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# Litigation strategies for minority owners

*Lawsuits involve great emotional and financial costs—but they're a viable option if the imbalance of power is untenable. An attorney explains how the system works.*

By Henry C. Krasnow

**L**AWSUITS are never fun, never as exciting as portrayed in the movies and never effective in extracting revenge or earning respect. They rarely result in clear-cut winners or losers. They always cause emotional and financial strain on the participants.

But lawsuits often are the best way to resolve a disagreement, because they involve an impartial third party (a judge or jury), who resolves an otherwise irreconcilable dispute by applying rules that are known in advance (what is commonly called “the law”).

There is an easy way to make virtually all family business lawsuits go away, regardless of the issue that ostensibly triggered the litigation: a buyout of one party’s interest in the business by the opposing party. This is how most family business lawsuits ultimately are resolved.

## Majority ownership as a trigger

In nearly all cases, family business litigation is triggered by the imbalance of power between the company’s majority owner and the minority owners. Generally, the majority owners decide:

- Who is employed by the business and what these employees are paid. (A minority owner may be dismayed to learn that he has no right to a job in the business.)
- What bonuses are given, who gets the bonuses and how large they are. (A minority owner has no right to receive the same bonus, in either total dollars or percent-

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age of salary, as the majority owners.)

- Whether any dividends or other distributions are declared. (A minority owner is powerless to object if majority owners use all of the company’s cash to pay themselves large salaries or fund luxuries like the purchase of a new car each year or first-class travel on business trips.)

Even if the minority owners decide that their best option is to sell, there is no obligation on the part of the majority owners or anyone else to buy the minority owners’ interest.

## When talking works: The easy solution

Obviously, it is preferable to avoid litigation altogether—to have the parties reach an agreement themselves through discussions, possibly with the help of a trusted neutral friend or adviser or a trained professional mediator.

In choosing a neutral party to help resolve the dispute, it’s crucial to ensure that the person has no stake in the outcome. Bear in mind that the company’s accountants or lawyers almost never are neutral. They may not own stock, but they still have a stake in the outcome. One result means that they will continue in their role. Another result means that they will be replaced.

If such talks are to succeed, everyone must remember to keep the focus on the business rather than on family issues. Attempts to resolve family business disputes often get bogged down in discussions about irrelevant issues like defining what is “fair,” listing family members’ personal needs or desires, or recalling what the founder intended or what happened years ago. After hours of arguing, no agreements about price are reached, and lots of resentments and painful memories are stirred up. Sometimes these “negotiations” even make compromise less probable. The ensuring rancor causes the majority owners to

refuse an offer to buy unless they can purchase at a severe discount, and the minority owners to feel angrier at their lack of power.

### **When talking fails:**

#### **What power does a powerless person have?**

Often, after hours of talking, minority owners realize that the question has become: "What, if anything (other than again throwing a tantrum or lowering my price), will make the majority owners pay me more money?" In other words, what would a minority owner do if he or she owned part of a goose that lays golden eggs, but all the golden eggs were going to the majority owner?

If the majority owner is not about to share any of the golden eggs, the *only* tactic (once asking, yelling and begging have failed) is to threaten to kill the goose.

How does one go about doing this? The answer, unfortunately, is clear—file a lawsuit that threatens the existence of the business. Several types of lawsuits can be brought.

**Statutory dissolution:** Many states have statutes that provide remedies for minority shareholders who are being "abused." (Similar statutes may apply to partnerships or limited liability companies.)

For example, a California statute provides for involuntary dissolution if those in control of the corporation have allowed "persistent and pervasive fraud, mismanagement or abuse of authority or persistent unfairness toward any shareholders or [if] its property is being misapplied or wasted by its directors or officers."

According to an Illinois statute, if a judge is persuaded that the corporation's assets "are being misapplied or wasted," the court can remove a director or officer, appoint a custodian to manage the business, require the purchase

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## **Most family business lawsuits ultimately are resolved by a buyout.**

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of the shares of the minority shareholder for their fair value, or dissolve the company.

Statutes such as these are cited only as examples and are not universal. The laws of New York and Delaware give minority shareholders far more limited rights.

**Fiduciary duties:** The minority owners could claim that the directors, officers, managing partners or majority owners have breached their "fiduciary duty." Each partner, officer and director of a corporation, and often the majority shareholder, owes a fiduciary duty to the business and sometimes its owners. A "fiduciary duty" is "lawyertalk" for the highest possible standard of honesty and care. Simply put, a fiduciary duty requires total honesty and prohibits all manner of self-dealing. Possible breaches of fiduciary duty would be loans of excessive amounts, use of corporate money for personal expenses

like art for the president's home or payment for personal vacations, gaining personal profit from business opportunities that could have been exploited or enjoyed by the company, or competing against the company.

**Failure to manage:** Under some circumstances, a lawsuit can be brought if the majority owners are also officers of the company and are not doing their job. A majority owner who is president of the company, takes five months of vacation and spends much of the rest of the time in her office managing her personal portfolio risks being sued for failure to manage.

