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Procedures and Remedies in Co-Owner Disputes

CalCPA Closely Held Business Conference

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PROCEDURES AND REMEDIES
IN CO-OWNER DISPUTES

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“AMICABLE” RESOLUTIONS

I. Negotiation

- A. Direct: Owner to owner
- B. Facilitated: e.g., mediation

II. Contractual Mechanisms

- A. E.g., buy-out provisions, rights of first refusal
- B. Arbitration or other dispute resolution

DISSOCIATION AND VOLUNTARY DISSOLUTION

I. General Partnership/Limited Liability Partnership

- A. Dissociation (*§ 16601 et seq.*)¹
 - 1. Events causing dissociation
 - a. Partner’s decision to dissociate
 - b. Death of partner
 - c. Event in partnership agreement causing dissociation
 - d. Partner’s expulsion pursuant to partnership agreement
 - e. Partner’s expulsion by unanimous vote of other partners for specified statutory reasons

¹ All references are to California Corporation Code.

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- f. Partner's expulsion for specified wrongdoing by court order upon application of partnership or another partner
 - g. Partner bankruptcy
 - h. Other circumstances specified by statute
2. Power to dissociate
- a. Partner always has right to dissociate, even if wrongful
 - b. Wrongful dissociation
 - i. Judicial expulsion
 - ii. Express breach of partnership agreement
 - iii. Partner bankruptcy
 - iv. Other circumstances specified by statute
 - c. Wrongfully dissociating partner liable to partnership and other partners for damages caused by dissociation
3. Effect of dissociation
- a. Partner's right to participate in partnership terminates
 - b. Partner's duty to refrain from competing with partnership terminates
 - c. Partner's fiduciary obligations continue only with respect to pre-dissociation acts or matters
4. Buy-out of dissociating partner
- a. Buy-out price
 - i. Amount distributable to dissociating partner if assets sold on date of dissociation for greater of

liquidation value or value of business if sold as
going concern without dissociating partner

ii. Damages caused by wrongful dissociation and other
amount owing from dissociating partner offset
against price

b. If no agreement reached in 120 days after dissociation,
partnership must estimate buy-out price and pay

c. Dissociating partner may petition court to determine
valuation if unsatisfied with estimate buy-out price

B. Circumstances Permitting Voluntary Dissolution (*§ 16801 et seq.*)

1. In a partnership at will, by express will of 50% or more of partners.

2. In a partnership for definite term or undertaking:

a. 90 days after certain dissociation events

b. by express will of all partners

c. upon expiration of the term or completion of the
undertaking

3. Upon events specified in the partnership agreement

4. If substantially all of the business of the partnership becomes
unlawful

C. Procedures Following Dissolution

1. Any partner may participate in winding up and dissolution

2. Partnership continues through winding up of business; judicial
supervision may be requested for good cause

3. Partnership may be bound by post-dissolution acts of partner and, except in limited circumstances, partners are liable to one another for respective shares of post-dissolution debts
4. Partnership may be reinstated by agreement of all partners prior to winding up
5. Statement of dissolution may be filed with Secretary of State
6. Settlement of accounts

II. Limited Partnership (§ 15681 et seq.)

A. Circumstances Permitting Voluntary Dissolution

1. Upon circumstances specified in the partnership agreement
2. Upon written consent of all general partners and a majority in interest of the limited partners
3. Upon the termination of a general partner, unless:
 - a. there are one or more general partners remaining who continue the business; or
 - b. a majority in interest of the limited partners agree to continue the business and admit a new general partner within 6 months

B. Procedures Following Dissolution

1. Dissolution overseen by non-wrongdoing general partners or, if none, by limited partners
2. Upon petition of 5% or more of limited partners or three or more creditors, court may enter a decree for protection of any party in interest

3. Certificate of dissolution filed with Secretary of State
4. Settlement of accounts
5. General partner can continue to bind partnership in specified circumstances

III. Limited Liability Company (§ 17350 et seq.)

A. Circumstances Permitting Voluntary Dissolution

1. Upon circumstances specified in the articles of organization
2. By vote of a majority in interest of the members, or more if specified in the articles of organization or operating agreement
3. Within twelve months from the filing of articles of organization if the company has not conducted any business and a certificate of cancellation is filed by:
 - a. the majority of the members;
 - b. if there are no members, a majority of the managers;
 - c. if there are no managers, the person signing the articles of organization or a majority of the persons signing the articles of organization

