SHAREHOLDER OPPRESSION AND DILUTION

Because of the gradual transfer of business equity that occurs during the course of most succession plans in the financial services industry, most next generation owners ("G-2" or "G-3") initially hold a minority ownership interest in the business – i.e., an ownership interest in less than 50% of the corporate stock or LLC membership units.

KEY POINTS

1. It is important to understand that many succession plans rely on an internal ownership track that creates additional shareholders, each with a minority interest.

2. The issues of shareholder oppression and dilution should be addressed before they arise, which is usually at the beginning of Tranche Two (the second sale of corporate stock or LLC membership units).

3. It is important for all owners (G-1, G-2, and G-3) to discuss these issues with their own respective legal and/or tax counsel during the planning stage of Phase One.

Owners in a minority position are usually subject to the will of the majority owner when it comes to the management of the business. That is commonplace and to be expected. However, the majority owner may go a step further and aggressively use their power against the minority owner. For example, the majority owner may vote against the company's payment of a dividend or distribution and thereby deprive the minority owner of the company's profits, or deny the minority owner access to company books and records.

Those examples may be considered instances of shareholder oppression, which occurs when the majority owner exercises his or her power in a way that exploits the minority owner.

All Succession Management Program ("SMP") participants should be aware of the possibility of shareholder oppression, because both the senior advisor ("G-1") and G-2/G-3 advisors may become minority owners at some point during the succession plan. (In the most common scenario, G-2 advisors are minority owners from the beginning of the succession plan to the middle, and the G-1 advisor may become a minority owner from the middle of the plan to the end.)

Furthermore, shareholder oppression can pose a serious threat to minority owners of closely-held businesses. Unlike publicly-traded companies, minority owners of closely-held businesses do not have a market in which they can liquidate their interests. If the minority owner is able to find a buyer, the sale price for the minority interest is usually subject to a large discount. These factors can make the minority owner of a closely-held business feel trapped if they find themselves in an oppressive situation.

Because of the SMP's occasional use of stock grants (e.g., the issuance of treasury stock at no cost to one or more key staff member-investors, typically following their purchase of stock) to transfer a small, but not insignificant, portion of business ownership, shareholder dilution may also be a concern. G-1 and G-2/G-3 advisors should be informed about how stock grants will affect the per-share value and voting power of their interests.

These issues may seem troubling, but the good news is that both the law and skillful planning can usually resolve them.

MINORITY OWNERS' RIGHTS AND THEIR ENFORCEMENT

The law has provisions to protect business owners who hold minority interests. However, in this field of law there is no one set of rules that applies to the entire United States. Each of the 50 states has its own business entity laws that include varying levels of minority owners' rights. Assessing the available protection under these laws is only the first step. The enforcement of minority owners' rights through a lawsuit is dependent upon tort laws, and each state has its own tort laws as well.

The complex relationship between state business entity and tort laws makes the advice of a local attorney absolutely necessary in order to determine the extent of a business owner's rights in any given situation. FP Transitions is not a law firm and cannot provide legal advice to address a client's specific needs.

Keeping in mind that a lawsuit is the absolute last resort, it remains important to acknowledge its possibility, and then implement a better strategy of protection through adept planning and a fair deal.

PLANNING TECHNIQUES

Buyout Provisions: G-1, G-2, and G-3 advisors are well positioned to reach an agreement to prevent shareholder oppression, because they each share, to some degree, the risks that come with being a minority owner.

An effective way to inhibit shareholder oppression is to draft into the enterprise agreement a buyout clause that defines and is triggered by the majority owner's oppressive conduct against the minority owner. The clause would obligate the majority owner to purchase the minority owner's interest at a defined value if triggered. The value should ideally be tied to an authoritative, neutral, and market-based valuation of the business at the time when he or she invokes the clause. Such a clause not only gives the minority owner an economic remedy against shareholder oppression, but it can also deter shareholder oppression by putting the majority owner on guard against the obligation of purchasing the minority owner's interest at a price favorable to the minority owner—a demand that the majority owner may be unwilling or unable to meet. FP Transitions' standard enterprise agreements include this form of protection.

Dealing with Shareholder Dilution: When G-1, G-2, and G-3 advisors address the issues of shareholder dilution that may arise as part of a succession plan, it is important that they remain focused on the big picture. Shareholder dilution, in and of itself, may not necessarily be a bad thing—especially in the context of a growing business. For example, an existing shareholder may balk at learning that their ownership percentage will be reduced from 10% to 8% following the admission of a new shareholder. But what would their response be if, as a result of that transaction, the value of the business was to increase from $1,000,000 to $1,500,000? In terms of dollar value, 8% of $1,500,000 ($120,000) is worth more than 10% of $1,000,000 ($100,000). The planning stage of Phase One is the best time to assess the risks and rewards that might come along with the use of a stock grant incentive.

Advisors who have zero tolerance for shareholder dilution can also prevent it with the use of an anti-dilution agreement. There are two types of anti-dilution agreements: full-ratchet and weighted-average. A full-ratchet agreement increases an owner's interest to the amount he or she would have owned at the lower offering price paid by incoming buyers, regardless of how much the original owner owns or how little the incoming buyers purchase. Alternatively, a weighted-average agreement uses a formula that takes into account the quantity of stock sold at the lower offering price. Both options should be discussed and reviewed with a legal team and tax counsel before they are signed.

FP Transitions is the nation's leading provider of equity management, valuation and succession planning services for the financial services industry. Based in Portland, Oregon, FP Transitions operates the largest open market for buying and selling financial service practices in the U.S.

Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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