the parties contemplated and addressed the issue.

Procedural areas which are often scrutinized include the selling entity's compliance with the requisite corporate formalities, particularly notice and disclosure obligations under federal and state law. Such statutory rights include timing of notice of stockholders' meetings to approve the sale, the quality of the notice, and the formalities for exercising dissenters' rights.

6. Business Focus, Priorities. A minority owner, whether desiring to make mischief or fervently convinced of its position, is entitled to scrutinize and criticize the business priorities

and focuses of the majority. Frequent areas of dispute involve new business opportunities, geographic areas of sale, distribution practices, treatment of disappointing product lines, joint ventures or outsourcing and hiring or retaining key personnel. While the minority may be well intentioned, and even correct, their voice could delay or require changes to the implementation of the majority's agenda and foster ill feelings between the parties. While deference is typically given to the majority's discharge of their business judgment on these matters, the airing of minority grievances may unleash these frictional costs between owners. Inter-owner agreements rarely prohibit a minority from challenging a majority's decision making. Giving a minority rights to vote on certain fundamental matters, however, may actually give the minority the feeling of participation, and an ability to air its views may establish greater trust between the majority and minority blocks. This trust and dialogue, in turn, may reduce risk of litigation ad tension.

7. Dissenters' Rights on Sale. While dissenters' rights are a creature of and will vary with state law, they typically provide grounds for challenges to the fairness of the price of the sale or merger transaction. Absent a showing of fraud or other egregious abuses, dissenter rights statutes will not allow a minority owner to block a transaction, but rather to seek a higher price for its shares. From a corporate law perspective, if a minority's ownership interest exceeds a specified percentage (in many states that level is 10%), the entity's ability to "squeeze out" a minority through a cash out merger will be more cumbersome and procedurally difficult. From an accounting perspective, if dissenters' ownership interest collectively exceeds 20%, the opportunity for oftentimes critical pooling accounting treatment of the transaction may be lost by the mere exercise of such dissenters rights. Many transactions have been aborted, or been repriced, due to the resulting unavailability of pooling accounting treatment. This is especially true in the modern world where a business' fair market value often far exceeds its book value and pooling treatment is desired to avoid amortization of goodwill. The majority therefore, should be take care to assure that minority owners waive their dissenters' rights, particularly if the minority's share is close to or exceeds 20%.

8. Information Rights. Minority owners, particularly in a venture capital context, frequently seek a full panoply of rights to obtain financial and operational information regarding the business. Information disclosed could range from financial statements, budgets, notices of default, major contracts, to sale proposals. Two major implications flow from such disclosure of information. First, to the extent that "knowledge is power", a minority owner may be better equipped to ask questions, challenge entity action and cause unwanted delays and confrontation. Second, dissemination of information increases the risk that it will be disclosed to competitors or those who could otherwise use the information to the entity's detriment. Concern regarding disclosure is intensified to the extent that the minority owner is also a competitor, supplier or customer of the entity and could use the sensitive information in negotiations with the entity. While non-compete and confidentiality agreements are classic approaches to minimize this risk, the practicalities of proof of disclosure as well as "putting the disclosed information genie back in the bottle" may be difficult.

9. Participation Rights. Minority owners frequently try to expand their rights to participate in the affairs of the business in a manner disproportionate to their minority position. They may seek rights to approve fundamental transactions through super-majority thresholds for

any number of matters. These may include the right to approve a sale, major acquisitions, budgets, capital spending, borrowing, compensation, hiring and firing of key personnel, and a litany of other subjects. Minority owners may also seek rights to participate on a board or board committee, or the right to attend meetings as an observer. In some situations, typically venture capital investments or collaboration with a strong manager, minority owners receive a right to cause the business to be sold, whether in total, or through an initial public offering. Finally, to the extent that minority owners have won approval rights over some major transactions, and there ultimately occurs a deadlock, many businesses afford both sides deadlock resolving mechanisms. These may include "dynamite" rights which allow either side to offer to buy out the other, and the other must respond by either agreeing or buying out the offering party for the same price per share. While the minority may not, as a practical matter, be able to actually proceed with the purchase of the majority's interest, in many cases the minority does have the resources and inclination to do so.

