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Let’s talk about the reality of shareholder disputes - by Roger Durkin

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Let’s talk about the reality of shareholder disputes. Shareholder disputes can occur as a result of a myriad of business risks. Corporations have shareholders, and LLCs have members. LLCs are managed by members as a group or by electing one or two as managers. There are two types of control: Member-run or manager-run. The members use an operating agreement to set management boundaries to guide the company. LLCs can be problematic in cases in which a member has no voting authority and a dispute arises.

The most common shareholder dispute is among family-owned businesses. This typically occurs when the founder dies and the business is acquired by the children. Usually, one or two siblings take over of the family business and run it as though it is a personal possession. After a few years, the business becomes a fiefdom. Those operating the business forget about the other siblings. Eventually, the other siblings realize their ownership interest is not yielding any benefit, which, in turn, leads to a lawsuit.

Here is a true example. The identity is shielded. The grandfather, an immigrant, started a business which grew measurably to a success. His only child was a daughter who took over the business when he died. She ran the business for 15 years before she died. The founder’s daughter had four children. Her oldest son, who worked for his mother, took over the business after his mother’s death. His three siblings went on with their lives. After running the business for about ten years, the oldest brother drew nearly a million a year in salary. He had a cash-counting room in his multi-million dollar home. Then, thunder and lightning struck. While researching the family’s history, a sibling discovered that the grandfather’s last will clearly indicated that he had not left the business to his daughter; rather, he had left it to the four grandchildren. Not surprisingly, a significant lawsuit erupted.

How do family businesses with multiple family shareholders fall apart? Gradually or suddenly, controlling management often drains the profits by taking excess salaries, misusing credit cards for personal benefits, skimming cash, committing other forms of fiduciary embezzlement, freezing out disgruntled minority shareholders, and/or running the business like a fiefdom by making important business decisions without corporate formality.

Often, people start a business with friends and relatives as shareholders. However, what happens if one of the owners, partners, LLC members, or corporate shareholders becomes physically sick, tires of the business, dies, divorces, or just wants to retire? Family shareholder litigation or a non-family shareholder feud would not occur if the business entity had a workable and definitive buy-sell agreement. Such an agreement would have enabled its owners to terminate their relationship without litigation.

Shareholder disputes in Massachusetts have significant case-law history as a guide. In Brodie v. Jordan 447 Mass. 866, (2006), the Massachusetts Supreme Court ruled that in the absence of a buy-sell agreement requiring the buyout of shares, the court did not have the power to impose a buyout of the minority shareholders whose rights had been breached. The court established protection for minority shareholders beginning with Donahue v. Rodd Electrotype Co. of New England, Inc. 328 N.E.2d 505 (1975). The court held that in close corporations "the relationship among the stockholders must be one of trust, confidence, and absolute loyalty" and that shareholders owe one another a strict fiduciary duty.

In Massachusetts, the type of value in a shareholder dispute is fair value–not fair market value and not market value. The Massachusetts approach to the determination of "fair value" is consistent with the position taken by the American Law Institute and the national trend of interpreting "fair value" as the proportionate pro-rata share of a going concern without any discount for marketability or minority status. [American Law Institute, Principles of Corporate Governance: Analysis and Recommendation, § 7.22(a) (1994)].

In Spenlinhauer vs. Spencer Press, Inc. 81 Mass. App. Ct. 56 (2011), the court cited a number of cases in support of its decision that the fair value of a minority interest was the pro rata value. In Shawnee Telecom Resources, Inc. v. Brown 354 S.W.3d 542 (Kentucky 2011), fair value was stated not as a hypothetical price at which the shareholder might sell his or her shares, but rather as the proportionate interest in the company as a going concern. Fair value does not consider what a hypothetical buyer might pay or what hypothetical seller might sell. It considers the fair value to be a pro-rata share of the going concern.

In the absence of court involvement, Massachusetts shareholders have only the entity's governing documents as a basis for minority shareholders' rights and remedies. Therefore, obtaining a workable and clearly worded buy-sell agreement is vital. If there is no buy-sell agreement, a dispute could arise regarding the manner in which the company is being operated. Shareholder disputes are serious business. If you hear thunder or see lightning, you should call an attorney to help calm the storm or–if necessary–litigate a resolution.

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