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Removing a Shareholder from a Business

Here is the flow of issues when a shareholder is removed from a business:

Termination of employment → Buy-back of shares → Non-competition → Claims for unfair oppression.

Let's start at the beginning, which is the end of employment.

Termination of Employment. The controlling owners of the business usually can fire shareholders who lack control, and remove them from the board of directors. If there's an Employment Agreement with the departing shareholder, the controlling shareholders must comply with that contract in firing the departing shareholder. If there's no Employment Agreement, the controlling shareholders will rely on the at-will status of all employees in California to terminate employment.

Getting fired hurts, because most shareholders who are active in a business depend on their salary from the business. This is why, notwithstanding an Employment Agreement or CA's at-will policy, the controlling partners need a good reason to fire the departing partner. Courts generally recognize a partner's reasonable expectation of continued employment by his business. Courts will protect a shareholder from being unfairly terminated and losing his salary (see below re "oppression").

Buy-Back of Shares. After termination of employment, the next issue for the controlling shareholders is whether to buy-back the departing shareholder's shares. If the departing shareholder keeps his shares, then he's still around -- he can vote the shares at any meeting of shareholders, including to elect directors, and he can receive his share of dividends.

The controlling shareholders only have a right to buy-back the departing shareholder's shares *if a contract gives them this right*. The law does not grant this right to the controlling shareholders. Usually you find a buy-back right in a Shareholders Agreement or a Buy-Sell Agreement. The contract might trigger the buy-back right at termination of a shareholder's employment, or perhaps upon mere dispute between shareholders. I talk about Shareholders / Buy-Sell Agreements at length on my website. These contracts are very important because they structure the buy-back process. Absent these contracts, the process devolves into an expensive free-for-all.

Now think about the buy-out price. A high buy-out price gives the exiting shareholder a windfall. A low buy-out price is unfair and leads to litigation. The trick is, in the Shareholders / Buy-Sell Agreement, to

use a procedure that ensures a fair price – for example, a neutral appraisal process, or an accounting formula. Payment terms are important too, because payment up-front in one lump sum is better than payment by promissory note over a long period of time.

Non-Competition. Non-competition clauses follow on the buy-back of shares. The controlling shareholders may only impose a non-competition covenant: (1) if a contract provides for it, and (2) only after the bona-fide buy-back of shares pursuant to that contract. Once again, the Shareholders / Buy-Sell Agreement is the contract that creates the non-competition right pursuant to the buy-back of shares.

If a business does not demand a non-competition clause, it should at least regulate the process by which the departing shareholder leaves. The business should control how the shareholder communicates with referral sources, employees and customers. The business needs an orderly and professional process for removing the shareholder. You don't want either side (whether the departing shareholder or the controlling group) to poison the other's well. Again, I talk about this a lot on my website.

Oppression not Permitted. In CA, controlling shareholders must treat minority shareholders fairly, and they may not use their corporate power to benefit themselves alone or otherwise unfairly hurt the minority. The legal term of art is the oppression of minority shareholders. For example, for a founder / shareholder who earns his living through the business, a court might consider it oppressive if the controlling shareholders fired the shareholder for no good reason thereby depriving him of his salary. Courts also don't like the unfair dilution of a minority shareholder's equity (called a squeeze-out). Controlling shareholders need legitimate business reasons for their actions against minority owners.

When oppressed by the majority, the minority shareholders have two legal remedies: (1) a tort cause of action for breach of fiduciary duty, and (2) involuntary dissolution. As to the latter, shareholders owning 1/3 or more of the stock can sue for involuntary dissolution. Minority shareholders will allege that a majority, controlling group of shareholders is committing unfair acts that cause financial loss to the minority. In most cases, a court will resolve an involuntary dissolution case by having the controlling group buy-out the minority, or by dissolving the business.

Enough said.

Freeman Dyson

- It is characteristic of all deep human problems that they are not to be approached without some humor and some bewilderment.
- A good cause can become bad if we fight for it with means that are indiscriminately murderous. A bad cause can become good if enough people fight for it in a spirit of comradeship and self-sacrifice. In the end it is how you fight, as much as why you fight, that makes your cause good or bad.

"And that's how you make a peanut butter sandwich."