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The Business Divorce

A primer on minority shareholder oppression rights

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? How do you navigate the business divorce?

The separation of business owners of a closely held entity will often match, and more often surpass, a marital divorce in terms of expense, complexity, and personal acrimony. Like a marital divorce, it concerns money, but not exclusively. Emotions can play a substantial, and quite often leading, role in the business breakup. Like a marriage, private business ventures almost always start with the utmost optimism. That is what makes a subsequent breakdown in the relationship all the more difficult and painful. This is particularly true of business divorces between family members.

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 available 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 confronted 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 fewer 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 toward 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 manage-

ment of the corporation's affairs."The essence of a deadlock claim is that the corporation is "unable to act."This most commonly occurs when two 50/50 shareholders are at loggerheads. A deadlocked corporation is one that, because of the 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. This adherence to the "reasonable expectation" test is consistent with the approach taken by most jurisdictions with similar oppression statutes.

New Jersey courts have held that control is dispositive in determining a corporation's majority and minority shareholders. What this means is that even a shareholder owning more than 50 percent of the corporation could be found to be a "minority" shareholder if he is not the shareholder in control. The focus is placed on that shareholder's power—or lack thereof. For example, regardless of actual ownership share, if the controlling shareholder's 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 shareholder one or more of the panoply of remedies available under the Statute.

The New Jersey appellate court's opinion in *Musto v. Vidas* is illustrative. In that case, the court affirmed the trial court's ruling that the majority shareholders effectively oppressed the minority shares, based, in part, on the reasonable expectations of the minority shareholder. The court deemed several actions violative of

the minority shareholder's reasonable expectations, including: termination of plaintiff's employment, alteration of the company's equal compensation agreement, and the majority shareholders' attempts to dilute the minority shareholder's stock interest. The court explained that such behavior "was an attempt to effectively 'freeze out' plaintiff as minority shareholder."

Remedies

Courts have a lot of options in fashioning remedies for a violation of the Statute. Oppressed shareholders may be entitled to equitable as well as statutory relief. 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.

When deciding which remedy or remedies to employ, a court generally considers such factors as the seriousness of the alleged oppression, the degree of harm to the respective shareholders, the effect on the company as a going concern, the potential loss of good will, and the potential harm to innocent third parties. The court will attempt to weigh the oppressed shareholder's reasonable expectations against the majority's ability to exercise its business judgment to effectively run 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 must be given to whether a marketability or minority interest discount should be applied in arriving at fair value. A marketability discount is sometimes used to account for the relative lack of marketability of a minority interest given no public exchange in which to sell. A minority interest discount, on the other hand, is a downward adjustment due to a minority shareholder's lack of control over the day-to-day affairs of the corporation. Unlike the marketability discount, which may apply to either a minority or majority stock interest in a corporation, the minority discount may apply only to a minority interest.

Generally, such discounts come into play when there is a sale of an interest of a close corporation to an outsider. However, in oppression cases, typically neither a marketability nor a minority discount is applied absent extraordinary circumstances. Otherwise, if such discounts were applied, that might encourage more oppression. The Statute does not allow the oppressor to harm his partner and the company and be rewarded with the right to buy out that partner at a discount. Thus, a discount may apply when the oppressor is bought out, but generally not when the oppressor remains in control and buys out the oppressed shareholder.

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 from the beginning 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. C

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COURTS HAVE A LOT OF OPTIONS IN FASHIONING REMEDIES FOR A VIOLATION OF THE STATUTE.