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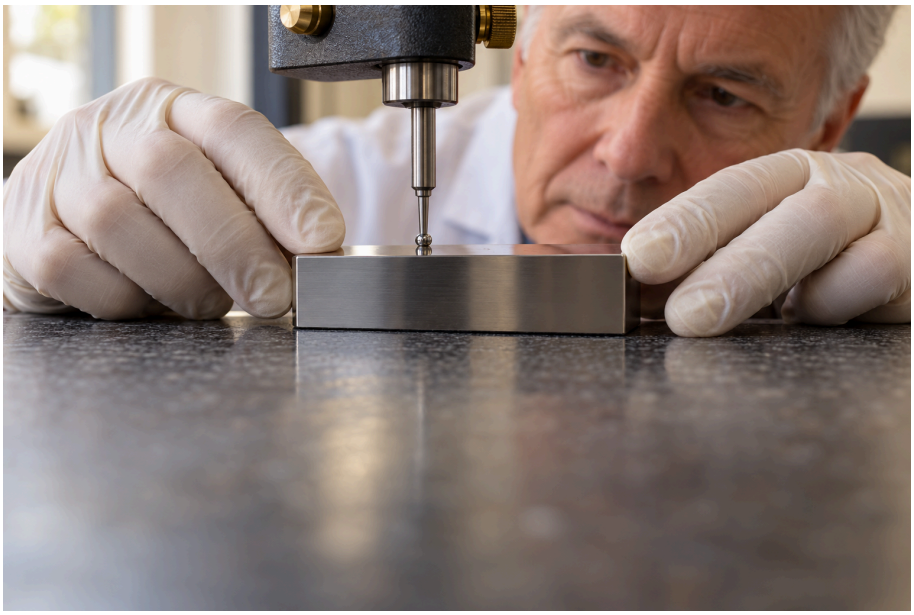
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Recapitalization Explained: Minority vs Majority Recaps

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What a recapitalization changes (and what it leaves alone)

A recapitalization ("recap") changes a company's capital structure: the mix of debt and equity, who holds the equity, or both. The business itself, its customers, staff and operations, is not sold to anyone. What changes is who has claims on it and in what order.

The word is used loosely in private markets. An owner selling 30% to an investor, an owner selling 70% while keeping 30%, and a company borrowing to pay its shareholders a large dividend are all called recaps. They have very different consequences for control, risk and cash. The term also has a narrower technical meaning: the Internal Revenue Code lists "a recapitalization" as one of the types of corporate reorganization in section 368(a)(1)(E) (26 U.S.C. 368). That tax category has its own rules, and this article does not try to explain them. For a short definition, see the recapitalization glossary entry.

This is a general explainer, not legal or tax advice. Outcomes differ by entity type (C corporation, S corporation, LLC), state of formation and deal terms.

The three common shapes:

Shape	Who provides the money	Who ends up with control	Where the owner's cash comes from
Minority equity recap	New equity investor buys a minority stake	Owner keeps control	Investor's purchase of shares (and sometimes new debt)
Majority recap with rollover	Investor buys a majority stake; owner reinvests part	Investor	Investor equity plus acquisition debt
Dividend (leveraged) recap	Lenders	Unchanged	New debt taken on by the company

Minority recap: selling a slice, keeping control

In a minority recap, an investor buys less than half of the equity. The purchase can be **secondary** (the investor buys existing shares from the owner, who receives cash) or **primary** (the company issues new shares and keeps the money for growth or to repay debt). Many deals mix both.

The owner keeps control and usually the operating role. In exchange, the investor typically asks for protections, described here generically because terms vary widely:

- a board seat or observer right;
- consent rights over major decisions (new debt above a threshold, acquisitions, sale of the company, changes to the owner's pay, related-party transactions);
- information rights (monthly or quarterly financials, an annual budget);
- liquidity terms: a path to exit after a number of years, sometimes a put right or a right to force a sale process;
- a preferred security with a liquidation preference or accruing return.

The last two items matter most. A "minority" investor with a right to force a sale after five years and a preferred return has a lot of influence over how the story ends, even without control today.

Illustrative example (fictional)

Corbel Instruments is a fictional calibration services company. Its 61-year-old founder owns 100% and wants to take some money off the table without retiring. An investor buys 35% of the shares from the founder for cash. The founder keeps 65% and stays CEO. The investor gets one of three board seats, consent rights over debt and acquisitions, and the right to initiate a sale process after year six if the founder has not bought it out. The founder has turned part of a concentrated holding into cash, and has also agreed, in substance, that the company will probably be sold within about a decade.

