

SHAREHOLDER DISPUTES WITHIN CLOSELY HELD ENTITIES

presented by:

J. Patrick Haywood

and

Mark K. York

Carruthers & Roth, P.A.

Phone: 336-478-1152

E-mail: mky@crlaw.com



Overview

- Types of entities and their governing laws
- The relationship
- Friction points
- Tools to avoid disputes
- Resolving disputes
- Significant Statutory Updates and Illustrative Cases

TYPES OF ENTITIES AND THE GOVERNING LAW

Types of Closely Held Entities

- **Partnerships**
 - A business formed by tacit agreement, oral agreement, or written agreement
 - Partners do NOT have limited liability for the liabilities or debts of the partnership

- **Limited Partnerships (“LPs”)**
 - A business created by application to the State of North Carolina
 - Two kinds of partners: general partners and limited partners
 - General partners are subject to liability for the liabilities and debts of the partnership
 - Limited partners liability is limited to their contributions to the partnership

- **Limited Liability Partnerships (“LLP”)**
 - A business created by application to the State of North Carolina
 - Only one class of partners
 - Generally, the partners are not subject to personal liability for the liabilities or debts of the partnership

Types of C-H Entities Continued...

- **Limited Liability Companies (“LLCs”)**
 - A business created by application to the State of North Carolina
 - It is a legal entity that exists separate from its members
 - Members cannot be sued individually for the actions of the LLC.

- **C-Corporations (“C-Corps”)**
 - A business created by application to the State of North Carolina
 - It is a legal entity that exists separate from its shareholders
 - Shareholders cannot be sued individually for the actions of the corporation

- **S-Corporations (“S-Corps”)**
 - Same as a C-Corporation except for pass through taxation

What Governs Closely Held Entities

- Partnerships
 - Partnership Agreement
 - North Carolina Uniform Partnership Act (N.C.G.S. § 59-31 *et seq.*)
 - Case Law

- Limited Partnerships
 - Partnership Agreement
 - North Carolina Revised Uniform Limited Partnership Act (N.C.G.S. § 59-31 *et seq.*)
 - Case Law

- Limited Liability Partnerships
 - Partnership Agreements
 - North Carolina Uniform Partnership Act (N.C.G.S. § 59-31 *et seq.*)
 - Case Law

What Governs C-H Entities Cont...

- Limited Liability Companies
 - Operating Agreement
 - Articles of Organization
 - North Carolina Limited Liability Company Act (N.C.G.S. § 57D-1-01 *et seq.*)
 - Case Law

- C-Corps and S-Corps
 - Shareholder Agreement
 - Articles of Incorporation
 - Bylaws
 - North Carolina Business Corporation Act (N.C.G.S. § 55-1-01 *et seq.*)
 - Case Law

THE RELATIONSHIP



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The Engagement

- The Parties
 - Family
 - Close friends
 - Classmates
 - Colleagues

- The Goals
 - Make money
 - Build a reputation
 - Fill a void in the market place
 - Exert control over one's future

The Marriage

- The commitment
 - Time
 - Money
 - Property
 - Credit

- Living with one another
 - Strengths and weaknesses
 - Management and leadership styles
 - Changing goals

Leading Up To The Divorce

- Goals diverge
- Styles diverge
- Risk tolerance deviates
- Snoring

FRICTION POINTS

Different Contributions

- Financial
 - Initial v. future equity balance
 - Reinvesting earnings v. distributing earnings
 - Future capital contributions
 - Marketing

- Participation
 - Management
 - Special skills or qualifications
 - Amount of time contributed

- Client / customer base
 - Initial v. future
 - Marketing

Different Long Term Goals

- Whether or not to expand market / stores
- Whether or not to diversify products / services
- Whether or not to cash out
- Whether or not to continue direct management
- Whether or not to permit next generation family involvement
- Whether or not to allow new members
- Whether or not to allow post retirement equity interests
- Whether or not grow number of employees

Different Risk Tolerance

- Whether or not to expand market / stores
- Whether or not to diversify products / services
- Purchasing v. leasing real estate
- Personal guarantees
 - Leases
 - Loans
 - Factoring agreements
- Whether or not grow number of employees
- Debt to asset ratio
- Types and quantities of insurance

Malfeasance

- Charging personal expenditures to the business
 - When does pleasure supplant marketing
 - Expense or compensation
- Diverting business opportunities
- Misappropriation of business assets
- Misuse of business labor, equipment or real estate
- Minority oppression
 - Employment
 - Decision making
 - Distributions
- Falsifying business records
- Embezzlement

TOOLS TO AVOID DISPUTES

Operating Agreements

- Who has operational management authority
- Employment expectations
- Methods for determining compensation
- Method for determining distributions
- Dispute resolution
- Method for adding members
- Future capital contributions

- Beware of too much detail

Stock/Interest Purchase Agreements

- Who is a party to the agreement
- When is the agreement entered into
- Who can demand
- When can demand
- What can be demanded
- Who determines price
- When is price determined
- How is price determined
- When or how is payment made

RESOLVING DISPUTES

Buyout Considerations

- Price
- Transition Period
- Guarantees
 - Loans
 - Factoring agreements
 - Leases
- Tax Considerations
 - Lump sum payment
 - Pension
 - Annuity
 - Assets in lieu of payment

Buyout Considerations Continued...

