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# DISSOLUTION AS A REMEDY FOR DISSENSION AND DEADLOCK IN THE NEW YORK CLOSELY-HELD CORPORATION

DANIEL H. O'CONNELL\*

## INTRODUCTION

IN a closely-held corporation the relationship between the owners, like that among partners, is one which requires a high degree of cooperation. When dissension and disagreement occur, however, a participant does not have the partner's absolute power to dissolve the business. Also, the shareholder-owner normally does not have the alternative available in a publicly-held corporation of selling his shares to outsiders without a sacrifice sale, either because of transfer restrictions or because of a lack of a market for his stock. When a closely-held corporation is organized, especially where provisions are included requiring unanimous consent for action by shareholders and/or directors, steps must be taken both to avert dissension and deadlock, and to provide solutions to the problem once it occurs.

There are numerous planning devices which, when tailored to the specific factual situation at hand, can provide a solution to the problem of dissension and deadlock once it arises. This article will attempt to analyze the role of dissolution as a possible remedy. The first section will define when dissolution is available in the absence of applicable contractual provisions. The second section will discuss the alternative of contractual dissolution provisions as a remedy.

## DISSOLUTION IN THE ABSENCE OF APPLICABLE CONTRACTUAL PROVISIONS

The New York Business Corporation Law<sup>1</sup> carried over the law contained in prior statutes in some respects and modified prior law in others. The provisions on dissolution contain substantial additions and modifications. Voluntary dissolution<sup>2</sup> (without judicial proceedings) is distinguished from judicial dissolution,<sup>3</sup> with the latter including a specific section applicable to deadlock.<sup>4</sup> The availability of dissolution by statute may be expanded or restricted in certain circumstances by the exercise of a court's equitable powers.

### A. *Dissolution in Absence of Deadlock*

#### 1. *Voluntary Dissolution*

One method of remedying dissension is determination by the shareholders to voluntarily dissolve without judicial proceedings. Under section 1001, dissolution may be authorized by a two-thirds vote of shares entitled to vote thereon

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1. N.Y. BUS. CORP. LAW (McKinney 1963) [Hereinafter cited as B.C.L.].

2. B.C.L. art. 10, §§ 1001-09.

3. B.C.L. art. 11, §§ 1101-17.

4. B.C.L. § 1104.

(except as otherwise provided under section 1002), or, under section 615, by the unanimous written consent of shareholders without a meeting. Section 1002 allows the certificate of incorporation to provide that any shareholder, or the holders of a specified number or proportion of shares, may force dissolution "at will or upon the occurrence of a specified event." However, in absence of such a provision, a two-thirds vote is necessary to effect dissolution without judicial proceedings.

## 2. *Judicial Dissolution*

The majority of the board of directors, under section 1102, or the majority of shareholders, under section 1103, may petition the court for dissolution upon the grounds that: (1) assets are insufficient to discharge liabilities, or (2) dissolution would be "beneficial to the shareholders." Under section 1111(a) the court has discretion in deciding whether the corporation should be dissolved. In making such determination, "the benefit to the shareholders of a dissolution is of paramount importance."<sup>5</sup>

### a. *Insolvency*

Sections 1102 and 1103 adopt the test of insolvency in the bankruptcy sense. In *In re Gail Kiddie Clothes*,<sup>6</sup> however, the court, in construing similar language under a prior statute, held that dissolution was not authorized merely because liabilities exceeded assets, but that the corporation must also be unable to pay its debts in the ordinary course of business. The latter test, insolvency in the equity sense, is the same general definition of insolvency adopted in the B.C.L.<sup>7</sup> Where such definition is meant to apply, only the word "insolvent" is stated in the statute.<sup>8</sup> Use of different language in sections 1102 and 1103 implies that a different test, insolvency in the bankruptcy sense, was intended.

### b. *Beneficial to Shareholders*

Since there are no cases construing what circumstances will satisfy the test of "beneficial to the shareholders" in the context of a section 1102 or 1103 petition, it is not possible to define with certainty the scope of its application. Case law construing the requirement in the context of deadlock warns of a restrictive interpretation.<sup>9</sup> Petitions by majority shareholders or directors based on dissension or deadlock will be judged by the deadlock statute,<sup>10</sup> and not by the above provisions. These sections should be available, however, upon grounds other than dissension and deadlock, heretofore recognized as a basis for equitable relief.<sup>11</sup> For example, the majority shareholders or directors could obtain

5. B.C.L. § 1111(b)(2).

6. 56 N.Y.S.2d 117 (Sup. Ct. 1945).

