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Civil LITIGATION

The case of a mutually assured dissolution

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Six pharmaceutical sales representatives decided to form a corporation, Stonetek. Each of the six shareholders owned 16.67 percent of Stonetek's stock. Their Shareholders Agreement provided that a shareholder's stock could be redeemed at book value, which would be periodically updated.

All six shareholders worked as sales representatives and helped manage the business, and Stonetek became highly successful. The shareholders were all paid the same base salary, and they shared the profits as compensation bonuses, based on their equal stock ownership.

As the years went by, Keith, Anita and Mick demonstrated their skills in business administration and development and gradually took over the role of Stonetek's executive committee; Charlie and Bill proved to be the most productive sales representatives. Brian was also a very productive sales representative, but over time, his production diminished as he lost accounts and, having amassed substantial personal wealth, began spending less time on Stonetek's business.

The other shareholders decided that Brian was no longer entitled to an equal share of Stonetek's profits in light of his disproportionately small contributions. Therefore, Stonetek changed the manner in which shareholders were compensated, going from a stock-based to a "merit-based" system.

Over the next two years, the other shareholders received substantially higher compensation bonuses, while Brian's compensation bonuses were significantly reduced. Brian resigned his position with Stonetek, and asked that the corporation buy his stock at a price based upon Stonetek's going-concern value. The other shareholders offered to pay book value (which had not been updated) for his stock.

Brian went to see a lawyer and said that he wanted out of Stonetek and wanted to be paid a fair price for his stock. The lawyer said, "Well, we can start a dissolution action, and include a breach of fiduciary duty claim and derivative claims. However, you probably won't be able to get a judgment compelling Stonetek to buy you out at your price, and you would be left with a dissolution. During the course of the lawsuit, we might be able to convince them to pay a fair price, but they could also dig in their heels and try to beat you on the merits because they do not want to dissolve Stonetek. Either way, it could get expensive and, even though it sounds like you have a case, you could lose."

Brian and his lawyer decided to send Stonetek a letter threatening litigation if Stonetek did not purchase Brian's shares based on Stonetek's going-concern value.

When Stonetek's shareholders received that letter, they went to see their lawyer (who had not been consulted when the compensation system was changed), and asked her to tell them that Brian had no case. The lawyer said, "Well, he could bring a dissolution action based on allegations that you breached your fiduciary duties. Both a dissolution action, and, if Brian were to win his case, a judicial dissolution, would be disruptive and expensive. If Brian sues, you would have two options: either defend the case on the merits, or negotiate a buyout price. I have seen case law where dissolution was ordered in similar circumstances, but I do not think that a court can order you to buy out Brian's shares. Either way, you may spend a lot of money litigating and still end up buying Brian out at his price to avoid dissolution."

Both lawyers' advice was sound. As corporate practitioners know, Business Corporation Law §1104-a(a) authorizes a shareholder in a closely-held corporation to bring a dissolution action if the directors or controlling shareholders have been guilty of illegal, fraudulent or oppressive actions against the petitioning shareholder, or have looted, wasted or diverted the corporation's property or assets.

However, BCL §1104-a(b) requires the court to consider whether liquidation is the "only feasible means" whereby the petitioning shareholder may reasonably expect to obtain a fair return on his investment, and whether liquidation is "reasonably necessary" for the protection of the rights and interests of all of the shareholders. In other words, the BCL gives the court discretion to craft a remedy other than dissolution.

In addition, BCL §1118(a) gives the corporation and its other shareholders the option to avoid dissolution under BCL §1104-a through an irrevocable election to purchase the shares of the petitioning shareholder "at their fair value." The election must be made within 90 days of the filing of the dissolution action, or, at the court's discretion at a later date. An election to purchase effectively stays the dissolution action, and the proceedings then focus on the determination of fair value.

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The problem for Stonetek and Brian is that the petitioning shareholder must own at least 20 percent of the corporation's stock to bring a BCL §1104-a(a) dissolution action, and Brian owns only 16.67 percent of Stonetek's shares. Although this fact does not bar Brian from petitioning for dissolution of Stonetek, it does take away the certainty and regularity of the statutory process.

Under New York law, a corporation's majority shareholders owe fiduciary duties to its minority shareholders, and even a shareholder with less than 20 percent of a corporation's shares may seek common law dissolution of that corporation based upon proof that the majority shareholders have engaged in "egregious conduct" which caused injury to the minority shareholder's interests, see *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 69-70 (1984); *Leibert v. Clapp*, 13 N.Y.2d 313, 315 (1963).

However, while there are numerous decisions defining the "oppressive actions" which would support dissolution under BCL §1104-a(a), there are few cases describing the "egregious conduct" which would support common law dissolution. In addition, the corporation and its other shareholders do not have the statutory right to stay a dissolution proceeding by making an election to purchase, and the New York courts have not formally allowed a minority shareholder the remedy of an "equitable buyout" in a common law dissolution action, see *Orloff v. Weinstein Enterprises, Inc.*, 247 A.D.2d 63, 66-67 (First Dept. 1998).

Therefore, if Brian started a dissolution action, the court would likely reject any claim for an "equitable buyout," and Stonetek would be unable to automatically stay the dissolution action by an election to purchase. This scenario obviously creates substantially more uncertainty than would be found in a BCL §1104-a(a) dissolution action, and opens the door for full-blown litigation in which the continuing viability of Stonetek is at stake.

This scenario also highlights an anomaly: A shareholder with a small amount of stock may have the ability to use the threat of a dissolution action to greater effect than a shareholder holding more than 20 percent of the corporation's stock. Of course, the litigants in a common law dissolution action must weigh the strengths and weaknesses of their positions and the associated risks involved, and these types of actions are, as demonstrated by the paucity of reported decisions, usually resolved short of judgment.

Moreover, although in the context of a common law dissolution action the court lacks the statutory authority to exercise its discretion to fashion a remedy other than dissolution, judges handling these cases clearly can, and often do, convince the parties to negotiate a buyout price for the minority shareholder's stock, thereby avoiding the disruption and expense that would flow from contentious litigation and a judicial dissolution.

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