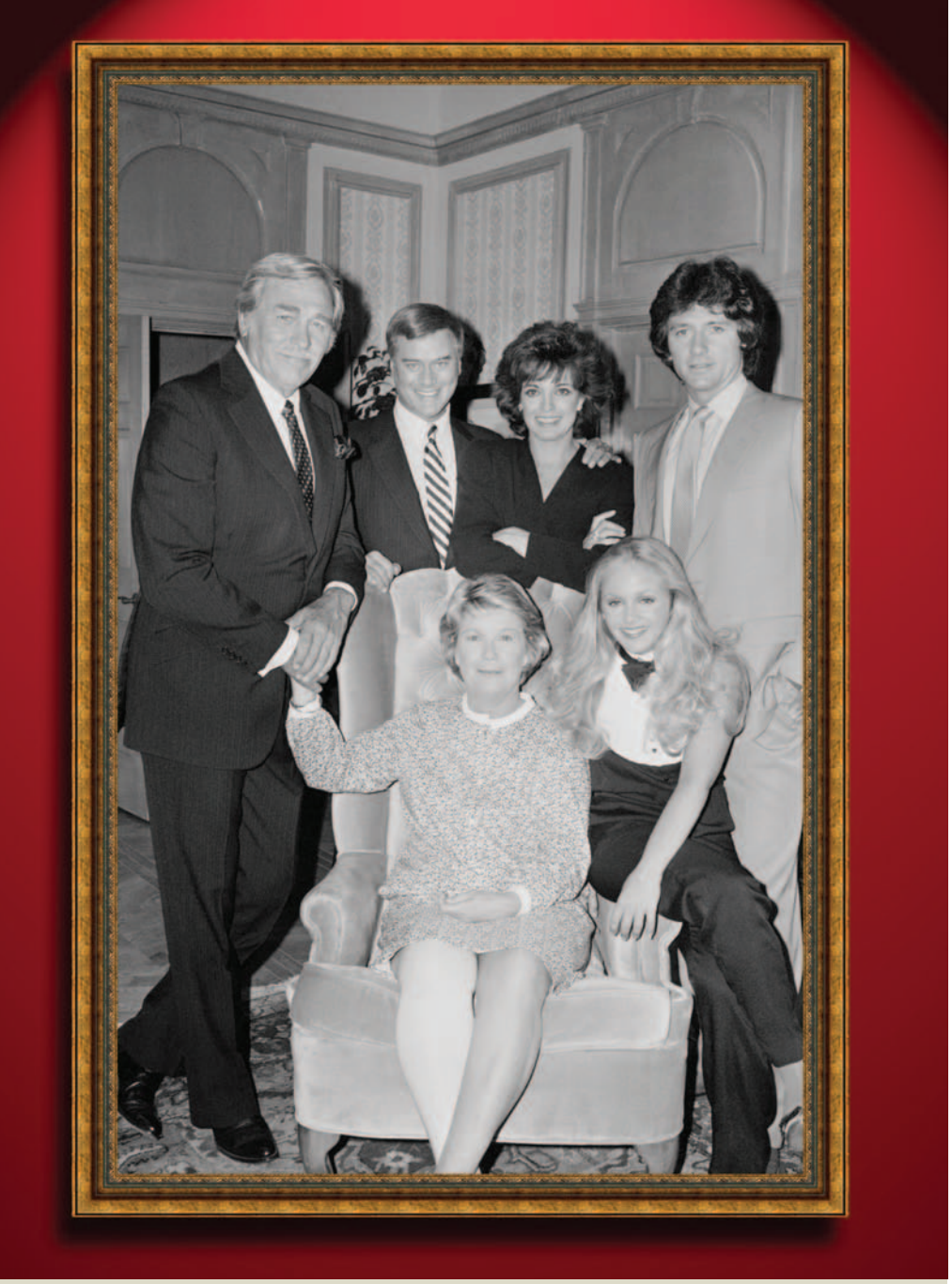

Business Succession Planning

Changing the Ground Rules

By David M. Naples

Closely held family-owned businesses constitute a significant portion of business enterprises in the United States. Perpetuating the family business is a common goal of many families. A critical issue in achieving this goal, and developing a successful transition to the next generation, is determining who will control the business—that is, who should own (or control) a majority of the corporation's voting stock. Limiting control to a single shareholder or small shareholder group is generally preferred in family businesses.

