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BUSINESS LAW ILLINOIS

Protection of Minority Owners of Corporations, Partnerships and Limited Liability Companies

A. Types of minority owners.

1. Investor.
 - a) Family and friends.
 - b) Angel.
 - c) Venture.
 - d) Someone who put in property or IP.
2. Employee.
3. Heir.
4. Competitor.
5. Judgment creditor of a former shareholder.

B. What an owner wants.

1. Return.
 - a) Dividends.
 - b) Sale proceeds.
2. Job.
3. Control.
4. Ability to sell to or buy from entity on favorable terms.
5. Participation in management.
6. Information about company.
7. Performance.

C. Corporations.

1. Shareholder protection devices.

- a) Judicial action.
 - i) Dissolution.
 - ii) Other types of specific relief such as injunctions.
 - iii) Money damages.
- b) Agreements.
- c) Provisions in the bylaws and articles.
- d) Cumulative voting.
- e) Pre-emptive rights.
- f) Fiduciary duties.
- g) More than a majority voting provisions.
- h) Dissenter's rights.

2. State of incorporation.

- a) Delaware is strict majority rule and has no statute allowing relief for oppression of a shareholder.
- b) Other states have higher voting requirements for certain transactions and oppression statutes.
 - i) i.e., Illinois requires a 2/3's vote for approval of a merger.

3. Grounds for judicial relief in Illinois, Sec. 12.56.

- a) Directors are deadlocked.
 - i) Shareholders are unable to break the deadlock.
 - ii) Either -
 - aa) Irreparable injury to the corporation is caused or threatened, or
 - bb) The business of the corporation can no longer be conducted to the general advantage of the shareholders.

OR

b) Shareholders are deadlocked.

i) Have failed for a period that includes at least 2 annual meeting dates to elect successors to directors whose terms have expired, and

ii) Either -

aa) Irreparable injury to the corporation is caused or threatened, or

bb) The business of the corporation can no longer be conducted to the general advantage of the shareholders.

OR

c) The directors or those in control have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent with respect to the petitioning shareholder whether in his or her capacity as a shareholder, director or officer.

OR

d) The corporation assets are being misapplied or wasted.

e) If the grounds for relief under Sec. 12.56 exist the court may order a variety of relief -

i) It can order the corporation or its shareholders, directors or officers or any party to the proceeding to do or not to do something.

ii) It can remove or appoint a director or officer or provisional director or custodian.

iii) It can order an accounting.

iv) It can order dividends be paid.

v) It can award damages.

vi) It can order the corporation to buy out all the petitioning shareholder's shares at fair value.

vii) It can order dissolution.

viii) The list of relief in the statute is not exclusive.

f) The corporation or one or more shareholders may elect to purchase all the petitioning shareholder's shares for fair value.

i) Within 90 days after the complaint is filed.

ii) Or later with court approval.

g) There is little law on what is irreparable injury to the corporation or what constitutes conduct of the business to the general advantage of the shareholders.

i) These requirements do not apply where the grounds are illegal, oppressive or fraudulent conduct.

aa) But what is illegal, oppressive or fraudulent?

4. Statutory devices.

a) Shareholders access to Information.

i) Corporations shall keep correct and complete records and books of account and minutes of director and shareholder action and a record of the shareholders.

ii) A shareholder or his or her agent has a right to inspect these records for a proper purpose upon written demand specifying the records sought with particularity and the purpose.

iii) The statute provides these rights can be enforced by mandamus.

iv) Upon written request a corporation must provide to a shareholder a balance sheet and profit and loss statement as of the end of its latest fiscal year.

v) Delaware does not require any financial statements but it explicitly states a director has a right to inspect books and records.

vi) Is the duty to provide accurate financial statements which disclose all material facts?

aa) If so, when the duty is breached does Rule 10b-5 under the Securities Exchange Act apply?

b) Cumulative voting.

i) Each shareholder in election of directors can give one candidate as many votes as the number of directors multiplied by the number of shares owned by the shareholder.

ii) The articles can eliminate cumulative voting rights.

c) Class voting.

i) The articles can create different classes of shares with

different voting rights.

aa) For instance Class B shares may be entitled to elect one or more directors.

bb) Or they may have veto rights on certain transactions.

d) Pre-emptive rights.

i) In Illinois there are none in corporations created after 1/1/82 unless the articles specifically provide for them.

e) Dissenter's rights.

i) A shareholder can dissent from and obtain payment for his or her shares in the event of the following corporate actions.

aa) Merger.

bb) Sale, lease or exchange of substantially all corporate assets.

cc) Amendment of the articles of incorporation which materially affects the dissenter's rights in certain matters as to preferential rights or cumulative voting (older corporations) or redemption rights.

f) Shareholders derivative action.

i) For wrong done to corporation.

ii) Must allege a demand made on the directors to obtain corrective action or why such a demand was not made.

g) Statutory provisions regulating transactions with interested directors.

i) Corporate transactions with a director are not per se void if fair.

ii) The director has the burden of proving fairness unless there was full disclosure and a majority of non-interested directors or shareholders approved of it.

iii) Delaware's law is slightly different and applies to transactions with officers as well as directors.

