

## Treatment of Minority Shareholders

This article focuses on the treatment of minority shareholders in the closely held corporate and company context. Issues such as minority shareholder oppression, minority shareholder rights and corporate responsibility to shareholders are covered. The impact of corporate bylaws for 2 shareholders and shareholder agreement on corporate shareholder meetings and board meetings is briefly addressed. The article concludes with a quick look at the minority shareholder lawsuit and the legal basis for minority shareholder litigation.

[AbdulJaami, PLLC](#): Saboor H. AbdulJaami, Esq.

### The Minority Shareholder

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A corporation that has a small number of shareholders is a “closely held” or “close” corporation. A closely held corporation’s shareholders are usually divided into two groups: (i) shareholders that have a controlling interest in the corporation; and (ii) shareholders that do not have a controlling interest in the company. The corporate shareholders that do not have a controlling interest in the company are known as “minority shareholders.”

Compared to a large-company corporate shareholder, minority shareholders have to work harder to preserve their shareholder rights. Because of the lack of a market for closely held corporate shares, shares held by minority shareholders are generally illiquid. Minority shareholders can find that their lack of corporate control is exploited for the financial benefit of majority shareholders.

#### Number of Shareholders

Closely held corporations are not defined by a set range or number of shareholders. Generally, in a situation where a corporate shareholder or corporate shareholders want to control the identity of other shareholders and keep ownership within a small group or “close,” you have a closely held corporation. Another important characteristic of the closely held corporation is that a market for the sale of company shareholder shares usually does not exist.

#### Discount on Minority Shareholder Shares

Minority shareholders often find that when they sell their shares in a closely held corporation they receive less than they expected. Often, the minority shareholder is being pressured to sell, but would rather keep their shares. Pressure may take the form of demands by the controlling shareholder(s), the forced merger or acquisition of the company, or family and economic circumstances.

Controlling shareholders generally argue that because the minority shareholder can only elect a minority of directors (if any) and cannot control the actions of the corporation, the minority shareholder should sell at a substantial discount. In fact, minority shareholder equity stakes generally sell at a 26-33% discount to market value.

Minority shareholders that do not bargain up-front for protective contractual arrangements may find that their minority interest is worth very little despite the value of the company or its assets.

## Minority Shareholder Rights

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Minority shareholder rights consist of rights that are generally available to all shareholders and rights that may be available under state close corporation laws. Corporations are governed by state law and shareholder rights are set out in the corporate statute of the company's state of incorporation. Typical rights are:

- The right to vote on the election of directors;
- The right to amend corporate bylaws;
- The right to amend articles of incorporation;
- The right to vote on major corporate events such as mergers, liquidation, or the sale of substantially all the corporation's assets;
- The right to take action through a written consent;
- The right to annual stockholder meetings;
- The right to call special stockholder meetings; and
- The right to inspect books and records and the list of shareholders.

However, minority shareholders often find that they are unable to exercise the above rights because the majority shareholder(s) control the corporation. Minority shareholders should address this issue by exercising their freedom to contractually secure greater rights than the corporate statute explicitly allows. In some states, "close corporation" statutes allow minority shareholders greater flexibility to preserve minority shareholder rights through contracts such as Buysell and Shareholder Agreements.

### Corporate Responsibility to Shareholders

Under U.S. law, shareholders are the owners of a corporation. The shareholders are entitled to elect directors who act on behalf of the shareholders. Shareholders do not control the decisions of directors. Once directors are elected, they are legally required to act on behalf of the corporation and all of the shareholders. The board of directors can manage the corporation as it chooses, despite the disapproval of the directors.

Board management of the corporation includes the appointment of officers. In many cases, the board delegates its management powers to the officers who are legally the agents of the corporation. Corporate officers' responsibility to shareholders is usually indirect since management power rests in the hands of the board.

Control of the board both through the certificate of incorporation and a board seat, and the careful drafting of corporate bylaws are the best ways of preserving corporate and corporate officer responsibility to minority shareholders.

### Corporate Bylaws for 2 Shareholders

The corporate bylaws provide for the management of the business and regulation of corporate affairs. The bylaws generally address the duties of officers, procedures governing shareholder and board meetings, access to corporate information, and similar matters.

