Advising business owners who hate their partners

By Jim Scheinkman and Katy Annuschat

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While shareholder discord at large public companies garners much of the nation's business headlines, shareholder disputes in closely-held businesses are much more likely to result in business failure. Shareholder disputes can be extraordinarily expensive and damaging to business operations, and smaller businesses frequently lack the financial resources and wherewithal to withstand the disruption wrought by warring shareholders. Voltaire once advised that "a long dispute means both parties are wrong." This is apt for disputes at privately held businesses when insistence on being "right" may very well translate into insistence on business failure.

Disputes within closely held businesses arise for a myriad of reasons. Often, familiarity does indeed breed contempt. For family owned businesses, disagreements over business decisions, combined with longstanding family or marital resentments, create perfect storms. Generational ownership changes may result in new ownership ill prepared to work collaboratively. In other cases, owners running the business may resent "carrying" passive owners. For businesses that have been partially acquired by private equity or other investors, original owners may have very different objectives than their new "partners."

While effective governance and conflict resolution mechanisms ameliorate the risk of business turmoil, such mechanisms are sorely lacking at most privately held companies. According to a 2010 PwC Family Business Survey, "*Kin in the Game*," 71 percent of family-owned businesses do not have conflict resolution procedures. Many corporations do not conduct regular board of director or shareholder meetings, let alone have a functioning board. For companies which have not had regular involvement from corporate counsel, it is not uncommon to discover that there is not only no existing buy-sell agreement, but also that bylaws are nonexistent, missing, or outdated.

When one or more of the warring shareholders reach out to counsel for advice, counsel must address quickly a myriad of issues, including counsel's own professional responsibility obligations, owner rights to information, the participants' fiduciary and other duties, meeting procedures, and dispute resolution mechanisms achievable under the California Corporations Code or by negotiation.

The first order of business for the attorney is to identify the client and determine whether the representation would involve a conflict of interest with another present or former client. As noted in the discussion accompanying Rules of Professional Conduct 3-600, "in dealing with a close corporation or small association, members commonly perform professional engagements for both the organization and its major constituents," and "when a change of control occurs or is threatened, members face complex decisions involving personal and institutional relationships and loyalties and have frequently had difficulty in perceiving their correct duty."

Consider, for example, an attorney who is asked for advice by a corporate principal when the attorney has represented the company on various matters and also handled estate planning and other personal matters for the shareholders. The attorney must ascertain whether the inquirer is seeking advice for the corporation or personally, whether parties adverse to the inquirer are also clients or former clients, and whether the attorney obtained confidential information of other clients which are material to the prospective new engagement.

The natural instinct of many lawyers when approached by someone with whom the attorney has had a longstanding relationship is to want to help immediately or to try to mediate a resolution. However, the attorney should resist this temptation until he or she has determined who the client is and whether that representation may be undertaken. For an attorney representing the corporation, Rule 3-600 requirements must be strictly followed, including the obligations to explain to participants that the corporation is the attorney's only client and to avoid misleading those individuals into believing that they may communicate confidential information to the attorney in a manner that will not be used for the corporation if the corporation is or becomes adverse to the individuals.

To successfully navigate a dispute, owners must understand their rights and obligations *vis-à-vis* fellow owners. The Corporations Code affords numerous protections for minority shareholders, including the right to cumulate votes for director elections and the right of directors and shareholders to information. Informational access is critical to protection of shareholder rights and corporate governance. Under Corporations Code Section 1602, directors have an "absolute right to inspect and

copy all books, records and documents of every kind." Case law has recognized there may be some limits on this right in the event that the records are being accessed to commit a tort against the corporation or otherwise violate fiduciary duties, or to access attorney-client privileged information of the corporation in litigation in which the director is adverse.

A voting deadlock between owners can be fatal to corporate operations. Corporations Code Section 308 provides for court appointed "provisional directors" to address deadlocks. For example, a director or holder of at least one-third of the corporation's voting power may bring an action for a provisional director if the corporation has an even number of directors who are equally divided and cannot agree as to management of the corporation's affairs so that its business can no longer be conducted to advantage or if there is danger that corporate property and business will be impaired.

Additionally, if the shareholders are deadlocked so that they cannot elect the directors to be elected at an annual meeting, shareholders holding 50 percent of the voting power may petition for provisional director or directors. A provisional director may be very helpful in ensuring that corporate governance procedures are observed and rights of individual shareholders respected, providing tie-breaking votes in some instances, and even acting as an informal mediator. However, it is a provisional remedy, and, in practice, provisional directors may be reticent to cast votes on difficult or contentious issues or on matters that have long-lasting implications.

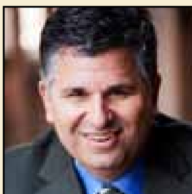
One card sometimes played is dissolution. The Corporations Code affords a shareholder with 50 percent or more of the voting power the ability to trigger a "voluntary" dissolution. A minority shareholder that has at least one-third of the common shares or equity of the corporation (excluding the shares of certain shareholders in some instances) can bring an involuntary dissolution proceeding on certain grounds, including instances of deadlock, pervasive fraud, mismanagement, abuse of authority, or corporate waste by controlling persons, or even if liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholders.

However, under Corporations Code Section 2000, a shareholder holding at least 50 percent of the voting power can avoid dissolution by directly buying, or causing the corporation to buy, the shares of the shareholders seeking dissolution for the "fair value" of their shares. For this purpose, "fair value" is based on the corporation's liquidation value, but taking into account the possibility, if any, of selling the business as a going concern.

There has been a significant amount of case law on Section 2000's determination of fair value, as well as other aspects of the statute. Section 2000 provides some interesting strategies to consider, such as addressing whether a shareholder seeking dissolution will withdraw its dissolution efforts to avoid a buyout, an open issue whether a buyout by the corporation must comply with the Corporations Code Section 500 requirements limiting shareholder distributions, and practical issues of how to arrange financing for a corporate buyout during contested proceedings.

In summary, there are many issues and strategies to consider when representing a client in a shareholder dispute. The focus of all participants, however, should be on an expedient resolution that preserves shareholder value. In the end, this may very well mean a negotiated buy-out of a party or a sale of the entire business. Early mediation between the parties can be very useful.

The focus by participants and their counsel should be for a business solution, and not emotional vindication. A shareholder not amenable to an expedient business solution should take heed of the words reportedly said by Pyrrhus after his "victory" over the Romans in the Battle of Asculum in 279 BC: "One more such victory will undo me!"



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