7. B.C.L. § 102(a)(8).

8. E.g., B.C.L. §§ 510(a), 513, 623(j).

9. See text accompanying notes 24-34 *infra*.

10. B.C.L. § 1104.

11. For review of the circumstances in which courts of equity have granted relief to

dissolution by a showing that the corporation never began business, that it has been inactive for a substantial period, or that the objects of the corporation have failed.<sup>12</sup> Even though not insolvent, a showing that continued operations will result only in loss should entitle the majority to relief.

### 3. *Equitable Relief*

Under the above statutory provisions, minority shareholders do not have the right to petition for dissolution. Where dissension arises which does not obtain the status of deadlock necessary for relief under the deadlock statute, but where such disagreement results in the majority shareholders imposing their will on the minority, will equity grant a petition for dissolution by the minority shareholders?

In the converse situation, the power of equity to *enjoin* dissolution upon petition by a minority shareholder was expressly recognized in *Kavanaugh v. Kavanaugh Knitting Co.*<sup>13</sup> The court held that the majority shareholders, acting as the board of directors, or when taking "corporate action" acting as shareholders, owe a fiduciary duty to minority shareholders and cannot use their power in bad faith or for their individual advantage or purpose. Bad faith, fraud, or other breach of trust constitutes a foundation for equitable relief. But, in the absence of bad faith or breach of trust, equitable relief will be denied.<sup>14</sup>

Historically courts have been reluctant to *destroy* corporate existence except when authorized by statute.<sup>15</sup> However, based on the power of equity to enjoin dissolution, the New York lower courts, before the passage of the B.C.L., recognized the power of equity to compel the majority shareholders, as directors, to dissolve a corporation upon petition by minority shareholders.<sup>16</sup> The courts would grant relief to a minority shareholder upon a showing that "the capital of the corporation was impaired by the majority looting the assets and thereby enriching themselves at the expense of the minority, or that the existence of the corporation is being continued for the sole purpose of benefiting those in control, at the expense of the other shareholders."<sup>17</sup> After the enactment of the B.C.L., the power of equity to grant dissolution to a minority

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minority shareholders by declaring liquidation or dissolution, see Hornstein, *A Remedy For Corporate Abuse—Judicial Power To Wind Up A Corporation At The Suit Of A Minority Shareholder*, 40 COLUM. L. REV. 220 (1940).

12. *Id.*

13. 226 N.Y. 185, 123 N.E. 148 (1919). *Accord*, *Levine v. Styleart Press, Inc.*, 31 Misc. 2d 106, 217 N.Y.S.2d 688 (Sup. Ct. 1961). Decision has sometimes been based on the alternative ground that the petition should be denied because not meeting the test of beneficial to shareholders when dissolution would prejudice the minority. *In re American Telegraph & Cable Co.*, 139 Misc. 625, 248 N.Y.S. 98 (Sup. Ct. 1931).

14. See *Greenfield v. Denner*, 23 Misc. 2d 797, 199 N.Y.S.2d 899 (Sup. Ct. 1960).

15. See *Israels, The Sacred Cow of Corporate Existence: Problems of Deadlock and Dissolution*, 19 U. CHI. L. REV. 778 (1952).

16. *Kroger v. Jaburg*, 231 App. Div. 641, 248 N.Y.S. 387 (1st Dep't 1931).

17. *Gross v. Price*, 284 App. Div. 964, 134 N.Y.S.2d 649 (2d Dep't 1954). *Accord*, *Aliotta v. Samperisi*, 2 App. Div. 2d 901, 157 N.Y.S.2d 143 (2d Dep't 1956); *Fontheim v. Walker*, 282 App. Div. 373, 122 N.Y.S.2d 642 (1st Dep't 1953), *aff'd*, 306 N.Y. 926, 119 N.E.2d 605 (1954); *Lennan v. Blakeley*, 72 N.Y.S.2d 901 (Sup. Ct. 1947), *aff'd*, 273 App. Div. 767, 75 N.Y.S.2d 331 (1st Dep't 1947).

