Overcoming the Minority Shareholder Disadvantage in the Small Business Corporation

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Occasionally, a business "asset sale" becomes a "stock sale" involving the seller receiving cash for much of the business value and retaining a non-controlling minority interest in the business corporation for the balance. *Why would a seller ever agree to sell a business under these conditions?*

Sometimes, the "asset sale" of a business becomes a "stock sale." And, sometimes that "stock sale" involves the seller retaining a minority interest in the business corporation. (We'll use the term "corporation" to refer to a C-corp, a sub-S corp, or a limited liability company, LLC. Regardless of the entity, the process and risks are similar.)

This can occur in at least two ways:

1. The purchase of a controlling interest in the selling corporation. (For example, 700 of the 1,000 outstanding shares.) These can be purchased from the selling share owner or a large enough number of shares can be purchased from the corporation itself to give the buyer controlling interest. There are tax planning and financial issues involved in either choice that need to be carefully reviewed with an experienced CPA.
2. The formation of a new corporation by the buyer which then purchases the assets of the selling corporation by conveying to the seller cash and shares (in the new corporation) so as to give the seller a minority (non-controlling) interest in the new corporation. For example, the parties agree on a $1,000,000 valuation of the business. NewCorp issues 1,000 shares. $700,000 and 300 shares are conveyed to the seller, and 700 shares are retained by the buyer.)

However it is done, the seller now owns a minority, non-controlling interest in a small business corporation with no market for those shares and no rights to any dividends or other distribution of profit. Basically, the shares are patently worthless and may remain effectively worthless for years or decades to come.

Why would a business owner ever agree to sell a business under these conditions? More qualified buyers can be attracted. Buyers may be more comfortable knowing the seller has some "skin in the game" and interest in the future success and growth of the business. The

seller may want the opportunity to participate in the anticipated increase in equity value under a new owner. The seller, in consultation with a CPA, may find some tax deferral advantage.

But still the minority interest is without any (or much) intrinsic value, short of trying to sue for a "partition" of the corporation because of demonstrable gross negligence or malfeasance by the controlling shareholder—not a very good way to preserve enterprise value.

How is this disadvantage overcome?

The answer is found in a carefully drafted shareholders agreement, in which all the shareholders and the corporation itself are parties. In this shareholders agreement, the minority shareholder is obligated to sell their shares to the majority shareholder(s) and/or the corporation, and the majority shareholder(s) and/or the corporation are obligated to buy the minority shares upon the occurrence of a "triggering event."

That triggering event can be the demand of either the minority or the majority owner, usually after a certain passage of time following the original purchase, or some other occurrence (e.g, the sale or merger of the corporation, dilution of ownership by an anticipated sale of more shares, the death, illness, or disability of one of the parties, etc.).

But at what value?

Here is the crux of the minority protection. Whether triggered by the majority or the minority or by some other event, the minority shareholder chooses from a number of pre-determined formulas the specific metric to be used in determining the corporation's value and, thus, the value of the minority percentage. Typically, four or five alternatives are set forth in the shareholders agreement, such as "most recent 'book value'," "one times gross revenue over the past 12-month period", "one and a half times revenue during the last fiscal year," "four times EBITDA during the prior four quarters," etc. However, one of the several formulas *must* be the value of the minority interest at the time of the Closing (the sale of the business) plus accrued interest at a set percentage rate. Using the "NewCorp" example at the beginning of this article, the value of the business was agreed to be $1,000,000, so the seller's minority 30% stake was worth $300,000, which would be the minimum value, plus interest from the time of Closing until the sale of the minority interest. Thereby, even if the majority owners diminish the value of the business, the minority shareholder still gets the minimum original deal.

Sometimes it would be prudent or practicable for the payout for the minority shares to be structured over a period of time and/or with a certain amount of notice for purposes of fiscal stability. (E.g., "upon 45 days advanced notice, the minority shares shall be repurchased, with payment made in 4 equal monthly installments, while the shares are held in escrow.")

Why is the corporation itself included as a party to the shareholders agreement?

Because the minority owner wants the majority shareholder(s) and the corporation itself to be jointly and severally liable for paying for the shares being bought back.

Then there's the "pass-through" that doesn't.

Another minority protection is needed in the event that the corporation is a sub-S small business corporation or an LLC. These are "pass-through" entities that pay no federal income tax directly (and usually no or little state income tax), "passing through" the tax liability to the shareholders, proportionate to their ownership. Actual distribution of the profit (or loss) is *not* required; but, nevertheless, each respective shareholder is imputed to have received that income (or loss). The controlling (majority) shareholder(s) may quite legally decide not to distribute profit at the end of the year, yet they and the minority shareholder will be liable for the tax on that income on their personal returns.

Consider the scenario where the majority shareholders reward themselves handsomely with generous salaries, deriving plenty of money out of the corporation to pay taxes on that salary and on their share of the undistributed profit. The minority shareholder, though, without a salary, still needs to pay the taxes on the profit not distributed. Depending on the size of the business, this could amount to an untenable situation requiring thousands or hundreds of thousands of dollars be spent from the minority shareholders other resources.

How is this sub-S dilemma remedied?

The shareholders agreement must contain a provision that within 60 days of the close of each fiscal year at least 50% of the profit must be distributed to all the shareholders. This will be more than sufficient to cover any possible state and federal taxes payable by the shareholders on all the income, both the distributed portion and the undistributed portion.

As in most things, the devil is in the details.

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About the Author:

With more than five decades of experience as an entrepreneurial manager, Tim Cunha has developed, purchased, and sold his own businesses in various fields, including computer hardware and software development, instrument manufacturing, biotech, wholesale distribution, publishing, marketing, and retail.

He founded Artronics, Inc., a graphic arts computer and software development company, in central New Jersey. Five years later, he sold it to Genigraphics Corporation, a former GE subsidiary, for several million dollars and corporate stock, and then served on their board of directors. He went on to handle numerous business transactions, including the transfer of intellectual property and the sale and acquisition of manufacturing businesses.

Tim earned a BA from Rutgers and a JD from Georgetown, is licensed to practice law in New Jersey (retired), and is a licensed California real estate (business) broker. He was the host of "The Business Beat" radio program on AM1220/KDOW. Professor Cunha taught undergraduate and MBA students on the faculty of the College of Business at Eastern New Mexico University, and prior to that was an adjunct professor at Stockton State College, Raritan Valley College, and Rutgers University. Currently, he teaches MBA students part-time as a Senior Lecturer on the Management faculty of a prestigious West Coast graduate school.