PLF *in*BRIEF

ISSUE 138 | SEPTEMBER 2019

Malpractice Prevention Education for Oregon Lawyers

LAW UPDATES

Business Breakups: Terminating Ownership Interests in Closely Held Businesses

By Robert J. McGaughey and Aurelia Erickson

When minority owners become dissatisfied with those in corporate control of a publicly traded corporation, they can simply sell their shares and immediately terminate the corporate relationship. Such is not the case for closely held businesses.

The market for minority interests in closely-held businesses is negligible. Often, the only persons interested in acquiring a minority ownership interest are the business's majority owners.

When majority owners become unhappy with minority owners, there are only a few recognized methods for forcing the minority owners to relinquish their ownership interests in the business entity.

This article will explore some aspects related to terminating the relationship between majority and minority owners in closely-held businesses.

1. NEGOTIATED RESOLUTION

The simplest and least costly method for severing the business relationship is through negotiations. Many of the methods discussed in this article are very costly in terms of legal fees, as well as in terms of the time and emotional involvement of the owners themselves. Negotiating an acceptable deal between the parties – even though the end result may not be fully satisfactory to either party – is often quicker and less costly than resorting to litigation. There are a number of mediators and professional organizations that deal with closely-held businesses and who can facilitate these negotiations.

Even in a negotiated resolution, there are technical legal, tax, and accounting issues which should be addressed fairly early in the negotiation process. It is important to involve legal, tax, and accounting assistance early, particularly when the parties are negotiating directly with each other.

2. BUY-SELL AGREEMENTS AND OTHER CONTRACTS

In the event of a falling out between business owners, contracts between those business owners – buy-sell agreements, the operating agreement, bylaws – should be reviewed to see if there is a contractual mechanism for resolving the dispute, or for giving one owner the right to force the other owner to buy or sell his/her ownership interest.

3. SQUEEZE-OUT MERGERS AND REVERSE STOCK SPLITS

If the majority owners wish to force the minority to sell their shares, there are forms of corporate reorganization that can accomplish this goal. These include squeeze-out mergers and reverse stock splits.

Squeeze-out mergers. In a classic squeeze-out merger, the majority owners contribute their shares in OldCo to a new corporation (NewCo). After this transfer, NewCo becomes the majority owner of OldCo's shares. Next, the two corporations adopt a plan of merger, merging OldCo into NewCo and requiring all individual shareholders (i.e., the minority owners) to be cashed out at the "fair value" of their shares.

Such mergers give those in control the ability to choose those shareholders staying on and those cashed out. These mergers are not usually available for S corporations as they will cause termination of S corporation status and are usually prohibited by internal contracts.

Prior to the adoption of the plan of merger, the majority owners usually engage a business valuation firm to determine a "fair value" of the shares. The statute requires those in control to offer a fair price for the minority's shares only a short time into the process, so a stock valuation is often the first step undertaken. This is also true because soon after the process begins, those in control will be irrevocably committed to buying out the minority at a fair price, making it important to know the cost of cashing out the minority.

Generally, the majority owners and the corporation retain independent counsel.

Reverse Stock Splits. In a reverse stock split, the corporation adopts a plan proportionately reducing the number of shares held by each shareholder, leaving the minority shareholders with less than one share each. The plan calls for the corporation to redeem all fractional shares for cash, forcing the minority shareholders to sell their fractional shares back to the corporation. This mechanism does not work if there are shareholders the company wants to keep who own less shares than the shareholder being ousted.

Both squeeze-out mergers and reverse stock splits give rise to "dissenter's rights" and a process covered by statute.[1]

4. ACTIONS ARISING OUT OF OPPRESSION AND DEADLOCK

ORS 60.661(2) has long permitted a shareholder to seek judicial dissolution of a corporation when the majority's conduct is "illegal, oppressive or fraudulent" or when there is a voting deadlock.

A similar provision exists in the newer ORS 60.952, which applies only to nonpublic corporations. However, unlike ORS 60.661(2), ORS 60.952 gives the corporation and/or the controlling shareholders the right to force the complaining shareholder to sell all of his/her shares at a price and on terms set by the court. This non-revocable election to buy-out must be made within 90 days after the lawsuit is filed by the unhappy shareholder.

Although ORS 60.661 only provides for dissolution as a remedy, courts usually fashion other remedies for oppressive conduct – relying on their traditional equitable power to protect minority owners.

The remedy commonly imposed by courts in oppression cases is an order requiring the controlling shareholders to purchase the shares of the oppressed minority at the "fair value" of those shares.

Usually, in order to trigger a remedy under ORS 60.661 or 60.952, the corporation must engage in some pattern of wrongful conduct or a single instance of wrongful conduct that is particularly egregious.

Courts will usually not intervene in the case of alleged director incompetence and mismanagement. Usually, either bad faith or fraud must be present in order for a court to intervene in internal corporate affairs.

Forced buyout. ORS 60.952(6) provides that within 90 days after a minority shareholder initiates an oppression lawsuit, either the corporation or one or more of its controlling shareholders may elect to force the plaintiff to sell his/her shares. Should such an election be made, the minority's oppression lawsuit is suspended and the court need only determine the "fair value" of the minority's shares and the terms of that purchase.

ORS 60.952(6) likely takes away the court's ability to fashion a remedy other than the buy-out of the unhappy shareholder. If the corporation or controlling shareholders elect to repurchase the plaintiff's shares, the court then determines price and terms. When setting payment terms, the court may take into consideration the impact of the bad acts on the share value and the ability of the corporation to pay.

5. BREAK-UPS AMONG MEMBERS IN AN LLC

Courts in Oregon and other states have often interpreted LLC statutes in a manner consistent with corporate law.

Expulsion. While there may be roundabout methods of doing so, generally a corporation cannot expel a shareholder. An LLC, however, can expel a member, unless the operating agreement provides otherwise. The LLC statute gives the LLC the right to expel a member who is acting wrongfully, either as defined in the operating agreement or as defined in ORS 63.209.

Although an LLC may expel a member, fiduciary duty considerations may apply.

Withdrawal. The LLC statute permits a member to withdraw from the LLC, unless prohibited by the operating agreement (which it often does). There is no similar provision under corporate law. The withdrawal may subject the withdrawing member to liability.

Even though a member may "withdraw" as a member, this does not mean that the LLC is obligated to cash out the withdrawing member's interest.[2] Absent provisions in the operating agreement addressing this issue, the withdrawing member loses the right to participate in management, but retains his/her economic interest (much like an assignee).

Dissolution. An LLC can be dissolved upon the occurrence of those events specified in the articles of organization or by vote of the members. An LLC may also be dissolved by the court.

Unlike the corporate statutes, the LLC statute contains no provisions for dissolution in the event of deadlock or where the corporation acts in a manner that is "illegal, oppressive or fraudulent."

The LLC statute uses the phrase: "if it is established that it is not reasonably practicable to carry on the business." There are no Oregon cases interpreting this language and no consistent interpretation by other courts interpreting this "reasonably practicable to carry on the business" language.

Despite the absence of a statutory basis for judicial intervention in the case of "oppressive" conduct, Oregon courts have long held that they have traditional equitable powers to protect minority owners and to fashion appropriate remedies. It is an open question whether this equitable power will also be applied to LLCs.[3]

Robert J. McGaughey and Aurelia Erickson are attorneys at McGaughey Erickson.