- Consulting agreement

- Non-compete agreement
 - Time
 - Territory
 - Activity restricted
 - Legitimate business purpose

- Non-solicitation agreement
 - Customers
 - Employees

- Non-disclosure
 - Trade secrets (includes customer lists)

Buyout Considerations Continued...

- Real estate
 - Ownership
 - Lease

- Valuation method

- Insurance

- Healthcare

Conflict Resolution

- Buy-Sell agreement
- Third party appraisal
- Mediation
- Litigation
 - Binding arbitration
 - State court (business court)
- Dissolution

Valuation

- In any proceeding brought by a shareholder under N.C.G.S. § 55-14-30(2)(ii) in which the court determines that dissolution would be appropriate, the court shall not order dissolution if, after such determination, the corporation elects to purchase the shares of the complaining shareholder at their fair value, as determined in accordance with such procedures as the court may provide. N.C.G.S. § 55-14-31(d).
- That statute neither defines “fair value” nor specifies the procedures for a court to use in arriving at it.

Valuation

- Fair Market Value

- The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant fact

- Treas. Reg. § 1.170-1(c)(2)

- Presumptions

- Dealing is arm's length
- Buyer and seller are **able** and willing
- Value reflects the economic and market conditions prevalent as of the effective date of the valuation
- Value is in terms of cash or cash equivalent

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Valuation Continued...

- Statement on Standards for Valuation Services No. 1, Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset
 - Issued by American Institute of Certified Public Accountants
 - Establishes standards for AICPA members who are engaged to, or, as part of another engagement, estimate the value of a business, business ownership interest, security, or intangible asset

Valuation Continued...

- Valuation Methods
 - The capitalization of net income method
 - The cash flow method
 - The capitalization of net discounted cash flow method
 - The capitalization of earnings method
 - The discounted future earnings method
 - The market value method
 - The adjusted book value method
 - The gross revenue multiplier method
 - The excess earning method
 - The industry standard method

Valuation Continued...

- Potential Adjustments
 - Fair market value of marketable securities
 - Related party receivables
 - Related party loans
 - Cash value of life insurance
 - Lack of marketability
 - Minority interest
 - Lack of control
 - Accelerated depreciation

SIGNIFICANT STATUTORY UPDATES AND ILLUSTRATIVE CASES

NC Limited Liability Company Act

- New LLC Act (N.C.G.S. § 57D-1-01 *et seq.*) became effective January 1, 2014 and fully superseded the previous LLC Act (N.C.G.S. § 57C-1-01 *et seq.*)

- Distinguish between the different types of ownership interests in an LLC
 - Members: an individual or entity that has been admitted to the LLC as a member, which entitles such member to certain membership rights
 - Right to vote, manage and inspect books and records
 - Right to receive allocations of income, credits, and losses, together with the right to receive distributions from the LLC

 - Economic Interest Owner: an individual or entity that owns an economic interest in the LLC but is not a member and does not have the other membership rights
 - Right to receive allocations of income, credits, and losses, together with the right to receive distributions from the LLC

NC LLC Act Continued...

- Allows, does not require, the use of a management structure similar to that used by corporations
 - Establishing a Board of Directors
 - Electing Officers such as CEOs, COOs, CFOs, Presidents, Vice Presidents, etc.

- Changes to Articles of Organization (see N.C.G.S. § 57D-2-21)
 - No longer required to specify Member-Managed or Manager-Managed
 - No longer required to specify life of LLC, all are perpetual like corporations (unless otherwise specified) allows the use of a management structure similar to that used by corporations, which includes establishing a board of directors and electing officers such as Presidents, Chief Executive Officers, Vice-Presidents, or Chief Financial Officers
 - If a PLLC, required to specify professional services rendered (e.g. medial, engineering, accounting, legal, etc.)

NC LLC Act Continued...

- Pursuant to N.C.G.S. § 57D-2-30(b), the Operating Agreement may not supplant LLC Act regarding:
 - Administrative matters with the Secretary of State
 - Rights of nonparties entitled to recovery or relief
 - Rights and protections of LLC
 - Rights and protections of LLC members
 - Right of member to bring derivative action
 - Right of member to bring action for judicial dissolution

- Provides that a judgment creditor's exclusive remedy against a non-member interest owner is a charging order (N.C.G.S. § 57D-5-03(a))
 - A charging order is essential a lien on the interest owner's rights to collect distributions from the LLC (N.C.G.S. § 57D-5-03(b))

NC LLC Act Continued...