B. Procedures Following Dissolution

1. Dissolution overseen by non-wrongdoing managers or, if none, the members
2. Notice to creditors required
3. Upon petition of any manager, any member or three or more creditors, court may enter decree for protection of any party in interest

4. Company continues through winding up process
5. Certificate of Dissolution shall be filed with Secretary of State upon dissolution; Certificate of Cancellation of Articles of Organization shall be filed upon completion of winding up
6. Settlement of accounts
7. Company may be reinstated by unanimous vote of the members prior to winding up; Certificate of Continuation to be filed
8. After payment to creditors, assets distributed to members as provided by § 17353
9. Claims against dissolved company may be enforced to the extent of undistributed assets or against members to the extent of assets distributed to them

IV. Corporation (§ 1900 et seq.)

A. Circumstances Permitting Voluntary Dissolution

1. By shareholder vote representing 50% or more of voting power
2. Upon approval by the board if the corporation:
 - a. is in Ch. 7 bankruptcy; or
 - b. has no assets and has conducted no business for the last five years; or
3. If the corporation has issue no shares and a certificate of cancellation is filed by:
 - a. the majority of the directors;
 - b. if there are no directors, the incorporator or a majority of the incorporators

B. Procedures Following Dissolution

1. Directors continue to oversee business during winding up period
2. The corporation must file a certificate setting forth the election to dissolve and the circumstances of the decision
3. The dissolution may be revoked prior to any distribution of assets by a majority of either shareholders or directors according to which body originally voted on dissolution – a certificate of revocation must be filed
4. A court may be asked to supervise the winding up process if necessary for the protection of any party in interest upon petition by the corporation, shareholders of 5% or more of total shares outstanding, any shareholder of a close corporation, or three or more creditors
5. A certificate of dissolution must be filed upon completion of winding up
6. Settlement of accounts, payment of creditors and distribution of assets
7. Corporation may recover improper distributions to shareholders for benefit of creditors
8. Claims may be pursued against dissolved company to extent of undistributed assets or against shareholders to the extent of assets distributed to them

CIVIL LITIGATION

I. “Derivative” claims

- A. Most common in corporations, but also possible for LPs and LLCs.
- B. Procedure
 - 1. Civil action brought in name of the entity, **not** the complaining owner
 - 2. Demand must first be made on director/general partner/manager to pursue action unless futile to make demand (*e.g.*, because wrongdoer(s) in charge)
 - 3. May be coupled with request for equitable remedies (see below).
 - 4. “Business judgment rule” provides a defense
- C. Judgment is in name of entity and damages payable to entity

II. Individual damage claims

- A. Requires showing of injury to complaining owner as distinct from injury to entity.
 - 1. Distinction important because determines form of action
 - 2. Sometimes difficult to separate out injury to business and injury to owner in small companies
- B. Damage claims may be coupled with request for equitable remedies (see below)
- C. Judgment
 - 1. Against shareholder: can include seizure and sale of stock
 - 2. Against partner/LLC member: may only result in “charging order” against partnership interest

III. Equitable remedies

A. Provisional director

1. Court may appoint in face of deadlock on corporation board

B. Receivership

1. Receiver may operate business pending resolution of action or oversee dissolution and liquidation
2. “Drastic” remedy that requires strong showing of wrongdoing or threatened or continuing injury
3. Receiver is officer of court and not agent of any party

C. Injunction

1. Requires showing that complaining party will be irreparably harmed if wrongdoing continues and likelihood of success in proving that wrongdoing actually occurring
2. Difficult to enforce and may embroil court in business operations
3. More likely in cases involving theft of trade secrets, unlawful competition by current or former co-owner

IV. Involuntary Dissolution

A. Involuntary dissolution of all business entities requires court action

B. General Partnership/Limited Liability Partnership (*§ 16801 et seq.*)

1. Who May Apply for Dissolution
 - a. Partners
 - b. Transferee of partnership interest if the partnership was for a definite term or undertaking which has expired