Majority recap and rollover: a partial sale

In a majority recap, an investor buys control, usually through a new holding company that acquires the business with a combination of the investor's equity, acquisition debt and the owner's reinvested equity (the rollover). The owner receives most of the value in cash, keeps a minority stake, and participates in a second sale later.

Economically, this is a sale of control with a retained interest. The mechanics of rollover equity, its tax outline and the protections a minority holder should ask for are covered in our article on seller notes and rollover equity; the key questions are whether the owner's rollover is in the same security and at the same price as the investor's, and what rights it carries.

Lenders define partial sales in their own terms. In SBA 7(a) lending, SOP 50 10 version 8.1 (effective October 1, 2026) describes a "Partial Change of Owner" as one where loan proceeds fund "the purchase of all or a portion of one or more owner's interest in the business or of the business itself" and "where at least one of the original owners remains as an owner after the sale and personally guarantees the loan" (SBA SOP 50 10 page; SOP 50 10 8.1, Appendix 15). The same appendix makes "multi-step partial changes of ownership", where existing and new owners form a new entity that becomes the 100% owner, ineligible. That is one example of how the structure that suits a sponsor-backed recap may not be available with every type of financing.

Debt-funded recaps: dividend and leveraged recapitalizations

In a dividend recap, the company borrows and uses the proceeds to pay a distribution to its shareholders (or to repurchase shares). Ownership percentages do not change. Leverage does.

Sponsors use dividend recaps to return capital to their funds before a full exit. Founder-owned companies sometimes do the same thing on a smaller scale. Either way, the company swaps equity value for a debt obligation that must be serviced from future cash flow.

What the research shows

The most direct recent evidence is a study of private equity-sponsored dividend recapitalizations by Abhishek Bhardwaj, Abhinav Gupta and Sabrina T. Howell, available as an NBER working paper and a Census Bureau Center for Economic Studies working paper. The authors use dividend recaps "where portfolio companies take on new debt to pay investor returns" as a setting to study a large increase in leverage. According to the Census abstract, after accounting for positive selection into more debt, "large leverage increases make firms much riskier, dramatically raising exit and bankruptcy rates but also IPOs," and dividend recaps "increase deal returns but reduce: (a) wages among surviving firms; (b) pre-existing loan prices; and (c) fund returns" (Census CES-WP-25-12). The NBER summary reports that total debt rises by about 84% on average and that the likelihood of financial distress rises by roughly 2.4 times the treated firms' mean (NBER Working Paper 33435).

How to read this:

- It is evidence about **PE-sponsored dividend recaps**, the sample the authors study. It is not a verdict on every recap, and minority or majority equity recaps are a different transaction.
- The finding that deal returns rise while fund returns fall is the authors' result for their sample, which they interpret as reflecting moral hazard via new fundraising.
- Employees and existing creditors bear part of the cost in the paper's results. An owner considering a debt-funded payout should expect lenders, staff and customers to notice the change in risk.

Illustrative example (fictional): what a dividend recap does to the numbers

Halden Supply is a fictional distributor with $5.0 million of EBITDA and $5.0 million of existing debt. Its owners borrow an additional $10.0 million and pay it out as a dividend. Assume, for illustration only, a 9% interest rate on all debt.

Measure	Before the recap	After the recap	After the recap, EBITDA down 30%
Debt	$5.0M	$15.0M	$15.0M
Debt / EBITDA	1.0x	3.0x	4.3x
Annual interest	$0.45M	$1.35M	$1.35M
EBITDA / interest	11.1x	3.7x	2.6x

Before the recap, a 30% fall in earnings would have left interest covered almost eight times. After it, the same fall leaves coverage at 2.6 times, before any principal repayment, capital spending or taxes. The owners have their $10.0 million; the company and its other stakeholders carry the risk that earnings fall. That is the mechanism the research above measures at scale.

An older academic literature studied leveraged recapitalizations of public companies in the 1980s; one entry point is David J. Denis and Diane K. Denis, "Managerial discretion, organizational structure, and corporate performance", *Journal of Accounting and Economics* 16 (1993), 209-236 (DOI). The paper is closed access and we list it as further reading only; no finding from it is used here.

Legal and tax guardrails to raise with counsel

Two sets of rules shape how cash can leave a company in a recap. We describe only what the statute text says, using Delaware corporate law and the federal tax code as examples.

