PROTECTING MINORITY SHAREHOLDERS IN A CLOSELY HELD CORPORATION

A minority shareholder in a closely held business is someone who owns less than fifty percent of the outstanding shares, while the majority shareholders have a controlling stake and retain the decision-making power as to how the business is operated.

All voting shareholders have the right to participate and vote on major decisions, including the election of board members. Minority shareholders also have a right to receive dividends and the right to inspect company financial records that are relevant to the shareholder's interest. When there is a difference of opinion regarding business decisions, the imbalance of power between the majority and minority shareholders often causes tension and, consequently, minority shareholders can find themselves in a vulnerable position.

The directors and majority shareholders in a closely held business have a fiduciary duty to the company and to all shareholders, including its minority shareholders. Their duty requires them to always act in the best interests of the company and in compliance with the company's corporate governance policies, as well as applicable laws. The basic principles of corporate governance include accountability, transparency, fairness, responsibility, and risk management.

When majority shareholders act in a manner that unfairly prejudices the minority shareholders, the minority shareholder may have a claim of oppression. Examples of majority stakeholders' breaching their fiduciary duties include:

- Voting for unreasonable compensation or unfairly increasing compensation for the majority shareholders;
- Withholding dividends;
- Majority shareholders making loans to the company at high interest rates;
- Forcing sales of stock at unfavorable prices;
- Using corporate funds for the benefit of the majority;
- Withholding material information from minority shareholders; and
- Making company decisions that personally benefit the majority.

In the event that the majority shareholders breach their fiduciary duty, he or she has the right to pursue legal remedies that are available under statutory or common law.

It is critically important that anyone deciding to invest in a closely held business consider the risk of being taken advantage of by the majority shareholders before acquiring a minority shareholder position. Key questions that should be considered in order to mitigate this risk include:

- What are the corporation's stockholder voting rights? i.e. who has the right to vote?
- How are the directors and officers either elected or appointed?
- Are there restrictions on the right to participate in a competing business?
- Do you have rights to purchase new shares in the company?
- How are your shares valued?
- Does the majority shareholder(s) have a right to purchase your shares? Under what circumstances is the right triggered?
- What is the total amount of shares authorized and issued?
- What are the substantive rules regarding the operation of the business?
- Does the corporation have a Corporate Governance policy and documents?

Another important consideration is whether or not the corporation has filed an S election in that all shareholders will be responsible to pay taxes on the profit earned by the corporation even if they did not receive a distribution to pay the tax, which is known as phantom income.

Minority shareholders should protect themselves from minority shareholder oppression and other issues that arise in closely held corporations by understanding and exercising their contractual rights, addressing key issues in advance, and pursuing legal remedies to hold majority stakeholders accountable if they breach any covenants under the shareholder agreement or statutory law.

If you have questions regarding closely-held corporations or any other business legal matters, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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