Selecting the appropriate successor, however, is not enough to assure a successful business transition. The founder must also plan for the potential conflict that inevitably will arise between family members. Conflict can significantly harm the health of the family business and, perhaps more importantly, damage family relationships. The origins of conflict are infinite. Inherent in all majority-minority shareholder relationships is the conflict that results from a majority shareholder's ability effectively to control the corporation. This is particularly so in closely held family corporations in which minority shareholders commonly have no ready market to sell their stock outside the family. Conflict can push minority shareholders to the breaking point if the majority shareholder attempts to "freeze out" a minority shareholder from management or the economic benefits of the family business. Personality clashes, the uniqueness of family relationships, differing expectations on operating the family business, and the founder's selection of the controlling shareholder all can lead to problems.

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Minority shareholders are afforded various statutory and common law rights. Absent modification in a corporation's governing documents or a shareholders' agreement, these rights operate as the ground rules that govern the relationship between the majority and minority shareholders. Unfortunately, in most cases, these rules, if unchanged, do little to reduce conflict in a family corporation or to protect minority shareholders from majority oppression. This article will provide an overview of these rules and suggestions on how to alter them to protect minority owners, increase communication among shareholders, and reduce conflict.

Shareholder Management Rights

The inherent conflict between majority-minority shareholders stems primarily from the hierarchical structure of corporations, which affords minority shareholders little say in corporate operations. Most state corporate statutes generally reflect traditional corporate theory that recognizes three distinct roles in corporate governance. Shareholders elect a board of directors. The board sets corporate policy, elects officers who manage the day-to-day operations of the corporation, and oversees management of the corporation.

Voting Rights

Although shareholders have the right to elect directors, few other corporate actions require shareholder approval. Under most state corporate statutes, shareholder approval is typically needed only for certain amendments to the corporation's articles of incorporation and bylaws, participation in a merger or other reorganization, the sale of all or substantially all of the corporation's assets outside the ordinary course of business, and voluntary dissolution. Even when shareholder approval is required, the majority shareholder generally has the power to determine the outcome. Indeed, because majority shareholders can typically elect the entire board, minority shareholders are essentially removed from participation in setting corporate policy or selecting the individuals who will run the business on a daily basis.

Rights to Act

Shareholders may take action at a duly held meeting of the shareholders and, in most states, by unanimous written consent of the shareholders.

Shareholder Meetings. All shareholders have the right to participate in shareholder meetings. Corporations must generally hold annual shareholder meetings for the purpose of electing directors and addressing other business that may come before the shareholders. Some states do not require a corporation to hold regular (or annual) meetings unless required by the articles of incorporation or bylaws, but allow shareholders holding a minimum percentage of the voting power of all the corporation's shares to demand a meeting if a regular meeting has not been held for more than a specified period. See Minn. Stat. § 302A.431. The Model Business Corporation Act (the "Model Act") contains a similar provision for close corporations (a corporation that elects this status and has 50 or fewer shareholders) and does not require an annual meeting be held unless a shareholder delivers a timely written request for the meeting. Model Act § 23. Corporations must hold special shareholder meetings if called or demanded by specified persons (for example, certain officers, one or more directors, or shareholder's holding some minimum percentage of the corporation's voting power).

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Unfortunately, most closely held corporations do not hold annual meetings. It is not uncommon for closely held corporations to go years without holding an annual meeting. Failure to hold shareholder meetings deprives a family corporation of a valuable forum for discussion and the opportunity for minority shareholders to debate, to take issue with the actions of the majority shareholders, and to make relevant inquiries about the corporation's business. Open communication, particularly in a family corporation, is critical to the success of any business. Lack of communication can lead to misunderstanding and, in turn, mistrust and a breakdown in family relationships. Rather than simply holding an annual meeting, most family businesses would benefit from holding more frequent meetings and permitting minority shareholders the right to demand, and compel, that annual and periodic meetings be held.

Action by Written Consent. Instead of holding a shareholder meeting, many shareholders appoint directors and take other shareholder action by written consent. The Model Act and most state corporate statutes permit shareholders to act by unanimous written consent on any action required or permitted to be taken at a shareholder meeting. Model Act § 7.04. Some states go further and allow, if authorized by the articles of incorporation, the written consent to be signed by shareholders holding the requisite voting power needed if the action was taken at a shareholder meeting. See Minn. Stat. § 302A.441.

