Minority Shareholder Oppression — An Equitable Remedy for a Wrongfully Terminated Owner in a Closely Held Company

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Terminating the employment of a minority shareholder without cause may result in unintended and significant financial consequences for majority shareholders. This article will address a new equitable cause of action, minority shareholder oppression, and how to avoid claims for minority shareholder oppression through carefully drafted agreements.

A common scenario for minority shareholder oppression

Consider the following scenario. Acme Corporation has two shareholders, Snake and Slick. Each owns 50% of the company with equal voting rights. Snake and Slick approach Gullible and offer to make Gullible an equal one-third owner and manager for a capital investment of $5 million.

At the time Snake and Slick make their offer to Gullible, Acme’s earnings before interest, taxes, depreciation and amortization (EBITDA) are $3 million. Other comparable companies in Acme’s industry sell for a five times earnings (or EBITDA).

Gullible accepts the offer and Snake, Slick and Gullible sign written contracts that provide: (1) Gullible pays $5 million to Snake and Slick; (2) Snake, Slick and Gullible become equal one-third owners with the same voting and distribution rights; (3) each is employed as a manager with equal management rights, which employment can only be terminated for cause after Acme gives notice and an opportunity to cure any performance deficiencies; and (4) upon termination of employment, the departing owner must sell their shares to Acme and Acme must purchase their shares for fair market value after applying contractually-required discounts for lack of marketability and lack of control.

Three years after the agreements are signed, Acme’s earnings have doubled to $6 million, giving Acme an enterprise value of $30 million. Acme’s book value (assets minus liabilities) is $9 million at the same time.

In year three, Gullible is out of the office for considerable periods of time attending to her sick and dying mother. Neither Snake nor Slick complain about Gullible’s absences. At the end of year three, Gullible’s mother dies and Gullible apologizes to Snake and Slick for not carrying her weight, promising to rededicate herself to work in the coming year.

One week later, Snake and Slick terminate Gullible’s employment and demand that Gullible sell her shares to Acme for $4 million. Snake and Slick’s demand is based on a business valuation report that concludes that the fair market value of Gullible’s ownership interest, after applying lack of control and marketability discounts, is $4 million. Three months after Gullible is terminated, Acme doubles the salaries for both Snake and Slick.

This factual scenario raises numerous issues, including: (1) did Acme breach Gullible’s employment contract (i.e., did it have cause to terminate Gullible’s employment); (2) if Gullible was not terminated for cause, did Gullible’s termination without cause trigger the buy-back provision of the shareholder agreement; (3) if the buy-back provision of the shareholder agreement was not triggered, can Gullible require Acme, Snake or Slick to purchase her ownership interest and, if so, at what price?

The Idaho Supreme Court recently recognized the equitable claim of minority shareholder oppression

Recent decisions from the Idaho Supreme Court suggest that Gullible can require Acme, Snake or Slick to purchase her shares for one-third of Acme’s enterprise value without applying marketability or lack of control discounts (Fair Value), i.e., for $10 million (assuming the enter-
prise value is determined by using a five times EBITDA multiple. The difference between Fair Value (no discounts applied) and fair market value (discounts applied) can create a significant difference in the value of Gullible’s one-third interest. While the ultimate discounts are fact specific to the company being valued, it is not uncommon for marketability and lack of control discounts to result in a fair market value determination that is less than one-half of the Fair Value determination. For example, applying an assumed 30 percent lack of control discount and a 43 percent lack of marketability discount would reduce Gullible’s $10 million Fair Value determination to a $4 million fair market value determination.

When adopting the common law claim of minority shareholder oppression, the Idaho Supreme Court noted that this is an equitable claim that (a) requires a breach of fiduciary duty, and (b) is only available if there is no adequate alternative legal remedy, e.g., money damages for breach of contract or a statutory remedy. Thus, only if the employment agreement, shareholder agreement and the provisions of the applicable corporate code do not address this factual scenario or otherwise provide an adequate remedy can the Court fashion an equitable remedy that is appropriate in the circumstances.

Idaho’s adoption of the equitable claim for minority shareholder oppression is consistent with the trend in other states, some of which have gone so far as to incorporate a mandatory repurchase obligation for Fair Value into their corporate code.

