



# Quarter Notes

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## Getting a Divorce from your Business Partner

What do you do if you hold a minority interest in a closely held corporation or limited liability company and the majority is running roughshod over you? What if you and your fellow shareholders are deadlocked and cannot agree on anything concerning the operation of the business?

If you find yourself in this predicament, the good news is that the situation is not hopeless. In New Jersey, the law affords protections and remedies to minority shareholders facing deadlock, oppression, or frustration of their reasonable expectations as owners. Consequently, oppressed shareholders need not suffer by being locked in a close corporation where they may be receiving no income, no return on their investment, and no ability to sell their shares.

### *The Oppressed Shareholder Statute*

The New Jersey Oppressed Shareholder or Deadlock Statute (the "Statute"), codified at N.J.S.A. 14A:12-7, was enacted to protect minority shareholders of closely held corporations. The Statute offers protection to minority shareholders from disputes that can arise as a result of: the close relationships between the shareholders; the unfettered dominance that sometimes can be exerted by the controlling shareholders over the minority; the lack of an open market for sale of a minority interest in the closely-held corporation; and, the hardship by someone who faces being "squeezed-out", mistreated or simply denied his or her reasonable expectations formed at the outset of the relationship.

Generally, minority shareholders of closely held corporations with less than 25 shareholders have standing to assert an oppression cause of action if they can demonstrate that their "reasonable expectations" have been frustrated or the majority has acted fraudulently, illegally or oppressively towards the minority. Cases interpreting and implementing the Statute, in further recognition of the "vulnerability" and special needs of minority shareholders, have ascribed three common characteristics that can cause things to go awry: (1) the fact that the majority has power to dictate to the minority the manner in which the corporation is run; (2) the reality that shareholders in a close corporation are often family members, and the company will deteriorate if personal relationships are destroyed; and (3) the inability of minority shareholders in a close corporation to sell their shares if they are dissatisfied with the corporate management. Because of these factors, the law generally imposes a fiduciary duty upon the majority, requiring it to act with utmost good faith and loyalty.

### *Deadlock*

The Statute provides for relief where the moving party demonstrates a deadlock causing inability to "effect action on one or more substantial matters respecting the management of the corporation's affairs." The essence of a deadlock claim is that the corporation is "unable to act." A deadlocked corporation is one which, because of decision or indecision of stockholders, cannot perform its corporate powers. If deadlock is shown, there are a range of available remedies, as discussed below.

### *Oppression*

Oppression is commonly defined as an act of cruelty, severity, unlawful exaction, or excessive use of authority. In determining "oppression," a New Jersey court will consider the seriousness of the violation and the minority shareholder's reasonable expectations.

New Jersey courts have held that control is dispositive in determin-

ing a corporation's "majority" and "minority" shareholders - the focus is placed on that shareholder's power - or lack thereof. What this means is that even a shareholder owning more than 50% of the corporation could be a "minority" shareholder if he is not the shareholder in control. If, for example, the controlling shareholder owns less than 50% of the corporation, but his exercise of voting power or circumstances allows him to freeze-out the other shareholder by terminating his employment, excluding him from participating in management decision-making, reducing his salary and other income, and/or disproportionately paying distributions of profits, then a court might very well find actionable oppression and accord that oppressed shareholder one or more of the remedies available under the Statute.

### *Remedies*

Courts have numerous options in fashioning remedies for a violation of the Statute. Possible remedies include, without limitation: the removal of a director, officer or employee; the restoration of a wrongfully-removed director, officer or employee; the appointment of a provisional director, custodian, fiscal agent or receiver until differences are resolved or until oppressive conduct ceases; a court-ordered buyout by one party of the other's interest; an auction by the parties; the sale to a third party; and/or, the dissolution of the company. Most often, the court will encourage, if not order, the buyout of the complaining minority shareholder's stock as the least draconian way to solve the problem. Dissolution is typically the last resort.

### *Fair Value and Discounts*

Where a buyout is ordered, the Statute provides for the minority shareholder to receive "fair value" for his or her interest in the corporation. Note that this is not to be confused with "fair market value", a term common in everyday discourse.

Consideration is sometimes given to whether a marketability or minority interest discount may apply. A marketability discount accounts for the relative lack of marketability of an interest in a private corporation given no public exchange in which to sell. A minority interest discount adjusts for a minority shareholder's lack of control over the day-to-day affairs of the corporation. In oppression cases, typically neither a minority nor marketability discount is applied absent extraordinary circumstances.

### *Avoiding the Business Divorce*

The best drafted documents in the world will not necessarily prevent or avoid all subsequent shareholder disputes. However, carefully crafted documents at the outset of the relationship can substantially reduce the potential for later conflict. Hence, the need for competent business counseling at the outset is critical. Good early legal counseling can help shareholders in a close corporation sidestep many of the pitfalls that await the unwary. Among other things, thoughtful consideration should and must be given at the beginning of the business relationship to an exit strategy if reasonable expectations turn out to be frustrated.

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