5. Fiduciary duties.

a) Most actions complaining of breach of fiduciary duty are derivative actions for harm to the corporation.

b) The fiduciary duties involved are:

i) Loyalty - do not compete.

ii) Care - take the care to inform yourself before acting, i.e., a director should read a compensation plan before approving it.

iii) Avoid conflicts of interests and self dealing - don't rent a plant you own to the corporation at 3 times the market rate of rent.

iv) Avoid usurping corporate opportunities - don't acquire real estate at a favorable price to rent to the corporation when you found out about it as a corporate officer assigned to look for new premises.

v) Duty of good faith and fair dealing.

vi) Duty to disclose all material facts - Fiduciaries cannot remain silent and just avoid misrepresentation.

c) The majority also owes a fiduciary duty directly to minority shareholders.

i) It is frequently referred to in squeeze-out mergers of a 90% or more owned subsidiary into a parent without a shareholder vote and with the minority being given cash for their shares.

aa) Delaware used to require a business purpose for this but no longer does because of appraisal rights.

bb) But fiduciary duties are still held to apply.

d) Fiduciary duties to shareholders can also become relevant under the Illinois statute allowing relief for for oppressive conduct.

e) What about a job? Is firing of a minority shareholder without good cause a breach of fiduciary duty?

i) Courts have generally said no.

ii) However, under the Illinois oppression statute a court is allowed to consider the legitimate expectation of the parties so relief may be available.

aa) The issue has not been decided.

6. Provisions in shareholder and employment agreements, bylaws and articles.

a) How does a minority have the bargaining power to get anything.

i) Before the die is cast the minority has something the majority or corporation wants.

aa) Money.

bb) Property.

cc) The potential shareholders is a prospective customer or supplier.

dd) The prospective shareholder is a prospective employee.

ii) Even after the fact there is sometimes bargaining power because the minority may be able to withdraw what it was put in.

aa) An employee can quit and the minority shareholder employee is often a key employee.

b) To determine what to cover think of what the majority can do and what will protect the minority shareholders against it.

i) Competition.

aa) The majority will not do it

bb) The minority holder can do it if his employment terminates or perhaps if other provisions of the agreement are not adhered to.

cc) The minority holder can compete even if he or she still holds stock. Some courts have held that holders of less than 50% have a fiduciary duty to the corporation not compete.

dd) Sometimes the parties contemplate that the minority holders will be involved in other competing businesses so provide for that in those cases.

ee) If you can't get a right to compete try to avoid a promise not to and if you can't do that try to narrow the restrictions.

c) Restrictions on majority voting rights.

i) Provisions which offer the minority shareholders a veto.

aa) High quorum requirement. If all shareholders or directors must be present in order to have a quorum then no action can be taken unless all are present.

bb) High vote requirement. If no action can be taken without a unanimous vote then each has a veto.

cc) There should be a mechanism to break deadlocks after a set period of time has passed so the corporation can do business.

dd) Name a person or entity to resolve deadlock.

ee) Arbitration or mediation.

ii) Provide that the minority shareholder gets the only vote when certain things happen.

aa) Breach of employment agreement - fertile grounds for argument.

bb) Not paid.

cc) Payments on shareholder debt not made.

dd) Dividends not paid.

iii) Class voting.

aa) Create different classes of shares, each with the right to elect one or more directors.

bb) Issue one class only to the minority.

d) Provisions relating to meetings.

i) Provide for adequate notice time.

ii) Provide for a form of notice that the shareholder will actually get.

iii) Specify a meeting place the shareholder can get to.

iv) Specify the rules for conduct of the meeting.

v) Allow the minority shareholders to call a meeting and put matters on the agenda.

e) Directorships.

i) State specifically that the minority can elect a certain number of directors or specify certain persons by name who will be directors.

f) Employment.

i) Provide a term that is in the employee's control, i.e. a term that automatically renews unless the employee elects to terminate.

ii) Specify the job and title.

iii) Provide against termination without cause.

aa) Specify and limit the causes.

iv) Specify pay and provide for increases.

aa) A practical way of going this is to require pay benefits, expense reimbursements and other compensation to be the same as the majority's or a specified percentage of the majority.

g) Liquidity.

i) Tag along rights - the majority cannot sell without getting the minority included in the sale.

aa) Preferably at the same price.

ii) Require a buyout by the corporation or the majority upon specified events.

aa) Retirement.

bb) Disability.

cc) Death.

dd) Termination of employment, for any reason.

ee) At the minority's option.

iii) Give the minority shareholder a right to require registration of his or her shares for public sale at the expense of the corporation.

aa) This will be feasible only in a limited number of corporations which qualify for public sale.

h) Information.

i) Specify what types of information the minority is entitled to and require the corporation to produce it.

ii) Require an audit and get input on the selection of auditors.

i) Self-dealing by the majority.

i) The majority takes all corporate income or a higher share though -

- aa) Excessive salaries and bonuses.
- bb) Corporate payment of personal expenses.
- cc) Leasing or selling property or services to the corporation.
- dd) Taking corporate opportunities, directly or indirectly.
- ee) Buying up claims against the corporation.