Shareholder action by written consent can be a useful and efficient means for shareholders to act, particularly when action is needed in short order and there is limited, or insufficient, time to hold a shareholder meeting. Unanimous written consents, however, prevent full and open discussion and debate and should be used only in extraordinary

situations. Authority to use non-unanimous written consents is generally not recommended for family-owned businesses because they permit a majority shareholder to take action without any input from minority shareholders and can be used as a tool to freeze out minority shareholders from management discussions.

Right to Inspect Records

Virtually all state corporate statutes grant shareholders the right to inspect certain corporate books and records on reasonable notice. The inspection right is important to allow minority shareholders to monitor actions of the majority shareholders

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and to participate effectively in shareholder meetings. In most states, however, the right to inspect records is neither absolute nor available to all corporate records. Under the Model Act, each shareholder is entitled to inspect, after giving notice, only basic corporate documents such as a corporation's articles of incorporation and bylaws (and amendments), shareholder resolutions (and written consents) for the past three years, communications to shareholders during the past three years, annual financial statements (which are required to be furnished to shareholders), names and business addresses of the current directors and officers, and board resolutions dealing with the creation of shares if shares issued under such resolutions are outstanding. Model Act § 16.02(a).

Other corporate books and records, such as excerpts of board and committee meetings, accounting records, and interim financial statements, may be inspected only for a proper purpose (described with reasonable particularity) and then only to the extent the records are connected with the purpose. Model Act § 16.02(b). Typically, a proper purpose is one reasonably related to the person's interest as a shareholder. Model Act § 16.02(b) (Official Comment). For example, assessing the competence of management and reviewing communications with other shareholders for various purposes such as encouraging a shareholder's approval of a specific transaction or a corporate change are relevant to a person's interest as a shareholder, but merely a disagreement with management is not.

In family corporations, it may be beneficial to alter default rules to allow shareholders greater access to corporate and accounting records to foster open communication and allow minority owners a greater opportunity to monitor majority shareholder actions. Founders should consider giving minority shareholders access to monthly or quarterly financial statements, annual budgets, periodic comparisons to budgets, and business plans.

Methods to Provide Minority Shareholders Greater Management Rights

Minority shareholders can be afforded greater participation in corporate operations by various means. How great a role minority shareholders should have in a family corporation depends on various factors and is unique to each family. These factors include (1) a minority shareholder's knowledge of the family business, (2) whether a minority shareholder is employed by the family corporation, (3) the personal relationship between the majority and minority shareholders, (4) any special business, financial, or legal skills of a minority shareholder, (5) the experience and skill of the majority shareholder, (6) whether the majority shareholder was selected by the founder, and (7) whether the founder desires to protect certain aspects of the business (to engage in a specific type of business, for example, or remain located in a specific geographic community). As a general guideline, only minority shareholders who are active in, or knowledgeable about, the family business should be granted an expansive voice in the business. Non-active minority shareholders and those not knowledgeable about the family business should usually have only limited rights to participate in management but may be granted authority to serve as a "check" on the majority shareholder's power and to protect the objectives of the founder.

Board Representation. Under normal procedures for voting for directors, majority shareholders can elect the entire board. One means to provide minority shareholders a greater voice in the family corporation is to grant them a right to appoint one or more directors to act as a "watchdog." There are various means to provide minority shareholders board representation, including cumulative voting, multiple classes of stock, voting agreements, or shareholder agreements. The benefits of minority board representation will depend, in part, on the corporation holding regular and periodic directors' meetings. It is at the directors' meetings that the minority shareholder appointee is afforded an opportunity to discuss and debate corporate policy. Therefore, if minority board representation is desired, it should be coupled with a requirement for quarterly or more frequent board meetings. Furthermore, the board should act by unanimous written consent only when necessary. Non-unanimous written consent, even if permitted under the state corporate statutes, should not be used because it can be used as a tool for the majority-shareholder-dominated board to freeze out the minority shareholder appointee.

- *Cumulative Voting*. Cumulative

voting, an alternative to normal voting for directors, is generally a poor method to grant minority shareholders representation on the board. Under the Model Act and most state corporate statutes, it is permitted only if the corporation explicitly "opts in." Model Act § 7.28. Under cumulative voting, each shareholder is typically permitted to cast a total number of votes equal to the number of shares owned multiplied by the number of directors to be elected. Minority shareholders can aggregate their votes to elect a single director or distribute them among two or more candidates. But the number of shares it takes to ensure that minority shareholders may appoint a director depends on a complex formula that takes into account various factors including the number of voting shares present and the number of board seats open for election. Changing the number of outstanding shares or the number of directors of the board changes the minimum number of shares required to elect one director. Moreover, shareholders may be required to give timely notice of their intent to vote cumulatively and cumulate their votes in the correct manner or it will fail.

