

OUTSIDE COUNSEL

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The Law of Corporate Divorce

Experience teaches us that one of the most important factors in determining whether a small business will be successful is how well the owners get along with one another. Law reporters are replete with judicial decisions whose genesis were failed business relationships. The care with which one must choose his business partners, however, is seldom a topic encountered by students in law or business school.

Just as it is inevitable that a certain percentage of marriages will end in divorce, the same is true of business partnerships. But how does one go about obtaining a "corporate divorce" when those differences between shareholders truly become irreconcilable?

Business Corporation Law provides that the holders of shares representing one half of the votes of all outstanding shares of a corporation entitled to vote in an election of directors may present a petition for dissolution on one or more of the following grounds:

- (1) That the directors are so divided respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained.
- (2) That the shareholders are so divided that the votes required for the election of directors cannot be obtained.
- (3) There is internal dissension and two or more factions are so divided that dissolution would be beneficial to the shareholders.

Director Deadlock

Where the directors are so deadlocked respecting the management of the corporation's affairs that the votes required for action by the board cannot be obtained, the court can order judicial dissolution pursuant to



BCL §1104(a)(1). The petition for judicial dissolution is a special proceeding brought on by order to show cause, and the procedure concerning issuance, publication, service,

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and filing of the petition is prescribed by BCL §1106. The venue of the proceeding is generally the county in which the office of the corporation is located pursuant to BCL §1112.

A petition adequately stated a cause of action for judicial dissolution due to director deadlock when it alleged that the corporation had no bank account because of disputes between the owners concerning the drawing of checks; corporate bills were not being paid, prompting lawsuits and a possible foreclosure action; where the directors could not even agree as to the location of an office for the business; and certain directors failed to appear at a board of directors meeting

for the purpose of attempting to resolve such issues.¹

Cases involving director deadlock are often seen where there are two, or another even number of directors. It is common to join a claim based on director deadlock under BCL §1104(a)(1) with one for shareholder dissension under BCL §1104(a)(3).

That the only two directors are not speaking to one another is not alone ground for judicial dissolution under §1104(a)(1).² The deadlock must be over a management decision.³

Shareholder Deadlock

If two shareholders are so deadlocked that they cannot agree to elect a third director⁴ or fill a vacancy on the board of directors,⁵ judicial dissolution under BCL §1104(a)(2) may be appropriate. Dissolution will not be ordered, however, where the corporation is otherwise functioning in an efficient manner, and the shareholder seeking dissolution has made no bona fide attempt to agree with the other shareholder on the selection of a third director.⁶

BCL §1104(a)(3) provides for judicial dissolution when "there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders." Where there is intense personal hostility between two 50/50 shareholders, which poses an irreconcilable barrier to the continued functioning and prosperity of the corporation, judicial dissolution may be the only viable remedy to resolve the dissension and deadlock.⁷ The underlying reason for the dissension is irrelevant, as is any attempt to ascribe fault to either party.

When the dissension between two shareholders led to an inability to agree on any corporate decisions, including the hiring and firing of employees, the election of officers, and corporate spending, judicial dissolution was an appropriate remedy.⁸

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In order to determine whether to grant judicial dissolution pursuant to BCL §1104(a), the court will generally order an evidentiary hearing. Indeed, BCL §1109 specifically contemplates and provides for such a hearing.

Whether to dissolve a 50/50 corporation in the face of dissension and deadlock rests within the sound discretion of the court.⁹ In considering whether to exercise its discretion to dissolve a corporation "the benefit to the shareholders of a dissolution is of paramount importance," according to BCL §1111(b)(2). In determining whether it would be beneficial to the shareholders to dissolve the corporation, BCL §1111(b)(3) specifically provides that "dissolution is not to be denied merely because it is found that the corporate business has been or could be conducted at a profit."¹⁰

The Minority Shareholder

As explained earlier, a 50/50 shareholder who seeks dissolution must show the existence of dissension and/or deadlock, and that dissolution would be beneficial to the shareholders. The burden for the minority shareholder seeking dissolution is different. The holders of shares representing 20 percent or more of the votes of all outstanding shares of a closely held corporation may present a petition for dissolution on either or both of the following grounds according to BCL §1104-a (a):

- (1) The directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders;
- (2) The property or assets of the corporation are being looted, wasted or diverted for non-corporate purposes by its directors, officers or those in control of the corporation.

In cases involving a minority shareholder seeking to dissolve a corporation due to fraud or oppressive conduct under BCL §1104-a(1), the leading case is *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 484 N.Y.S.2d 799 (1984). Here, the New York Court of Appeals declared that conduct would be deemed oppressive within the meaning of the statute where it "substantially defeats the 'reasonable expectations' held by minority shareholders in committing their capital to the particular enterprise."

When courts do grant dissolution due to oppressive conduct probably the most frequently cited ground is the termination of the minority shareholder's employment by the corporation.¹¹ The reason is that continued employment with the closely held

corporation is generally one of the returns on his investment that the minority shareholder has a reasonable expectation of maintaining.