The IBCA allows an oppressed shareholder to sue for dissolution

The dissolution provisions of the Idaho Business Corporation Act (IBCA) provide that: “The Idaho district court . . . may dissolve a corporation . . . in a proceeding by a shareholder if it is established that . . . [t]he directors or those in control of the corporation have acted or are acting in a manner that is illegal, oppressive or fraudulent, and irreparable injury to the corporation is threatened or being suffered by reason thereof.” Further, the IBCA provides that “[i]n a proceeding . . . to dissolve a corporation . . . the corporation may elect or, if it fails to elect, one (1) or more shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares.”

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— IBCA

Applying the IBCA, Gullible could file a complaint in district court to dissolve Acme based on the oppressive conduct of Snake and Slick. But in any such proceeding, she cannot force Acme, Snake or Slick to purchase her ownership interest. Rather, the IBCA gives Acme, Snake and Slick the option, but not the obligation, to purchase Gullible’s shares for fair value.

Complicating matters further, the dissolution section of the IBCA does not define “fair value.” However, the appraisal rights section of the IBCA does. “Fair value” means the value of the corporation’s shares determined: (a) Immediately before the efectua-

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Applying McCann, if Gullible can prove that Snake and Slick breached a fiduciary duty owed to Gullible and that the dissolution value of her shareholder interest is significantly less than the going concern Fair Value of her one-third interest, she can bring an equitable claim for minority shareholder oppression. Applying the facts set forth above, Gullible would argue that Snake and Slick breached their fiduciary duties by: (1) manufacturing the termination of Gullible’s employment so that Snake and Slick could purchase her shares for $4 million, at a time when the shares had a Fair Value of $10 million (using a five times EBITDA multiple); and (2) doubling their salaries without any business justification. Additionally, Gullible would argue that the dissolution value of her shareholder interest is not an adequate remedy because the liquidation value of her one-third interest is $3 million or less (one-third of Acme’s book value), while the Fair Value of her interest is $10 million (using a 5 times EBITDA multiple).

Thus, if Gullible is successful on her claim for minority shareholder oppression, she might recover $10 million for her ownership interest (i.e., the Fair Value of her interest), whereas if her employment was terminated for cause, she might only recover $4 million (i.e., the fair market value of her interest after applying the contractually-required discounts for lack of control and lack of marketability).

Minority shareholder oppression claims can be avoided

In this case, the shareholder agreement requires Gullible to sell her shares to Acme for fair market value upon the termination of her employment. The shareholder agreement does not specify whether the buyout is triggered for all terminations or just a termination for cause.

The employment agreement, on the other hand, requires cause for termination of Gullible’s employment. If the shareholder agreement applies to all terminations, Snake and Slick could terminate Gullible’s employment for no cause and, by doing so, acquire Gullible’s shares for a considerably reduced price after marketability and lack of control discounts are applied.

Alternatively, a court could: (1) determine that the shareholder agreement is ambiguous and let the factfinder decide whether the compulsory buy-out provision is triggered by a termination without cause; (2) allow Gullible to pursue a claim for breach of the implied covenant of good faith and fair dealing because Snake and Slick wrongfully deprived Gullible of her contractual rights to employment and ownership in Acme; or (3) allow Gullible to pursue a claim for minority shareholder oppression.¹⁴

Applying the Idaho Supreme Court’s holding in McCann v. McCann, Acme presumably could have avoided all of these issues by carefully drafting the shareholder agreement so that it clearly defined the purchase price in the event of a termination without cause.

Conclusion

In the end, without a carefully drafted shareholder agreement or buy-sell agreement, majority owners in a closely held company may expose themselves to the mandatory repurchase of a minority owner’s interest for Fair Value when they terminate the minority owner’s employment in an illegal, oppressive or fraudulent manner.

Endnotes

3. Id. at n.97.
4. McCann, 152 Idaho at 818-19, 275 P.3d at 833-34.
5. Id. at 819, 275 P.3d at 834.
7. IDAHO CODE § 30-29-1430(2)(b).
8. IDAHO CODE § 30-29-1434(1).
9. IDAHO CODE § 30291301(4).
10. McCann, 152 Idaho at 819, 275 P.3d at 834.
11. Id.
12. Id.

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