- *Agreements and Multiple Classes of Stock*. A more precise method to provide minority shareholders board representation is through the use of (1) multiple classes of stock, which grant each class the right to appoint a specific number of directors, or (2) a shareholder agreement or voting agreement. Most state corporate statutes and the Model Act allow shareholders to predetermine the desired board composition. See Model Act § 7.32.
- *Number of Directors to Appoint*. Founders typically desire minority shareholders to appoint a particular portion of the board. To protect the desired board composition, the number of directors comprising the board should be set and limitations should be placed on the majority shareholder from increasing the number of directors and reducing the minority's representation on the board. If the number of board members is increased, the minority shareholders' appointment rights should increase as well.
- *Limitations*. Although minority board representation can increase a minority shareholder's participation in setting corporate policy, albeit indirectly, alone it does little to limit the majority shareholder's control of the corporation. The board will typically continue to be dominated by the majority shareholder, and the minority shareholder appointee will usually be unable to block the decisions of the majority shareholder appointees. If the founder desires to alter the balance of power, minority board representation should be coupled with one or more veto powers.

Veto Rights. Veto powers are a common method to provide minority shareholders a greater voice in management and to protect them from majority oppression. It serves as a "check" on the majority shareholder's power. Although veto rights may prevent a majority shareholder from taking certain actions without a minority shareholder's consent, they do not give minority shareholders a right to compel action. To achieve affirmative control, shareholders can agree in advance, typically in a shareholders' agreement, on certain corporate actions or policies. Common methods to create veto powers are (1) to increase director and/or shareholder voting requirements, (2) to require shareholder approval of board actions, and (3) to increase shareholder and/or director quorum requirements. Veto powers, however, may not be absolute and the minority shareholders may have a duty not to act arbitrarily. See, e.g., *Smith v. Atlantic Properties, Inc.*, 422 N.E.2d 798 (Mass. App. Ct. 1981).

- *Higher Voting Requirements—Supermajorities*. Under most state corporate statutes, shareholders take action by the affirmative vote of the shareholders holding a majority of the voting power present at a duly held meeting. Directors typically act by a majority present at a duly held meeting. The authority of the shareholders and directors to act can be modified to require any action to be taken by a specified percentage of all the shareholders or directors, as the case may be. The percentage should be high enough to allow a specific shareholder or a group of shareholders, or a minority shareholder board appointee, to have the ability to block actions. Because of the tendency to create deadlock, however, unanimous voting requirements are not recommended and are usually invalid.

Only minority shareholders who are active in, or knowledgeable about, the family business should be granted an expansive voice in the business.

Perhaps more important than determining the voting percentage is determining whether the supermajority vote requirement should apply to all

director or shareholder actions or only to specific transactions. The answer depends on the dynamics of the family, the objective of the supermajority requirement, and the role the founder desires the minority shareholders to have in the business. If the founder has specifically selected an individual to have control, the increased voting requirement should only apply to significant activities. This will act as a check on the majority shareholder's authority and assure that specific objectives of the founder are carried out. For example, a founder who desires the family corporation to stay in existence, remain located in a particular geographic area, or engage in a specific business may limit the veto right to actions that deviate from the given objective.

- *Board Action Subject to Shareholder Approval*. Supermajority voting requirements are not the best tool to provide minority shareholders a check on the majority shareholder's power to control the corporation. As discussed above, few corporate actions need shareholder approval. Moreover, even though a director appointed by minority shareholders may block a board action, the minority director appointee, like all directors, has a fiduciary duty to act in the best interests of the corporation and all shareholders. In other words, the director cannot act solely in the best interests of the minority shareholder. An effective way to shift power to the minority shareholders is to limit the board's authority to act on specific matters without the prior approval of some supermajority of the shareholders. For example, board actions that may require shareholder approval include any amendment to the articles of incorporation that would adversely affect rights of existing shareholders; confessing a judgment against the corporation, incurring a debt, or making a capital expenditure in excess of a specific amount; selling assets outside the ordinary course of business; participating in a merger or similar transaction; investing in another entity; transactions with employees and shareholders; or issuing stock to any person. The right to block issuance of additional shares is often needed to protect the veto powers of minority shareholders. Issuance of additional stock can dilute a minority shareholder's interest in the corporation to the extent a supermajority vote or quorum is negated. Statutory preemptive rights may also protect against dilution by granting existing shareholders the right to purchase a pro rata share of any new shares offered by the corporation. Preemptive rights, however, can be difficult to work with and only benefit minority shareholders if they have the economic means to acquire additional shares.
- *Higher Quorum Requirements*. Another means to provide minority shareholders a veto power is to increase quorum requirements for board and shareholder meetings to something greater than a majority. (Like unanimous voting requirements, unanimous quorum requirements are not recommended and are invalid in most states.) Higher quorum requirements also serve to provide greater director and shareholder participation in the decision-making process. But, because quorum requirements apply to all director's and shareholder's meetings, the appropriate percentage needed for a quorum should be carefully considered to prevent one or more of the directors or shareholders from creating deadlock.

