Business Divorce in New York State: The courts may call the shots if you deadlock

Consensual rather than judicial dissolution is almost always preferable

By: JOAN M. SECOFSKY | RICHARD I. JANVEY

Here is a good example of the unintended consequences of a scorched earth approach to a business divorce in New York. A shareholder/employee who originally intended to buy a business on his own terms, and then requested judicial dissolution, is being forced by the court to buy out the other shareholder—and the court will set the price. That's because the actions of the two 50/50 shareholders triggered the New York State Business Corporation Law ("BCL") scheme to deal with disposal of shares when the owners are unable to come to terms.

The root cause of the situation is the absence of shareholder agreements and buy-sell provisions. The lack of proper documentation is an ongoing issue in closely-held businesses, partnerships and joint ventures. A bad situation to start was made even worse when the shareholders quickly resorted to litigation to press their demands.

From our vantage point, admittedly three hours south of the drama, the situation almost certainly would have been better resolved through mediation or arbitration. Consensual rather than judicial dissolution is almost always preferable.

In this case, *In re Clever Innovations, Inc.*, ___ App. Div. 3d ___, ___ N.Y.S.3d ___ (3d Dep't April 5, 2012), Article 11 of the BCL came into play under which a petition for dissolution may be commenced upon deadlock among directors or shareholders (§ 1104) or under "special circumstances" (§ 1104-a). [i]

Paul Nielson, the founder of Clever Innovations in Saratoga, New York, in 2002 gave 50% of the shares to an employee, Christopher. Christopher was involved in the company's day-to-day operations and was compensated by salary and dividends. When Paul died in 2009, his wife Gwen, who was not a shareholder, was an active officer who handled the company's banking and financial affairs.

The relationship between Gwen, the estate administrator, and Christopher deteriorated to such a degree that the bank froze Clever Innovation's account because of authorization issues. Gwen and Christopher then worked out an interim arrangement: Christopher would operate the business and keep Gwen fully informed while they negotiated a sale to Christopher of the estate's 50% interest in Clever Innovations.

Christopher, however, ignored their agreement and instead commenced a proceeding under BCL § 1104, claiming deadlock. At the

same time, he essentially opened a competing business, funded with income from Clever Innovations.

Gwen commenced her own competing BCL § 1104-a proceeding, alleging oppressive conduct on Christopher's part, and sought a mandatory buyout by Christopher of the estate's shares for fair value pursuant to BCL § 1118. [ii]

In an unreported decision, the court denied Christopher's motion to dismiss Gwen's petition and ordered Christopher to purchase the shares (even though he did not voluntarily elect to do so), thereby involving the full panoply of Section 1118. Christopher naturally appealed, and the appellate court affirmed.

Had Christopher instead pursued mediation, he probably would be a much happier man today.

The appellate court rejected Christopher's claim of deadlock because the record demonstrated that the parties had agreed on an interim operating arrangement that was not fully implemented because of Christopher's unilateral actions. The court concluded that the estate was the victim of oppressive conduct and showed "special circumstances" under Section 1104-a. Finally, it agreed that the lower court properly exercised its discretion "in ordering the extraordinary remedy of a forced buyout" rather than dissolve Clever Innovations.

There is no reason to assume there will be agreement on the price of the shares. An application under Section 1118(b) to determine the fair value of the estate's shares is likely as is a reference to a referee—and so it will go!

We recently represented a client in a similar situation. Our client was a 50% shareholder in a successful consulting company and had deadlocked with the other shareholder. The shareholder agreement, drafted years earlier by a deceased relative, was essentially useless.

The shareholders started with the identical goal: to destroy the other financially and psychologically through litigation. Divorce was the only solution, but we knew dissolution under the BCL would be costly and not necessarily productive, especially given the parties' hostility towards each other.

We and the lawyer for the other shareholder persuaded the two shareholders to try an innovative form of mediation. Both had confidence in the company's outside accountants to value the consulting firm's assets and settle numerous significant and petty disputes. They agreed that there would be no appeal from any fact decision of the accountants.

We worked on the dissolution for six months. The owners divided the business and moved on with their lives, divorced but not financially destroyed. Although there remains ill will, our client recognizes that the route he took was far less costly and, most importantly, more protective of his client base, than the scorched earth policy that he originally sought. Rather than a court or a referee making decisions and valuing assets, he far preferred allowing the accountants, who knew and understood the shareholders and the business, to make those critical decisions that allowed him to move relatively seamlessly into his new business.

[i] Under both Sections the court may not deny dissolution "merely because it is found that the corporation has been or could be conducted at a profit." (§ 1111(c)). A petition also may be commenced by the attorney general (§ 1101), by the directors or the shareholders after a meeting where a majority of the board or shareholders, respectively, resolves to dissolve because the assets are "not sufficient to discharge its liabilities" or "they deem a dissolution to be beneficial to the shareholders" (§§ 1102, 1103). In addition, §1104(c) provides that any shareholder can petition for dissolution if the shareholders are so divided "that they have failed, for a period which includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired or would have expired upon the election and qualification of their successors."

[ii] BCL § 1104-a has a 20% of the voting shares minimum and is limited to corporations that are neither publicly traded nor registered under the Investment Company Act or 1940. It provides two grounds for dissolution: (1) the directors (or those in control) have engaged in "illegal, fraudulent or oppressive actions toward the complaining shareholders;" or (2) the corporation's assets or property "are being looted, wasted, or diverted for non-corporate purposes by its directors, officers or those in control of the corporation." Section 1104-a, and its companion Section 1118 (applicable only to proceedings under Section 1104-a), anticipate active judicial involvement. Under Section 1104-a, the court must take into account whether liquidation (1) "is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment;" and (2) "is reasonably necessary for the protection of the rights and interest of any substantial number of shareholders or of the petitioners." The court may order the adjustment of stock valuations or surcharge the directors or those in control "upon a finding of willful or reckless dissipation or transfer of assets of corporate property without just or adequate compensation."

Under Section 1118, after a petition is filed, other shareholders may elect to purchase petitioner's shares "at their fair value and upon such terms and conditions as may be approved by the court,…" If the parties cannot agree, the court may stay the proceeding to "determine the fair value of the petitioner's shares as of the day prior to the date on which such petition was filed, exclusive of any element of value arising from such filing…" The court has discretion to (1) preclude the procedure if the would-be purchaser does not make its election within ninety days of the filing of the petition; (2) not permit withdrawal of the election; (3) award interest on the valuation; (4) award petitioner reasonable expenses, including attorneys' fees, if the court permits a late election; and (5) require the would-be purchaser to post security sufficient to secure petitioner for the fair value of the shares.

Joan M. Secofsky, Senior Counsel, focuses on corporate and securities litigation, arbitration and mediation. Jsecofsky@diamondmccarthy.com

Richard I. Janvey, Partner, is a business advisor, mediator and litigator involved in commercial, inter- and intra-company disputes and internal investigations. Richard has completed numerous mediation programs, including the Program on Negotiation at Harvard Law School's Mediation Workshop. RJanvey@diamondmccarthy.com

Both are based in the New York office:

DIAMOND McCARTHY LLP

620 Eighth Avenue (between 40th & 41st Streets), 39th Floor, New York, NY 10018
Phone: (212) 430-5400 Fax: (212) 430-5499