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Corporate In-fighting: Battling the Boardroom Bully

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When I was little, I wanted to be a Superhero. I loved playing Batman and Robin with my Dad. Superheroes stand up to bullies and save the day. Unfortunately, Superheroes also have to wear itchy uniforms—and I hate itchy. Most importantly, Superheroes rarely get to write on yellow pads of paper. So, I became a lawyer (like my Dad) and now I fight bullies of a different kind.

My client, and the heroine of this story, "Robyn," came in for help combating "Joker," the bullying president and shareholder of their family's corporation in which she owned stock. To make matters worse, Joker was also Robyn's brother.

To the bat-cave . . . [cue Bat music]

BACKGROUND

Robyn's parents were hard working western New Yorkers who owned a farm and gradually accumulated wealth. Mom and Dad saved their sheckles and even put Joker, one of four children, through law school.

In turn, when Joker graduated he used his new skills to form a closely held holding corporation for the family farm and their other assets.

As Mom and Dad got older, they transferred stock in their closely-held family corporation to the children, as part of their estate plan.

Joker attended to the corporate formalities and promised Mom and Dad that the corporation would be used to provide for them and, later, for their increasingly numerous grandchildren.

Of course, I wouldn't be writing this if Joker had kept his promise.

SELF-DEALING

Last spring, Robyn learned that Joker was also using his skills as an attorney to transfer assets out of the corporation and to his own family, at a deep discount. Joker's self-dealing was depleting the corporate assets and diluting his fellow shareholders to whom he owed a fiduciary duty. *Ajettix Inc. v. Raub*, 9 Misc.3d 908, 912 (N.Y.Sup. 2005) (the "'relationship between shareholders in a closed corporation, vis-á-vis each other, is akin to that between partners and imposes a high degree of fidelity and good will'").

Robyn arranged a meeting with Joker to discuss his questionable transfers. Joker arrogantly refused to discuss anything with his sister and ignored her reasonable complaints. Joker had the corporation under his control and he was a lawyer. Joker figured he could bully his sister into submission and persistently ignored all attempts to informally resolve this dispute.

Joker underestimated Robyn, who is anything but helpless.

DISSOLUTION OF THE CLOSELY HELD CORPORATION

A closely held corporation is defined as one in which none of the shares is listed on a national securities exchange, or is regularly quoted in an over-the-counter market by a member of a national or affiliated securities association. *See* BCL § 620(c).

Checking the legal utility belt, we find some useful weapons for helping minority shareholders combat bullying in the boardroom. To the Bat-mobile.

Robyn owned twenty-five percent of the corporate stock. Accordingly, in addition to other rights she had as a shareholder, she was entitled to file a petition for dissolution of the corporation pursuant to article 11 of the Business Corporation Law. Business Corporation Law § 1104-a(1) allows a holder of at least twenty percent of all outstanding shares entitled to vote in an election of directors, and meeting other statutory criteria, to petition the New York State Supreme court for judicial dissolution upon a showing that those in control of the corporation have acted in an illegal, fraudulent and/or oppressive manner towards the petitioner. BCL § 1104-a. A successful petitioner may secure liquidation of the corporation's business, assets and affairs and distribution thereof to those entitled thereto according to their respective rights. BCL § 1111(c).

The legislature also authorized the court to award attorney's fees to the

successful petitioner. BCL § 1104-1(d).[1] The statute also provides for an immediate injunction to prevent further looting or dilution by Joker, immediate discovery of corporate assets and prompt access to the corporate books. BCL §§ 1104-a(c), 1106(d) & 1115.

THE BUY-OUT OPTION AND VALUATION

The petition for dissolution got Joker's attention but, instead of contritely disgorging the money he siphoned out of the corporation, he continued to bully, demanding to purchase Robyn's shares at a fraction of their fair market value. Naturally, Joker's purchase offer did not include repayment of the money he had already deftly removed from the corporation.

Brother Joker shrewdly took advantage of BCL § 1118, which enabled him to halt the dissolution proceeding by forcing Robyn to sell her shares to him at "fair market value", as determined by the court. Such an election effectively converts a dissolution proceeding into a valuation proceeding.

While the court may consider self-dealing in determining fair market value, the "1118 election" prevents Robyn from dissolving the corporation. Joker's 1118 election would still entitle Robyn to the value of her shares but it also gave him a tactical advantage in limiting the Joker's financial exposure. If Joker purchased Robyn's shares, he would not have to pay back all the money he took from the

[1] Unfortunately, court awards of attorney's fees rarely reflect the actual cost of litigation.

corporation; at most, he would only have to repay that portion that corresponded to Robyn's shares. Even if Joker had to pay Robyn, he would be insulated from paying his other siblings, who did not sue, for their stock. Holy hostile takeover!

The court would ultimately decide the fair value of Robyn's shares. The valuation of stock in a closely held corporation may be subject to a discount for "lack of marketability". This is also known as an "illiquidity discount." Closely held corporations "by their nature contradict the concept of a 'market' value" and the valuation of its stock "should include consideration of any risk associated with illiquidity of the shares". *In re Seagroatt Floral Co., Inc*, 78 N.Y.2d 439 (1991).