**Derivative actions:** Some claims can be brought as a "derivative action." In other words, if the corporation is paying an excessive salary to its president, the corporation must sue, since it is being harmed. If the president also controls the company, a shareholder can sometimes bring a "derivative action," since the shareholder's ability to sue is "derived" from the company.

**Squeeze-out or oppression:** Majority owners can be liable if they try to "squeeze out" or oppress the minority owners by tactics to force the minority owners to sell their interest at below its value. These claims are rare (since it's usually the minority owner who wants to sell), but a claim becomes possible if the majority initiate discussions to buy out the minority and then change corporate policies to make minority ownership less attractive.

**Deadlocks:** Most states give a judge the power to dissolve a business if the company's shareholders or directors are deadlocked.

### **What is there to win?**

"But," a minority owner might say, "these laws talk about dissolving the company. My goal is to have my interest bought—not to have the company dissolved. How does the dissolution or disqualification of the majority owners as officers help me get a higher price?"

First of all, "dissolution" does not mean "dissolution." It means that the company would be sold. But, if the company is sold, the most likely buyers are the majority owners. No one else knows the business as well, has as much information or wants it as badly. Dissolution means that the majority owners would have to find a new partner who would provide the money to buy out the unhappy minority owner.

Second, disqualification of the majority owners as officers means that they lose their jobs, and their jobs are often the golden eggs. Even if the chance of being disqualified is small, few majority owners would take that risk. They'd generally pay more money to avoid taking that gamble.

### **Will it be too expensive?**

Any lawsuit will be expensive. The important issue is how much the minority owners are willing to invest to increase the price they're being offered. One thing is certain—talk has failed! If they do nothing, they will get nothing.

Certainly, the legal fees spent by the business ought

not bother the minority owners. This money was not going to them, anyway. It may be going to the company to finance its growth or to pay for the majority owners' fancy cars and salaries, but it is not going to the minority owners.

When choosing an attorney, be wary of any lawyer who promises the emotional satisfaction of revenge—one who promises to be a street fighter to help you “punish” and “get even” with the people who “abused” you. This is a mistake, since revenge is not the goal. The goal is to make the majority owners realize that it is preferable to pay a higher price for the stock than to risk going to trial. If the minority owners' lawyer behaves vindictively, he will not help the majority owners reach this realization. People don't want to make deals with someone they dislike.

### **What are the chances of winning?**

“Wait a minute,” a minority owner might say. “Lawyers have told me that I can't force anyone to buy my stock and I have very little chance of winning a case. Shouldn't I just wait longer?”

Many lawyers will tell you they are not optimistic about winning. After all, the law in this area is not clear, and at the outset the lawyer does not yet know enough “facts” to predict a victory. But that does not mean doing nothing would yield better results.

Minority owners sometimes find that their chances of “winning” are greater than they thought:

- The majority owners may want to avoid taking chances that the family's reputation would be tarnished or the family finances would be exposed.
- If the company has cheated on its income tax, a judge might end the minority owner's forced investment. Most judges have little tolerance for tax cheats.
- Judges often take an aggressive role in encouraging compromise at a “fair” price.
- The majority owners' expense account reimbursements may seem excessive to a judge or members of a jury, who probably drive less expensive cars, don't fly first class and don't have vacations paid for by their employers.
- A “smoking gun” can often be found in the majority owners' private communications with the company's lawyers or accountants, which will sometimes be disclosed to an unhappy shareholder.

The majority owners' lawyers are not sure they will win, either. This lack of certainty will create doubt about the business's future and anxiety about the consequences of the minority owner's claim.

Remember, in order for the minority owners to win,

all that is required is for them to receive a higher price for their interest. It's like horseshoes—you don't need to win; all you need to do is come close. The minority owner does not need to win the lawsuit—she need only create enough anxiety, uncertainty, fear or ambiguity in the minds of majority shareholders to induce them to pay a higher price for the minority interest.

In addition, while the lawsuit (and appeal, if there is a trial) is pending, the business is operating under a cloud that may prevent the majority from doing what they want. Their bank may restrict the amount of money available, require more collateral for loans or refuse to renew a loan

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until the matter is resolved. Transactions like acquisitions will be put on hold. The ability to raise new capital is destroyed. All expenditures are evidence. The majority owners will feel compelled to limit their use of the business's money to fund travel, vacations, expense reimbursements, bonuses and even salaries for themselves and their families.

Majority owners who come to grips with the issue realize that they are in a “no-win” situation. Losing at a trial (even if they have only a 20% or 30% chance of losing) is a disaster, while winning simply puts them back to where they were before. They have nothing to gain and lots to lose. The minority owner, on the other hand, has only the attorneys' fees to lose, and a great deal to gain. Eventually, most majority owners will realize that they are on the wrong side of the risk-benefit analysis and decide that purchasing the minority interest for a higher price than previously offered is the only way out of this dilemma.

Remember that the issue under dispute is not about family; it's about business. Anger and the desire for revenge warp anyone's ability to be rational and understand when they have “won” the best price. The issue for the minority owners is how much money they can get without incurring inappropriate risk—not how much pain they can inflict. **EB**