Corporate law: when can a company pay a dividend or buy back shares? Under the Delaware General Corporation Law, directors may declare and pay dividends out of surplus, or, if there is no surplus, out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year (section 170(a)). A corporation may not purchase or redeem its own shares for cash or property "when the capital of the corporation is impaired or when such purchase or redemption would cause any impairment" of capital (section 160(a)(1)) (8 Del. C. Chapter 1, Subchapter V). Directors who approve a large debt-funded payout are making a judgment under these limits, which is one reason boards obtain solvency or surplus analyses first. Other states, and LLCs, have different rules.

Tax: is a redemption a sale or a dividend? When a corporation redeems a shareholder's stock, section 302 of the Internal Revenue Code determines the treatment. If one of the tests in section 302(b) applies, the redemption "shall be treated as a distribution in part or full payment in exchange for the stock" (sale treatment). The tests include a redemption that is "not essentially equivalent to a dividend," a substantially disproportionate redemption, and a complete termination of the shareholder's interest. If none applies, the redemption "shall be treated as a distribution of property to which section 301 applies" (26 U.S.C. 302). In a minority recap where the company, not the investor, buys back the owner's shares, this distinction can change the owner's tax result. S corporations and partnerships have their own regimes.

Questions to take to counsel and tax advisers:

- Is the transaction a purchase of shares by the investor, a redemption by the company, or both?
- For a redemption, which section 302(b) test, if any, is expected to apply, and why?
- Does the company have surplus (or qualifying net profits) for any dividend, and who will document it?
- How do existing loan covenants restrict new debt, dividends or redemptions?
- For an S corporation or LLC, how do the entity's own rules change the analysis?

Recap or sale: how owners usually frame the choice

Factor	Points toward a recap	Points toward a full sale
Liquidity need	Wants some cash now, not all	Wants to convert most wealth to cash
Control	Wants to keep running the company	Ready to hand over decisions
Risk appetite	Comfortable keeping exposure, possibly with more leverage	Wants to stop bearing business risk
Time horizon	Expects to stay involved for years	Wants a defined exit date
Succession	Successor not ready yet; recap buys time	No successor, or successor is the buyer
Second bite	Believes the next sale will be larger	Prefers certainty over a possible second payout

Illustrative worksheet (fictional answers)

The owner of a fictional landscaping company, Fenwick Grounds, answers five questions before talking to any investor:

1. How much cash do I need in the next two years, and for what? ("Enough to diversify about half my net worth.")
2. How many more years do I want to run the business? ("Five to seven.")
3. Would I accept a board where I can be outvoted on a sale? ("Not yet.")
4. How much debt would I let the company carry if things went badly? ("No more than we could repay in three years.")
5. Who could run the company if I stopped tomorrow? ("Nobody yet.")

These answers point toward a minority equity recap with limited leverage, not a dividend recap and not a majority sale. The value of the worksheet is that the owner writes the answers before an investor's term sheet frames the question.

How sponsors find recap situations

Recap candidates tend to share a profile: profitable, long-held, founder-led, with an owner who wants liquidity but is not ready to leave. Public records can suggest that profile but cannot confirm it:

- **Ownership tenure:** state registry formation dates and long-running officer names.
- **Founder still operating:** the founder named as the licence holder, registered agent or principal on recent filings.
- **No visible successor:** no second-generation or senior manager named in filings or on the company's site. Absence of evidence is not evidence of absence.
- **Capital needs:** expansion signals (new locations, permits, hiring) that suggest primary capital could be useful.

Each item is a signal to record with its source and date, not a conclusion about what the owner wants. The ownership and succession overview covers the wider demographic context, and our page on proprietary deal flow discusses what the evidence says about approaching owners directly.

What to record when a recap conversation starts

When an owner agrees to talk, the facts that decide whether a recap is feasible are mostly internal to the company. A short record, each line with an evidence status:

Fact	Source	Status
Current cap table (owners, percentages, classes)	Owner; corporate records	Requested
Existing debt, maturities, covenants on dividends and new debt	Loan agreements	Requested
Entity type and state of formation	State registry	Verified

Fact	Source	Status
Owner's stated goals (liquidity, control, timing)	Meeting notes	Owner statement
Successor candidates	Owner	Owner statement
Recent profitability	Financial statements	Not yet received
Prior approaches or offers	Owner	Owner statement

Keeping "owner statement," "verified" and "not yet received" apart is the core of good evidence standards: the investment case can then be traced back to what was checked and what was only said.

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A useful target list needs more than company names. Docket focuses on the questions that determine whether a company fits an investment mandate, including the evidence needed to support or qualify each answer. Our research approach makes the connection between screening criteria, source material and conclusions visible to the team reviewing the work.

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