

Litigation Between Owners of a Small Business

Disputes between owners are an all too common occurrence for closely held corporations, limited liability companies and partnerships. Conflict can arise when a business is doing well (taking the lion's share of credit and profit) or doing poorly (casting blame, shirking responsibility and shifting loss). Good sense dictates sound planning including solid and unambiguous business formation and governance documents which minimize grey areas. When litigation is unavoidable, the focus should shift to issue identification, assessment of likely outcomes and informed strategizing.

Below are bullet points setting forth issues related to the proper formation of a small business and then moving on to issues typically encountered in litigation. Ideally, these topics have been anticipated in the business formation and governance documents and may be quickly disposed of through negotiated settlement or motion practice in litigation. If an expeditious and inexpensive resolution is not possible, also summarized are common issues typically arising with internal small business litigation.

The purpose of the bullet points is to highlight potential issues. The list is not comprehensive. More detailed and focused analysis can be applied once the particular facts and circumstances are known:

- (1) Forms of Ownership
 - A. New Jersey Limited Liability Company Act, NJSA 43:2B-1 – default rule, if no operating agreement, relationship covered by Act
 - B. NJ Business Corp. Act, NJSA 14A:1-1
 - C. NJ Partnership Act , NJSA 42-1A-30
 - D. Tax issues
 - E. Corporation; S Corp; LLC; Partnership

- (2) “Operating” Agreement should:
 - (i) Explicate the rights and obligations of those managing the company
 - (a) Extent of personal liability of members, standard
 - (b) Indemnification
 - (c) Extent members can conduct business with company
 - (ii) How members share in the economic results of the company
 - (iii) Admission of new members – revaluation of interests upon admission of new member
 - (iv) Governance Structure
 - (a) ability to bind company
 - (b) Appointment of Officers - Percentage of approval needed, method of voting; designation of authority
 - (c) Appraisal Rights
 - (d) Inspection Rights
 - (v) Incorporation of Exit Strategy
 - (a) Buy-out rights at death, disability, scheduled retirement
 - (b) Resignation
 - (c) Limits on benefits of majority/power of majority
 - (vi) Terms under which member can assign interest
 - (a) permissible or impermissible and under which conditions
 - (v) Alternative dispute resolution
 - (vi) Forum selection, choice of law, and jury waiver
 - (vii) Reimbursement or shifting of attorneys' fees - standard

- (3) Common Issues in Litigation
 - A. Basis for Liability
 - (i) Self dealing/Breach of fiduciary duty
 - (a) Misappropriation of assets
 - (b) Misdirection of corporate opportunities
 - (c) Failure to report or provide access and inspection of books and records
 - (d) Disregard for proper corporate governance
 - (ii) Oppressed Minority – reasonable expectations of minority shareholder is touchstone standard of whether majority has been oppressive – Mullenberg, 143 N.J. 168, 179 (1996); Brenner, 134 N.J. 488, 509 (1993)

B. Remedies

- (i) NJSA 14A:12-7 [Oppressed Shareholder statute; close corporations]
 1. Dissolution – disfavored, seen as extreme
 2. Partition – typically used when business assets are real estate. Newman, 70 N.J. 254 (1976)
 3. Judicial appointment of:
 - (a) Custodian – 14A:12-7(4) - broad power
 - (b) Provisional Director – 14A:12-7(3) - deadlock situations
 - (c) Special Master – Rule 4:41 – quasi-judge, rarely used
 - (d) Commissioner – Rule 4:63-1 - partition of property
 - (e) Special fiscal agent – Roach, 42 N.J. 243 (App. Div. 1956) – equitable remedy not found in statute
- *Input on selection is key to usefulness of judicial appointment
4. Buy-Out – judicially ordered, issues:
 - (a) Who buys out whom?
 - (b) Who can afford to buy out whom?
 - (c) Valuation process
 - (d) Equitable adjustments to the Fair Market Value, e.g., value has been depressed because of acts of wrongdoing, shareholder; “marketability discount” – Balsamides, 160 N.J. 352 (1999)
5. Non-Compete Orders – typical in buy-out scenario
6. Injunctions – typical in oppression scenario against oppressive conduct, e.g., requiring dividend, reducing excessive salaries to majority
7. Lock-out – ordered when risk of physical altercation
8. Inspection of Books and Records - 14A:5-28 – minority has right to inspection and can use accountant; majority has fiduciary duty to keep proper records
9. Award of attorneys’ fees - NJSA 14A:12-7(8)(d)
10. Additional Equitable Remedies
 - (a) forfeiture of salaries – Raynolds, 69 N.J. Eq. 299
 - (b) Reformation of by-laws – Konsuvo, 91 N.J. Super. 353 (Ch. Div. 1986)
 - (c) Refusal to enforce agreements – Id.
 - (d) Declaration of dividends
 - (e) Release of excessive reserves
 - (f) Reduction of excessive bonuses
 - (g) Accountings
 - (h) Invalidation of corporate actions, e.g., sweetheart loans
 - (i) Reinstatement of employment, salary benefits
 - (j) Straw owner liable under imputation doctrine. NCP Litig. Trust, 187 N.J. 353 (2006)

(4) Irreconcilable Disputes Between Owners – see Sections (2) and (3) above

A. Litigation

1. Forum selection/choice of law
 2. Emergent relief, e.g., restraints available?
 3. Appointment of Receiver/Custodian
 4. Valuation issues – expert witnesses
 5. Reimbursement of attorneys’ fees – NJSA 14A:12-7(8)(d)
- ### B. Alternative Dispute Resolution – provided in formation documents?
1. Mediation – structured settlement negotiations
 2. Arbitration – alternative to litigation; binding or non-binding
- ### C. Insurance coverage to pay litigation costs and to cover ongoing business losses
- ### D. Impact on Financing – need to add replacement guarantors or additional collateral

- (5) Bankruptcy
- A. Types
 - 1. Chapter 7 – liquidation
 - 2. Chapter 11 – reorganization for business
 - 3. Chapter 13 – reorganization for individual
 - B. Remedies (assuming qualified after full disclosure of finances)
 - 1. Stay of pending litigation, including collection efforts against business
 - 2. Discharge of unsecured debts – fraud or breach of fiduciary duty by wrongdoing owner may make debts non-dischargeable. See, e.g., 11 USC Section 523(a)(4)

Diligent pre-planning is always a sound investment to keep a small business on course. In the event litigation is unavoidable, the attorneys, arbitrators and the courts will look to the business formation and governance documents as they assess the particular facts, and then weigh those facts against New Jersey’s statutory scheme and the case law interpreting those statutes. The results of litigation are never guaranteed, but in most situations the ultimate resolution of any particular dispute, whether by negotiated settlement or litigated determination, will be heavily influenced by analysis similar to that set forth above.

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