shareholder was reaffirmed in *Leibert v. Clapp*,<sup>18</sup> the first case in which the Court of Appeals expressly recognized such power. Although the court unanimously agreed on the power to act, the court split four to three on whether the complaint stated a cause of action. Among other things, the complaint alleged "looting" of the assets by the majority, continuing the corporation's existence for the sole purpose of benefiting those in control at the expense of the minority, and the attempt by the majority to "freeze-out" the minority by coercing them to sell their stock at an inadequate price. Language in the opinion led one writer to believe that *Leibert* expanded the area in which equity would act to protect a minority shareholder, with more emphasis to be placed on the motives of those in control and less on the outward effects of their bad faith conduct.<sup>19</sup> The validity of this conclusion is subject to question in light of the subsequent case of *Kruger v. Gerth*.<sup>20</sup> The majority shareholder, in control of the board of directors, paid himself a fixed salary and bonus designed to consume nearly all earnings. No dividends had been paid since the corporation was organized. Citing the test applied in the pre-1963 cases, the appellate division held there was no evidence of looting or impairment of capital, nor maintenance of the corporation solely for the benefit of defendants at the expense of the minority. The court distinguished *Leibert v. Clapp* by the absence of a calculated impairment in the value of the capital stock to coerce the minority to sell to the majority at a depressed price. The court did not attach any special significance to the fact that the corporation was closely-held. Since there was no prospect of the corporation ever making enough profit to pay dividends, the result was that the minority shareholder was stuck with common stock which was both unprofitable and unsalable. In a recent case the Court of Appeals reached the same result in a substantially similar factual situation, holding that the minority shareholders had failed to state a cause of action.<sup>21</sup>

The availability of equity to a minority shareholder as a remedy for corporate dissension which has not reached the status of deadlock seems very limited, to be applied by the courts only in extraordinary cases. Accordingly, equity is clearly not available to a minority shareholder who simply wants out of a bad bargain, nor is it enough that such shareholder thinks it undesirable for the corporation's business to continue, or that he is dissatisfied with the handling of the corporation by the controlling shareholders.<sup>22</sup> Before relief will be granted, the court must find actual looting and dissipation of assets and not just the diversion of profits, and possibly a further finding of an intent by the majority to force the minority to sell at a low price. Nevertheless, if the corporation is operating at a loss, relief will presumably be granted, based on cases

18. 13 N.Y.2d 313, 196 N.E.2d 540, 247 N.Y.S.2d 102 (1963).

19. Comment, *New York Broadens Availability Of Involuntary Dissolution For Intra-corporate Oppression Of Minority Shareholders*, 39 N.Y.U. L. Rev. 697, 699 (1964).

20. 22 App. Div. 2d 916, 255 N.Y.S.2d 498 (2d Dep't 1964), *aff'd mem.*, 16 N.Y.2d 802, 210 N.E.2d 355, 263 N.Y.S.2d 1 (1965) (*aff'd* by a 4 to 3 vote).

21. *Nelkin v. H.J.R. Realty Corp.* (N.Y. Ct. App. Dec. 11, 1969).

22. Hornstein, *supra* note 11, at 230-31.

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decided before *Kruger v. Gerth*, where the controlling shareholders provide themselves with substantial and unjustified increases in salary.<sup>23</sup>

### B. *Dissolution Based on Deadlock*

The problem of deadlock will arise in the following circumstances: (1) where there is an even split on the board of directors; (2) where a super-statutory vote is required for director action and one director vetoes corporate action; (3) where a shareholder vote is required and either a statutory provision or the certificate of incorporation requires a greater percentage vote than a majority, and one or a minority of shareholders veto the action; and (4) where there is long-continued friction and disagreement over corporate policy, never obtaining the dignity of deadlock which paralyzes the corporation, but which in fact results in a reduction of the corporation's profitability and effectiveness.

#### 1. *Statutory Provision*

Section 1104 deals specifically with deadlock. Under section 1104(a), a petition may be presented by the holders of fifty percent or more of shares entitled to vote for the election of directors on the following grounds: (1) director deadlock resulting in the inability to vote on the management of the corporation's affairs; (2) such division among shareholders that the votes required for the election of directors cannot be obtained; and (3) internal dissension between factions of shareholders to such an extent "that dissolution would be beneficial to the shareholders." If the certificate of incorporation requires a super-statutory vote for shareholder or director action, under section 1104(b) the petition can be presented by the holders of more than one-third of the shares entitled to vote for voluntary dissolution under section 1001. Finally, *any* shareholder can petition under section 1104(c) if the shareholders are so divided that for two consecutive annual meeting dates they have been unable to elect successor directors. Under section 1111, the court has discretion whether to grant the application for dissolution, but in exercising such discretion, "the benefit to the shareholders" is the most important factor to be considered, and dissolution is not to be denied merely because the corporation's business "has been or could be operated at a profit."

#### 2. *Case Law Under Prior Statute*<sup>24</sup>

Under the statute in effect before the B.C.L. a petition for dissolution could be maintained based on director or shareholder deadlock.<sup>25</sup> The courts had discretion concerning whether the petition would be granted with primary weight given to whether or not dissolution would be "beneficial to the stockholders or members and not injurious to the public."<sup>26</sup> When considering what was bene-

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23. *Kruger v. Jaburg*, 231 App. Div. 641, 248 N.Y.S. 387 (1st Dep't 1931).