The subjects of valuation and discounts are worthy of their own essays. As a general guidepost, the more liquid a corporation's holdings, and the greater the market for its shares, the less the value of its stock should be discounted. *See*, *e.g., Cinque v. Largo Enterprises of Suffolk County, Inc.*, 212 A.D.2d 608, 610 (2nd Dep't 1995) (no discount where the corporation's assets consisted of only real property and cash and no good will); *Whalen v. Whalen's Moving & Storage Co., Inc.*, 234 A.D.2d 552, 554 (2nd Dep't 1996) (discount only applied to goodwill portion of corporate value); *In re Rateau*, 59 AD3d 1037, 1037 (4th Dep't 2009); *Markman v. Exterior Delite, Inc.*, 14 Misc.3d 910, *8 n.2 (N.Y. Sup. 2006) (10% marketability discount); *see generally In re Seagroatt Floral Co., Inc.*, 78 NY2d at 446 (adjustment for illiquidity risk applies to share price as a whole and not individual vendable assets, such as good will).

"Business Corporation Law § 1104-a was enacted for the protection of minority shareholders, and the corporation should therefore not receive a windfall in the form

of a discount because it elected to purchase the minority interest pursuant to Business Corporation Law § 1118. Thus, a minority interest in closely held corporate stock should not be discounted solely because it is a minority interest." *Blake v. Blake Agency, Inc.*, 107 A.D.2d 139, 149 (2nd Dep't 1985) (citations omitted) (25% discount). Nor should majority shareholders benefit from a mandatory reduction in the fair value of minority shares because such reduction would serve to encourage misconduct by the majority in order to drive down the value, and thus the purchase price, of minority shares. *Friedman v. Benway Realty Corp.*, 87 N.Y.2d 161, 169-70 (1995); *cf.* BUSINESS CORPORATION LAW § 623; *cf. also Congel v. Malfitano*, 31 N.Y.3d 272, 297 (2018) (minority discount applies to minority partner who illegally attempted to dissolve; value of goodwill not considered).

Naturally, my trusty butler, Alfred, was prepared for Joker's maneuver and had already prepared an application to compel him to post security as proof he had the means to buy Robyn's shares. BCL § 1118(c)(2). The court quickly granted our application. Now there was a reserve of money in play and Joker had some skin in the game. Although we had made progress. Robyn knew that Joker would never treat her fairly unless he faced the prospect of repaying everything he had taken from the family corporation and, by extension, from the other shareholders (who appeared unwilling to stand up to Joker).

Saints preserve us. Could this be the end of Robyn's quest for justice? Stay tuned to this bat-journal for the stunning (or at least morally satisfying) conclusion . . .

THE SHAREHOLDER'S DERIVATIVE ACTION

Robyn amended her lawsuit to include a "shareholder's derivative action." BCL § 626. The derivative action allows a shareholder to sue on behalf of her corporation when its officers and directives wrongly refuse to do so (such as when they are the putative defendants). The plaintiff shareholder thus "derives" her right to sue from and on behalf of her corporation. Robyn could now seek to hold Joker accountable to the corporation for the *full* amount he removed from the corporation while simultaneously litigating the issue of the fair value of her shares. *See Edmonds v. Amnews Corp.*, 224 A.D.2d 358 (2nd Dep't 1996); 15A NY JUR 2D, BUS. REL. § 1294. [Ka-pow! Boff! Crash!]

As long as she owned her shares, Robyn could continue to demand justice for herself, her siblings and the corporation. "[T]here is no bar to a shareholder pursuing both dissolution and derivative actions simultaneously". *Slade v. Endervelt*, 174 A.D.2d 389, 390 (1st Dep't 1991); *Edmonds v. Amnews Corp.*, 224 A.D.2d 358 (1st Dep't 1996); *Matter of Davis*, 174 A.D.2d 449, 452, (1st Dep't), *appeal dismissed,* 79 N.Y.2d 820 (1991); BCL § 626(a).

CONFLICT OF INTEREST

Joker had another problem: the same law firm that was defending him against the charge of looting the corporation was also defending the corporation that was now derivatively suing him for his transgressions (and apparently at a discount). This created a clear conflict of interest: the corporation would naturally want its money

back and President Joker would naturally not want to repay what he took. Robyn moved to disqualify Joker's counsel.

"An attorney who simultaneously represents two or more clients with adverse interests may be disqualified from appearing or may be permitted voluntarily to withdraw." Likewise, a corporation that is more than a passive litigant in a derivative action must be represented "by independent counsel whose interests will not conflict with those of the individual defendants." *Russo v. Zaharko*, 53 A.D.2d 663, 666 (2nd Dep't 1976) (citation omitted; emphasis added). "One who has served as attorney for a corporation may not represent an individual shareholder in a case *in which his interests are adverse to other shareholders*." *In re Greenberg*, 206 A.D.2d 963, 964 (4th Dep't 1994) (emphasis added).

"Any doubts as to the existence of a conflict should be resolved in favor of disqualification." *Chang v. Chang*, 190 A.D.2d 311 (1st Dep't 1993). "The disqualification of an attorney is a matter which rests within the sound discretion of the court and will not be overturned absent a showing of abuse. That discretion was not improperly exercised by Special Term since, in a disqualification situation, any doubt is to be resolved in favor of disqualification." *Schmidt v. Magnetic Head Corp.* 101 A.D.2d 268, 277 (2nd Dep't 1984) (citations omitted).

Joker now faced the very real prospect of losing his lawyer, incurring additional expense and battling the corporation in addition to his sister.

CONCLUSION

Robyn (Batgirl?) successfully stood up to Joker who, like most bullies, ultimately backed down in the face of a determined and unflinching adversary. Seeing no way out and facing the prospect of his own mounting legal bills, Joker relented and paid Robyn a reasonable price for her stock.