## Saboer H. AbdulJaami

Attorney and Counselor at Law

410 Park Avenue, Suite 1530  
New York, NY 10022-4407

Tel: 1.646.435.0668  
Fax: 1.646.435.0664  
email: [sabduljaami@shajlaw.com](mailto:sabduljaami@shajlaw.com)  
web address: [www.shajlaw.com](http://www.shajlaw.com)

Closely held corporation bylaws, generally corporate bylaws for 2 or more shareholders, should pay extra attention to how each provision affects minority shareholder rights. The articles of incorporation should require that a supermajority shareholder vote is needed to amend the bylaws.

With regard to corporate bylaws for 2 shareholders, it may make sense to require that the board consist of the two shareholders and have some mechanism for tie-breaking or the input of an uninvolved third-party during major corporate decisions such as sale of the company.

### **Corporate Shareholders Meeting and Board Meetings**

State incorporation laws generally provide for an annual shareholders meeting during which the shareholders vote to elect directors. Shareholders may also have the right to call special meetings in addition to the annual shareholders meeting. Minority shareholders should be aware that state corporation law usually allows shareholders to amend the bylaws without the approval of the board, but requires board approval for amendments to the certificate of incorporation.

Similar to the annual shareholder meeting, the board typically also has an annual meeting and both meetings are conveniently scheduled for the same day. Bylaw provisions tend to govern the board meeting. Under state corporate law, significant corporate matters, such as the sale of the business, cannot be undertaken without a shareholder vote.

Minority shareholders should be aware that a closely held corporation may not follow corporate formalities. Directors generally do not have authority to act, unless assembled at a board meeting. However, the board of directors may be authorized to act using unanimous written consents in lieu of board meetings.

### **Shareholder Agreement**

Minority shareholders can get and keep some measure of control through contractual agreements. Shareholder agreements come in many forms, but typically focus on three areas:

- Voting – Shareholder voting agreements; Irrevocable proxies; Voting trusts
- Employment and Executive Control – executive Employment agreements
- Management and Governance – comprehensive Shareholder agreement

Minority shareholders should be aware that the courts may not honor an employment agreement if it prevents the board of directors from changing officers, salaries or policies, or retaining an executive, without the permission of the contracting parties.

A comprehensive shareholder agreement will usually address corporate governance, voting for significant transactions, succession in the case of the death or disability of key shareholders, annual distributions, limitations on board authority, and other subjects.

Visit our website or click to download our [Negotiating Shareholders Agreements](#) presentation.

## Minority Shareholder Oppression

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Minority shareholders may find that their investment is illiquid and their shareholder rights are being exploited. This usually happens when minority shareholders fail to protect themselves. Certificate of incorporation and bylaw amendments, along with shareholder agreements, go a long way towards preserving the value of a minority investment and reducing minority shareholder oppression.

In extreme cases of illiquidity and exploitation, the minority shareholder may request that a court involuntarily dissolve the corporation. Involuntary dissolution is a statutory remedy that the court may impose if a minority shareholder can prove "oppression."

Minority shareholder oppression refers to "conduct that substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise...A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations..." *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984)

Historically, courts have been reluctant to order involuntary dissolution and have made it tough to prove oppression. Recognizing that, some state incorporation now provide for intermediate relief such as the appointment of a custodian or provisional director.

### Corporate Board Members Shareholder Harassment

An outgrowth of minority shareholder oppression, corporate board members' shareholder harassment may also negatively impact the liquidity of a minority stake. The best way to deal with this issue is at the outset, through the corporation's certificate of incorporation and bylaws, and possibly through a shareholder agreement. After the fact remedies include seeking the help of the courts and initiating a shareholder lawsuit on the basis of minority shareholder oppression.

### Minority Shareholder Litigation

A minority shareholder may turn to litigation to alleviate the burden of exploitation and investment illiquidity. Minority shareholder litigation typically focuses either on the majority shareholder's breach of a fiduciary duty or minority shareholder oppression.

In a minority shareholder lawsuit, the court may rule that the closely held corporation is similar to a partnership and therefore shareholders owe each other a fiduciary duty similar to that owed by partners in a partnership.

Whether a minority shareholder lawsuit focuses on fiduciary duty or oppression, proving exploitation is a necessity. Exploitation generally takes the form of salaries, bonuses, "perks," and fringe benefits going to the benefit of majority shareholders while the minority shareholder gets less or none.

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**Saboor H. AbdulJaami**

Attorney and Counselor at Law

410 Park Avenue, Suite 1530  
New York, NY 10022-4407

Tel: 1.646.435.0668

Fax: 1.646.435.0664

email: [sabduljaami@shajlaw.com](mailto:sabduljaami@shajlaw.com)

web address: [www.shajlaw.com](http://www.shajlaw.com)