In most states, a majority shareholder in a closely held corporation has a fiduciary duty, to the corporation and the shareholders, to act in the best interest of all shareholders.

Protecting Against Economic Freeze-out

In addition to majority shareholders' power to eliminate minority participation in management, they can freeze out minority shareholders from the economic benefits of equity ownership. There are numerous techniques to freeze out minority shareholders including failing to pay dividends, eliminating employment opportunities for minority shareholders or selectively reducing their salaries, siphoning corporate profits through excessive compensation to corporate insiders and corporate agreements and leases with the majority shareholders and their affiliates, and preferentially redeeming a majority shareholder's stock without a corresponding offer to buy out the minority shareholders on a pro rata basis.

State Law Protections Against Freeze-outs

Most states attempt to protect minority shareholders from oppression by imposing a fiduciary duty on the majority shareholder and providing shareholder dissolution rights and dissenters' (or appraisal) rights.

Fiduciary Duty of Shareholders. In most states, a majority shareholder in a closely held corporation has a fiduciary duty, to the corporation

and the shareholders, to act in the best interest of all shareholders. This generally requires the majority shareholder to exercise his power in good faith and in a manner that does not oppress or "freeze out" the minority

Most state corporate statutes contain some type of voluntary or involuntary dissolution provisions.

owners. For example, in Minnesota shareholders have a duty to act in an honest, fair, and reasonable manner. Minn. Stat. § 302A.751, subd. 3a. Breach of the shareholder duty usually gives rise to a direct action on the injured shareholder's behalf, as opposed to a derivative action on behalf of the corporation. Not all acts of self-interest by a majority shareholder constitute a freeze-out, however. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657 (Mass. 1976).

A critical factor is whether the conduct in question produces a benefit to the corporation or merely to the majority shareholder. In the latter case, the majority shareholder may need to demonstrate why the conduct was fair and reasonable. Some courts, however, have required the minority shareholder to prove the challenged transaction was not fair if it was approved by disinterested directors or the noncontrolling shareholders after full disclosure. For these reasons, it may be advisable to obtain disinterested director approval of all significant majority shareholder transactions with the corporation and actions that could freeze out minority shareholders. This is particularly true when the majority shareholder desires to terminate a minority shareholder's employment.

Compensation is often a significant component of a minority shareholder's economic benefit from stock ownership. If the termination is not coupled with a buyout of shares, many courts have found the minority shareholder excluded from the benefits of his or her investment, and, therefore, the termination oppressive. The reasonable expectations of the parties are important in determining if the termination constitutes oppression. It is not surprising, therefore, that cases have generally favored the majority shareholder when the termination is coupled with a contractual obligation to buy out the minority shareholder's shares. The courts in these cases essentially defer to the parties' reasonable expectations as contained in the agreement requiring buyout on termination. In some states, any written agreement, including employment and shareholder agreements, among shareholders or among shareholders and the corporation, is presumed to reflect the parties' reasonable expectations about its subject matter. Minn. Stat. § 302A.751, subd. 3a.

Dissolution Rights. Most state corporate statutes contain some type of voluntary or involuntary dissolution provisions. These states provide oppressed minority shareholders an exit strategy from the corporation in the absence of a contractual buyout arrangement. Under the Model Act, on petition of a shareholder, a court may dissolve a corporation if (1) the directors are in a deadlock that the shareholders cannot break and the corporation has suffered, or is threatened to suffer, irreparable injury or the corporation's affairs can no longer be conducted for the advantage of the shareholders generally; (2) the directors or those in control have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent; (3) the shareholders are deadlocked and have not been able to elect directors for two annual meetings; or (4) the corporate assets are being misapplied or wasted. Model Act § 14.30(2). Oppression is a common ground for dissolution by petition of minority shareholders

who do not have contractual exit rights. The Minnesota legislature expanded these grounds to include actions by the board or those in control that are unfairly prejudicial toward one or more shareholders in their capacity as a shareholder or director of a non-public corporation or officers and employees of a closely held corporation. Minn. Stat. § 302A.751.