- ii) Majority Issuing stock to themselves.

- aa) At a low price.
 - bb) For services or property.
 - cc) Either outright or warrants or options.
 - dd) Pre-emptive rights do not always exist and sometimes, if they exist, do not apply to treasury shares.
 - ee) Also the majority gets to set the price and the minority may not have the funds to purchase at any price.
 - ff) Prohibit new share issuance without consent.

- i) Watch out for mergers, redemptions, stock splits and dividends and share exchanges.

- j) Protect against watered stock.

- i) Prohibit issuance of new shares or give the minority a right to buy its share of them for the same price everyone else pays.

- k) Security for money or property furnished to the corporation.

- i) The minority shareholder who puts up money or property should be secured and given preference over other shareholders and creditors if possible.

- ii) Provide that the minority gets debt in the amount of the value furnished, secured, if possible, and the right to convert the debt to stock.

aa) Specify the price at which debt is converted to stock.

iii) Allow greater voting rights if payments on the debt are not made.

l) Require dividends.

i) Require at least enough dividends in an S corporation to pay income taxes.

aa) Determining the amount is hard because shareholders can have different federal and state income tax rates.

7. The use of mergers to avoid restrictions.

a) Mergers are sometimes used to avoid restrictions applicable to one of the corporations involved. The surviving corporation can have different bylaws and articles of incorporation.

b) In a triangular merger one corporation is merged into another which is a subsidiary of the parent. The parent is not a party to the merger and is not a party to any agreement binding the subsidiary.

i) The shareholders of the target company can be transferred to the parent company if the consideration they get in the merger is stock in the parent once held by the acquiring subsidiary.

c) Protect against getting around the agreement by requiring minority approval of all transactions that would allow it, for instance -

i) Mergers.

ii) Reverse or regular stock splits.

iii) Transfer of corporate assets to another corporation.

iv) Issuance of a lot of stock to other shareholders.

8. Mechanisms to secure control or protect minorities in a corporation.

To Perfect Control	Provision	To Protect Minorities or Limit Control
no	preemptive rights	yes

no	cumulative voting	yes
no	limits on removal of directors	yes
no	staggered directors terms	yes
no	class voting on specific subjects	yes
low	quorum requirements	high
low	vote required for action	high
one	number of directors	high
yes	voting trusts	no
yes	proxy solicitation	---
yes	multiple holding companies	---
yes	non-voting stock or debt which converts to voting stock in certain events	yes
no	employment agreements for shareholders	yes
anywhere	meeting places	local
high	number of shares required to call a meeting	low
short	notice of meeting	long
no	directors, officers and salaries mandated by shareholder agreement	yes

D. LLC'S (limited liability companies) and partnerships

1. In a partnership a partner could always dissolve the partnership.
2. Limited partnership and LLC statutes have often been amended to eliminate this right for tax purposes.
 - a) If a partner can get his share of the partnership assets then IRS says no discount can be allowed for a gift of a minority interest to the partner.
 - b) A limited partner or LLC interest owner who owns a minority interest will ordinarily want to retain the right which can be done by putting it in the agreement.
3. Partnership and LLC statutes seldom provided the protection for a minority that corporate statutes did.
 - a) So check the statute for your LLC or partnership to see what it provides.
 - b) Illinois has incorporated some protective provisions in its LLC act.
 - i) Right to inspect books and records.
 - ii) Dissolution for oppressive conduct.
 - iii) But no other remedies are specified.
 - iv) Fiduciary duties are diluted for LLCs.

4. Partners cannot compete with their partnership regardless of the percentage interest they own. The right of an LLC interest owner to compete varies depending on the particular statute the LLC is formed under.

a) Minority shareholders, at least those having no veto or other powers, traditionally had the right to compete.

b) Rights to compete or not to do so should be covered in the partnership agreement or operating agreement.

5. The items minority shareholders should consider should also be considered by holders of minority interests in LLCs and partnerships.

6. In addition to the matter of concern to a minority shareholder in a corporation, partnership and multi owner LLCs are taxed differently from corporations.

a) They are taxed as partnerships.

b) All entity income or loss winds up on the owner's tax return.

i) This does not mean any cash is distributed to the owners to pay any resulting tax.

ii) Provision should be made for this in the partnership or operating agreement.

E. Separate lawyers.

1. A minority owner will always get a better deal if he or she, has his or her own lawyer.

a) And the minority holder never has a separate lawyer because of the expense.

b) This creates possibilities later when something arises under an agreement worked out by one lawyer. If you can show the lawyer represented both parties the agreement may be void or voidable.

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