2. Grounds for Dissolution
 - a. Frustration of economic purpose
 - b. Conduct by another partner making it unreasonable to carry on in business together
 - c. Otherwise not reasonably practicable to continue partnership in conformity with partnership agreement
 3. Procedures Following Dissolution
 - a. Business dissolved and wound up in accordance with decree
 - b. Settlement of accounts
- C. Limited Partnership (*§ 15681 et seq.*)
1. Who May Apply for Dissolution
 - a. Any Partner
 2. Grounds for Dissolution
 - a. Not reasonably practicable to continue partnership in conformity with partnership agreement
 - b. Misappropriation, waste, persistent and pervasive fraud, abuse of authority, or unfairness toward any partner by general partner(s)
 - c. Dissolution reasonably necessary to protect the rights or interest of the complaining partners
 3. Procedures Following Dissolution
 - a. Winding up conducted according to dissolution decree.

- b. Settlement of accounts
- D. Limited Liability Company (*§ 17350 et seq.*)
- 1. Who May Apply for Dissolution
 - a. Any Member or Manager
 - 2. Grounds for Dissolution
 - a. Not reasonably practicable to continue business in conformity with articles of organization or operating agreement
 - b. Dissolution reasonably necessary to protect the rights or interest of the complaining members
 - c. The business of the company has been abandoned.
 - d. Management is deadlocked or in dissention
 - e. Those in control of the company have engaged in or knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority
- E. Valuation and buy-out procedure
- 1. Non-plaintiff members may buy out plaintiff members at “fair market value” (determined by court if necessary)
 - a. Triggering statutory buy-out procedure results in stay of involuntary dissolution action
 - b. Court appoints three appraisers
 - c. Valuation considerations

- i. Damages for breach of contract caused by bringing dissolution action may be included in valuation
 - ii. Compare “fair value” in analogous procedure for corporations
 - d. Valuation date is date action commenced, unless court orders otherwise
 - e. Purchaser may decline to pay “fair market value” and permit LLC to be dissolved
- F. Procedures Following Dissolution
 - 1. Winding up conducted according to dissolution decree
 - 2. Settlement of accounts
- G. Corporations (*§ 1800 et seq.*)
 - 1. Who May Apply for Dissolution
 - a. One-half or more of directors in office
 - b. Shareholder(s) representing one-third or more of total outstanding shares, outstanding common shares, or total equity
 - c. Any shareholder if the corporation was for a definite term which has expired
 - d. Any person expressly authorized by the articles of incorporation
- H. Grounds for Dissolution
 - 1. Corporation has abandoned its business for more than one year

2. Directors are deadlocked and shareholders are unable to elect an uneven number
 3. Shareholder deadlock or dissention or failure at two consecutive annual meetings to elect successor directors
 4. Those in control of the corporation have engaged in or knowingly countenanced persistent and pervasive fraud, mismanagement or abuse of authority, unfairness to shareholder(s), misappropriation or waste
 5. For a close corporation, if dissolution is reasonably necessary to protect the rights and interests of the complaining shareholders
 6. The expiration of the term if the corporation was formed for a specific term
- I. Procedural mechanisms specific to corporate dissolution actions
1. Any shareholder or creditor may intervene prior to trial
 2. Attorney General may bring action in cases of serious fraud, abuse, illegality, or failure to pay taxes for five years
- J. Valuation and buy-out procedure
1. Non-plaintiff shareholders or corporation may buy out plaintiff shareholders at “fair value” (determined by court if necessary)
 - a. Triggering statutory buy-out procedure results in stay of involuntary dissolution action
 - b. Court appoints three appraisers

- c. "Fair value" is liquidation value, taking into account the possibility of a sale of the business as a going concern in liquidation
 - i. Damages for breach of contract caused by bringing dissolution action may be included in valuation
 - ii. Valuation may **not** discount for minority interest
 - iii. Unclear whether income taxes and liquidation costs may be taken into consideration in valuation
- d. Valuation date is date action commenced, unless court orders otherwise
- e. Purchaser may decline to pay "fair value" and permit corporation to be dissolved

K. Procedures Following Dissolution

1. Directors shall wind up business subject to court supervision
2. Business is carried on only to the extent necessary for the beneficial winding up thereof
3. Court oversees/determines rights of shareholders to assets, payment of creditors and distribution of assets
4. Creditors shall make proof of claims after publication of notice
5. After settlement of accounts and winding up, the court may enter an order declaring that the corporation is wound up and dissolved
6. Any court order effecting dissolution must be filed with the Secretary of State