

# Legal Brief

## Recognizing Minority Shareholder Oppression



As the economy continues its struggles, minority shareholders in closely held corporations remain at risk of oppression at the hands of majority shareholders. Just as in good economic times when majority shareholders may desire to maximize their returns at the expense of minority shareholders, the current tough economic climate facing many businesses creates incentive on the part of majority shareholders to protect their own shrinking returns by using their power to take actions detrimental to minority shareholders.

Majority shareholders have a fiduciary obligation to minority shareholders of the utmost good faith and loyalty, and have a duty to protect the interests of the minority. Therefore, a policy of corporate governance, where the objective is the denial of benefits to the minority interest, runs afoul of this fairness standard and calls to question the majority's fulfillment of its fiduciary duty to the other shareholders. This is especially true in a closely held corporation where shares are not publicly traded and a fair market is rarely available.

Pennsylvania courts have held that majority shareholders' duty to the minority prevents them from using their power in such a way as to exclude the minority from their proper share of the benefits accruing from the enterprise. The failure of majority shareholders to fulfill their duty to minority shareholders often results in what is known as "oppression."

Oppressive actions refer to conduct that substantially defeats the "reasonable expectations" held by minority shareholders in committing their capital to the particular enterprise. A majority shareholder may not use the corporate process to deny minority shareholders the right to participate in the corporation or to exclude minority shareholders from their proper share of benefits accruing from the enterprise.

A "freeze-out" or "squeeze-out" occurs

in a closely held corporation when a minority shareholder is removed from office or his power or compensation is substantially diminished, in an attempt to exclude the shareholder from any meaningful role in the corporation or deny him benefits from the corporation. Such an attempt by a majority shareholder to freeze-out or squeeze-out a minority shareholder constitutes a breach of this fiduciary duty. Tactics employed against a minority shareholder to achieve such a freeze-out include, but are not limited to:

- the withholding of dividends;
- terminating the employment or reducing compensation of the minority or their family members;
- paying excessive salaries to majority shareholders;
- withholding information relating to the operation of the corporation;
- appropriation of corporate assets to other interests benefiting the majority;
- refusing to enforce contracts that are beneficial to the corporation because the enforcement of those contracts would be personally detrimental to the majority;
- siphoning off corporate assets by entering into leases or loans with terms favorable to the majority while at the same time detrimental to the minority;
- denying minority shareholders appraisal rights; and
- failure to hold meetings and excluding the minority from a meaningful role in the corporate decision-making.

Recognizing minority shareholder oppression is one thing. Preventing or remedying oppression is another. Prevention is limited due to the inherent qualities of minority shareholder status — lack of controlling interest and illiquidity of minority

shares. The most effective means to prevent minority oppression is careful negotiation of the shareholder agreement at the outset.

Unfortunately, litigation often results. In addition to derivative actions brought on behalf of the corporation, direct claims by minority against majority shareholders include breach of fiduciary duties/oppression, breach of a shareholder or stock purchase agreement, breach of an employment agreement and/or wrongful discharge. Remedies generally are designed to restore to the minority the benefits reasonably expected but not received. Depending upon the circumstances, remedies available to minority shareholders include inspection of corporate books, accountings, forced payment of dividends or other distributions, forced appraisal or buyout of minority shares, recovery of lost salary and other forms of compensation, and relief from a noncompete agreement. In extreme cases, the corporation may be forced to dissolve. ☆

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