- Operating Agreement
 - Articles of Organization and all other documents the LLC files with the North Carolina Secretary of State are deemed part of the operating agreement
 - Authorizes economic interest owners to be parties to the operating agreement (N.C.G.S. § 57D-2-31)
 - The operating agreement may be in any form, including written, oral, implied, or any combination thereof (N.C.G.S. § 57D-2-30)
- Removes the grounds for dissolution for management deadlock and misapplication/waste of assets
- Take away: relook at existing operating agreements

NC Business Court

- Revised N.C.G.S. § 7A-45.3 requires the Business Court to issue a written opinion granting or denying a motion under North Carolina Rules of Civil Procedure 12, 56, 59, or 60, "or any order finally disposing of a complex business case" except for orders approving a settlement or a jury verdict

- Revised N.C.G.S. § 7A-27 allows for direct appeal to the North Carolina Supreme Court, by passing the Court of Appeals, for:
 - Final judgments
 - Interlocutory appeals affecting a substantial right
 - Orders discontinuing the action
 - Orders granting or denying a new trial

NC Business Court Continued...

- Revised N.C.G.S. § 75A-4 requires that the following types of cases be sent to the Business Court:
 - Contested tax cases on appeal from the Office of Administrative Hearings
 - Cases falling within the Business Court's jurisdiction (N.C.G.S. § 7A-45.4) in which the amount in controversy is at least \$5 million
 - N.C.G.S. § 7A-45.4 cases falling within the Business Court's jurisdiction are involve material issues relation to:
 - **Disputes involving the law governing corporations, partnerships and limited liability companies**
 - **Disputes involving securities**
 - **Disputes involving anti-trust**
 - **Disputes involving trade-mark law**
 - **Disputes involving the ownership, use, licensing, lease, installation, or performance of intellectual property**
 - **Disputes involving trade secrets**
- Take away: more disputes will end up in the business courts

Royals v. Piedmont Electric Repair Co.

- In *Royals*, the plaintiff, a minority shareholder, sought judicial dissolution of the corporation.
- The corporation avoided dissolution by paying the oppressed shareholder the “fair value” of his shares, but the fair market value was not the same as “fair value.”
- The court held the lack of control discount should not be applied when a minority shareholder is compelled to sell his shares.

EHP Land Company, Inc. v. Boshier

- In *EHP* the parties disagreed on how the assets of a partnership were to be valued upon the withdrawal of a partner.
- The partnership was developing a resort community on 750 acres. The partnership agreement said that EHP was entitled to the book value of its interest, to be adjusted based on the fair market value of "any inventory owned by the partnership."
- The critical word for construction by the court was "inventory," which was undefined in the agreement.

EHP Land Continued...

- The plaintiff included all the developed and undeveloped real property owned by the Partnership in its interpretation of "inventory."
- The defendant contended that "inventory" was limited to assets developed and held for sale, which would not have included the undeveloped real property.
- Looking to dictionary definitions, the court concluded that undeveloped lots to be developed in the future were within the scope of the "inventory" of the partnership.

In The Matter of The Ruth Cook Blue Living Trust

- In *Ruth Cook* the court had to address the valuation of shares of a closely held business, a local railroad, owned by a Trust.
- The Trust Agreement provided that upon the death of Mrs. Blue) the shares were to be offered to the members of her family "at the value established by the accounting firm engaged by the Railroad as of December 31 of the year preceding my death."
- The Trustees and the family members entitled to buy the shares disagreed about the value of the shares.

Ruth Cook Blue Continued...

- The Court ruled, on summary judgment, that the word "value" meant "'fair market value' of the Railroad shares as the same would be viewed by the Trust, as prospective seller, and the Blue family, as prospective purchasers."
- The term "value" did not mean the fair market value of the shares if they had been offered to the general public.
- The Court, rejecting an argument by the Trustees that they were entitled to challenge the methodology of the accounting firm, held "that since Ruth Cook Blue is deemed to have embraced the expertise of [the accounting firm] by virtue of the Trust Agreement, it is likely that criticism of [the accounting firm's] valuation methodology would be of limited probative value."

Vernon v. Cuomo

- In *Vernon* the court ordered dissolution and the corporation sought to buy the withdrawing shareholder's shares for fair value.
- The issue was that the only asset was an unproven technology, silicone-free syringes, which would enable syringes to be pre-filled without risk of contamination.
- The key problem faced by the Court in this valuation process was how to protect against a windfall by the majority shareholders if the technology proves to be extremely valuable while not requiring the majority to pay too high a price should the technology not be adopted by the medical industry.

Vernon v. Cuomo Continued...

- The Court approved of the methodology of the appointed appraiser, who had extensive IP valuation experience.
- The appraiser's methodology included (1) the discounted future economic income method, (2) the Latin Hypercube simulation algorithm to generate income estimates, (3) the Fisher Pry model to project a market adoption rate for the technology, and (4) the Monte Carlo simulation method to consider uncertainties in the company's underlying earning potential.
- Ultimately, the Court concluded that a royalty sharing arrangement would best capture the value of the technology for both sides and prevent a windfall for either party.
- The Court found that the plaintiff's shares were worth a specific amount, plus a royalty sharing arrangement of a specified percentage.