10. Future Opportunity Rights. A majority owner may desire to expand the business, or buy a competing or complementary line, by forming a new entity in which the minority does not participate, and thereby exclude the minority from benefiting from this new opportunity. This raises issues such as affiliated entanglements discussed above, the loyalty of the majority to the existing business, breach of fiduciary duty and usurping corporate opportunity. The majority may have the burden of showing that the existing business was not financially capable of consummating the transaction or that the new business was not a similar one to the existing business. Even if the majority can shoulder this burden, its allocation of its time, resources and loyalty between the two businesses may then be subject to the minority's scrutiny. Conversely, minority owners may have interests in competing businesses and may not have the same fiduciary duty to offer opportunities to the business.

11. Co-Sale Rights. Minority owners may be well aware that their ownership interest in the business may be heavily discounted due to a variety of factors, including the minority position, illiquidity of the interests and restrictions on transferability. As a result, they will attempt to assure the right to sell their interests in the business at the same time, and on the same terms, as the majority. These "tag along" rights may not pose a problem for the majority owners, particularly if they are selling all of their interests. Tag along rights may impinge on the majority's flexibility, however, if (a) it desires to reap a premium for itself, at the expense of the minority, for possessing control of the business, (b) it desires to sell, or the buyer's desire to buy, only a portion of its interests and therefore the minority's tag-along rights will reduce the majority's sale proceeds accordingly or (c) certain procedural requirements in the tag-along process are not followed and thus render the sale susceptible to challenge. Conversely, if a buyer desires to purchase all ownership interests in a business, the minority's refusal may result in a blocked sale or reduced price. Majority owners should consider requiring minority owners to participate in the sale in those circumstances through so-called "drag-along" provisions. These clauses require the minority to sell their shares in the business, on the same terms and conditions as the majority's sale, if required by the third party or if the majority believes that such inclusion will enhance the prospects for the sale.

12. Redemption Rights. Minority owners often have rights to have their shares repurchased at a predetermined formula price (whether book value, multiple of earnings or cash

flow, or fair market value or some other valuation method). Obligations to repurchase the minority's interests could impact the business' free cash flow and divert resources from investment in more productive activities, or distributions to all shareholders, to recapitalization. The increased leverage inherent in repurchasing minority owners may either undermine the financial integrity or viability of the business. Further, repurchase obligations may breach covenants with lenders and sometimes violate state law restrictions against redemptions which render an entity technically insolvent.

13. Need for Additional Capital. Businesses frequently need additional capital to fund expansion or cover operating deficits. Many state statutes do not provide "pre-emptive rights" to all shareholders (i.e. the right to subscribe to a sufficient number of shares to retain the same percentage ownership. Absent such a provision in a shareholders agreement (and sometimes a corporation's charter in states where such rights are automatic expressly waives these rights), a minority owner may desire to have these rights to avoid dilution. While a majority owner may try to soothe the minority's concerns by pointing out that the minority owner will simply own a smaller piece of a bigger pie, this logic does not always prevail. The minority may also contest the purchase price per share of the new financing, particularly if the financing is below the price at which the minority purchased its shares. Even if the price is higher, the minority may still contend that the price is nonetheless a bargain. If the new round of financing takes the form of preferred stock or some debt instrument, the minority may have a field day challenging the payment terms, interest rate, covenants and other provisions of the debt or preferred instruments.

Conclusion

Given the oft times unrealistic expectations of minority business owners, the just as common short shrift given to minority owners by the majority, the boundless creativity of lawyers and the receptivity of the judicial system, the existence of minority owners can be contentious and a source of frustration for all parties. The sensitivity of the majority owners to common pitfalls in their relations with their minority partners, together with their taking reasonable precautions prior to and after offering ownership positions to minority owners can minimize litigation, improve harmonious inter-owner relations and improve the business entity's prospects for success.