On the other hand, the failure of the majority shareholders to allow the minority shareholders access to corporate records and to account to them on a regular basis was not oppressive where the minority shareholders had not previously sought to be actively involved in the management of the business.¹²

In another case, the failure to declare dividends and to elect the minority shareholder to the board of directors was found not to constitute oppressive conduct within the meaning of the statute.¹³

If the majority shareholders are guilty of wasting corporate assets for non-corporate purposes, or usurping corporate opportunities for themselves, judicial dissolution may be ordered pursuant to BCL §1104 a(a)(2). Thus, dissolution was appropriate where the majority shareholders of a real estate corporation were guilty of, among other things, the sale of four undeveloped parcels of realty to other corporations in which the majority shareholders had an interest.¹⁴

Alternatives to Dissolution

Section 1104-a(b) requires that the court, in determining whether to order dissolution, take into account:

- (1) Whether liquidation of the corporation is the only feasible means whereby the petitioners may reasonably expect to obtain a fair return on their investment; and
- (2) Whether liquidation of the corporation is reasonably necessary for the protection of the rights and interest of any substantial number of shareholders or of the petitioners.

Dissolution has been described as "a 'drastic' remedy, and before ordering it the court must consider whether it is the only means by which the complaining shareholders can reasonably expect to receive a fair return on their investment or whether it is reasonably necessary to protect their rights and interests."¹⁵

Although dissolution may be a drastic remedy, when fulfillment of the oppressed minority shareholder's reasonable expectations by alternative remedies is doubtful, "such as when there has been a complete deterioration of relations between the parties, a court should not hesitate to order dissolution."¹⁶

The Court of Appeals made clear in *Kemp & Beatley* that in dissolution cases brought under §1104-a: "Every order of dissolution,

however, must be conditioned upon permitting any shareholder of the corporation to elect to purchase the complaining shareholder's stock at fair value (see Business Corporation Law, §1118)."

Thus, it is common for the court, when ordering dissolution, to make it conditional, i.e., the corporation will be judicially dissolved unless the majority shareholders or the corporation buy out the minority shareholder for fair value.

In addition, in any dissolution proceeding brought pursuant to §1104-a, the other shareholders have 90 days within which to elect to purchase the petitioner's shares at fair value, pursuant to BCL §1118(a).

Corporate dissolution litigation is usually expensive and fraught with emotion. It is generally preferable to attempt to resolve the issues giving rise to the conflict by agreement, whether by buy-out, or otherwise. In those cases where there is no alternative, however, Business Corporation Law supplies a statutory framework to achieve that corporate divorce.

(1) *In re Alsol Holding Corp.*, n.o.r., 137 N.Y.S.2d 184 (Sup. Ct. Kings Co. 1954).

(2) *Hayes v. Festa*, 202 A.D.2d 277, 612 N.Y.S.2d 561 (1st Dep't 1994).

(3) *In re Seamerlin Operating Co.*, 307 N.Y. 407 (1954); *In re Parveen*, 259 A.D.2d 389, 687 N.Y.S.2d 90 (1st Dep't 1999).

(4) *In re Casale-Chadwick, Inc.* 31 Misc.2d 699, 221 N.Y.S.2d 608 (Sup. Ct. N.Y. Co. 1961).

(5) *In re Goldstone*, 40 A.D.2d 971, 338 N.Y.S.2d 756 (1st Dep't 1972).

(6) See, e.g., *In re Cantelmo*, 275 A.D.2d 231, 88 N.Y.S.2d 604 (1st Dep't 1949).

(7) *In re T.J. Ronan Paint Corp.*, 98 A.D.2d 413, 469 N.Y.S.2d 931 (1st Dep't 1984).

(8) *Greer v. Greer*, 124 A.D.2d 707, 508 N.Y.S.2d 217 (2d Dep't 1986).

(9) See, e.g., *In re Topper's Hamburger of Distinction, Inc.*, 28 Misc.2d 626, 213 N.Y.S.2d 117 (Sup. Ct. N.Y. Co. 1961).

(10) *Accord, Tavlin v. Munsey Candlelight Corp.*, 69 A.D.2d 865, 415 N.Y.S.2d 438 (2d Dep't 1979); see also, *T.J. Ronan Paint Corp.*, supra, 98 A.D.2d at 418, 469 N.Y.S.2d at 934.

(11) See, e.g., *In re Upstate Medical Associates, P.C.*, 292 A.D.2d 732, 739 N.Y.S.2d 766 (3d Dep't 2002); *Burack v. I. Burack, Inc.*, 137 A.D.2d 523, 524 N.Y.S.2d 457 (2d Dep't 1988); *In re Imperatore*, 128 A.D.2d 707, 512 N.Y.S.2d 904 (2d Dep't 1987); *Ginzberg v. Art-Lloyd Metal Products Corp.*, 112 A.D.2d 423, 492, N.Y.S.2d 83 (2d Dep't 1985); *In re Wiedy's Furniture Clearance Center Co.*, 108 A.D.2d 81, 487 N.Y.S.2d 901 (3d Dep't 1985).

(12) *Brckman v. Brickman Estate At The Point, Inc.*, 253 A.D.2d 812, 677 N.Y.S.2d 600 (2d Dep't 1998).

(13) *In re Smith*, 154 A.D.2d 537, 546, N.Y.S.2d 382 (2d Dep't 1989).

(14) *In re Charleston Square, Inc.*, 295 A.D.2d 425, 743 N.Y.S.2d 170 (2d Dep't 2002). See also, *Petruglia v. Whirlwind Music Distributors, Inc.*, 126 A.D.2d 948, 511 N.Y.S.2d 718 (4th Dep't 1987).

(15) *Gimpel v. Bolstein*, 125 Misc.2d 45, 49, 477 N.Y.S.2d 1014, 1017 (Sup. Ct. N.Y. Co. 1984).

(16) *Kemp & Beatley*, supra, 64 N.Y.2d at 74, 484 N.Y.S.2d at 806.