Many courts have been reluctant to dissolve the corporation to remedy an oppressed minority shareholder when buyout at the fair value of the injured shareholder's shares would be an adequate remedy. Model Act § 14.34 (2000) (Official Comment). Consequently, some courts have interpreted their state dissolution statutes to include buyout as an alternative remedy. The Minnesota legislature has expanded the permissible remedies to "any equitable relief it deems just and reasonable," including buyout of the injured shareholder's shares. Minn. Stat. § 302A.751.

The Model Act takes a slightly different approach to buyouts. It creates a defensive mechanism for the corporation and other shareholders to avoid the risk of dissolution by granting the corporation and other shareholders the right to elect to purchase the petitioning shareholder's shares. Model Act § 14.34(a)–(b). If the election is timely made and the parties are unable to agree on a purchase price in 60 days, the court must determine the fair value of the shares. Model Act § 14.34(c) and (d). Unlike Minnesota and other states, under the Model Act neither the petitioning shareholder nor the court may initiate the buyout.

Dissenters' Rights. All state corporate statutes and the Model Act grant shareholders the right to dissent from specific corporate actions and to be paid the fair value for their shares. Thus, dissenters' rights (or appraisal rights) allow minority shareholders an exit if they disagree with certain decisions of the majority shareholders. Because the actions that trigger the appraisal rights vary by state, these rights provide a limited escape valve. Under the Model Act, appraisal rights are triggered by certain mergers, share exchanges, sale of all or substantially all the corporation's assets, certain amendments to the articles of incorporation affecting shareholder rights, and conversion of the corporation to a nonprofit or unincorporated entity. Model Act § 13.02(a).

Methods to Prevent Freeze-out. Although remedies are available to the oppressed minority shareholders in most states, they often require litigation. In most family corporations, litigation can significantly and permanently scar family members and eliminate any chance of healing wounds caused by the oppressive act. Instead of relying solely on state law remedies, family corporations may be better served by trying to minimize the majority shareholder's ability to freeze out the minority shareholders. Some methods to do so include:

- *Mandatory Distributions*. The corporation's governing documents can provide for mandatory distributions if the corporation's cash flow and/or earnings exceed a specified level. This is particularly useful to provide an economic return to minority shareholders not employed by the corporation. In the case of S corporations, mandatory distributions should be required to enable minority shareholders to pay income taxes attributable to their distributive share of the corporation's income. Mandatory distributions have drawbacks. They can limit a corporation's working capital and in the case of C corporations result in double taxation.
- *Employment Agreements*. Employment of a minority shareholder can be memorialized by an employment agreement that sets forth the shareholder's length of employment and compensation. To protect against the majority shareholder siphoning profits though excess compensation, a minority shareholder's employment agreement may provide for salary increases in proportion to other key employees, including the majority shareholder. Liquidated damages or severance pay may be provided in the event the minority shareholder's employment is terminated without cause.
- *Exit Strategies*. A mechanism to redeem the stock of a minority shareholder should be created. For example, minority shareholders active in the family business may have a buyout tied to termination of employment, disability, and other events. For non-active shareholders, the corporation could have a "call right" to buy out the minority shareholder's shares after a specified period, and the minority shareholder could be granted a "put right" to require the corporation to buy out its shares after a specified period.
- *Disinterested Director*. Many times a family member is inclined to act differently in front of outsiders. Having a disinterested director on the board may encourage a more business-focused approach by family board members. Moreover, the disinterested director can provide necessary objectivity and, in some cases, serve as a tiebreaking vote in the event of management or shareholder deadlock.

Conclusion

A successful business transition requires more than simply determining an appropriate successor. It requires an environment and ground rules that minimize conflict among family members and protect minority shareholders from oppression. Founders must be mindful that default corporate rules governing the relationship among shareholders do little to reduce conflict. These rules should be altered to meet the expectations of the various parties and ensure that the desired board composition or balance of power is obtained. Founders also must understand the effect these changes will have on themselves, their long-term objectives for their businesses, and the long-term relationships within their families. ■