24. All cases cited in this section involve closely-held corporations.

25. GEN. CORP. LAW § 103 (McKinney 1929).

26. GEN. CORP. LAW § 117 (McKinney 1929).

ficial to shareholders, the courts adopted a restrictive interpretation of the statute. In an early case, one court held that the statute contemplated "nothing less than the inability of the corporation to function because of a paralyzing failure of management."<sup>27</sup> This standard was applied not only where the petition was based on director deadlock, but also where dissolution was sought because of the shareholders' inability to elect a board of directors. Thus in *In re Cantelmo*,<sup>28</sup> where a petition was presented by one of two shareholders based on the shareholders' inability to elect a third director, the court denied the petition because the inability to elect a third director did not interfere with the efficiency of management, and the corporation was operating at a profit.<sup>29</sup> Even where the dissension among the owners adversely affected the business, relief would be denied without a showing that the deadlock went to a vital and material aspect of the corporate operations.<sup>30</sup> The existence of mere unpleasant relations between shareholders did not qualify. For example, bickering arising from the unhappy marital affairs of the shareholders was held insufficient grounds for dissolution.<sup>31</sup> On the other hand, the court would grant dissolution where the facts evidenced a division described as "irreconcilable" or "complete" with a resulting dissipation of assets where the interests of creditors were in jeopardy if the corporation were continued.<sup>32</sup>

Whether the petition was based on director deadlock in the management of corporate affairs or on the inability of the shareholders to elect directors, the requirement of shareholder benefit reduced itself ultimately to proof of irreconcilable division,<sup>33</sup> with the further requirement that such division be evidenced by resultant losses, either presently or within the near future. Although the courts did not usually discuss the further requirement that dissolution not be "injurious to the public," probably implicit in the courts' reasoning was the feeling that ordering the death of a corporation had an adverse effect on the public interest and that a going business should be continued for the protection of creditors and employees.<sup>34</sup>

### 3. Probable Future Trends

The restrictive interpretation of the prior statute was unsatisfactory, at least where closely-held corporations were involved. Consideration of only

27. *In re Landau*, 183 Misc. 876, 878, 51 N.Y.S.2d 651, 653 (Sup. Ct. 1944).

28. 275 App. Div. 231, 88 N.Y.S.2d 604 (1st Dep't 1949).

29. *Accord, e.g., In re Seamerlin Operating Co., Inc.*, 307 N.Y. 407, 121 N.E.2d 392 (1954); *In re Landau*, 183 Misc. 876, 878, 51 N.Y.S.2d 651, 653 (Sup. Ct. 1944); *In re Williamson*, 85 N.Y.S.2d 93 (Sup. Ct. 1948).

30. *In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954).

31. *In re George W. Anderson, Inc.*, 104 N.Y.S.2d 184 (Sup. Ct.), *aff'd without opinion*, 279 App. Div. 594, 107 N.Y.S.2d 556 (2d Dep't 1951).

32. *E.g., In re Hy-Lite Plastics, Inc.*, 8 Misc. 2d 101, 165 N.Y.S.2d 888 (Sup. Ct. 1957); *In re Bob's Fashion Furriers, Inc.*, 52 N.Y.S.2d 279 (Sup. Ct. 1944); *In re Kaufman Circle Express Co., Inc.*, 177 Misc. 106, 29 N.Y.S.2d 264 (Sup. Ct. 1941).

33. Note, *Deadlock as Grounds for Voluntary Dissolution Under New York General Corporation Law*, 50 COLUM. L. REV. 100, 103 (1950).

34. *Cf. In re Radom & Neidorff, Inc.*, 307 N.Y. 1, 119 N.E.2d 563 (1954).

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pecuniary benefits to the shareholders disregards the obvious burden on a shareholder who wishes to end an unsatisfactory personal relationship. Even if the corporation is operating at a profit and there is no paralysis of management, dissension in a closely-held corporation will normally have a detrimental effect on the operations of the corporation. Forcing the corporation to continue will normally result in a wasting of assets. The argument that continuance of the corporation is in the public interest may have validity for the large, publicly-held corporation, but not for a corporation which is in reality a partnership. The provisions of the B.C.L. are designed to reverse such a restrictive approach and to relax the requirements for dissolution. The provision in section 1111, that dissolution is not to be denied simply because the corporation is operating at a profit, presumably overrules such cases as *In re Cantelmo*, which relied heavily on probable continued profitability as grounds for denial of a petition. The courts should no longer require that "irreparable injury must occur before resort may be had to the remedy designed to avert it."<sup>35</sup> Also, the grounds for petition have been expanded through the addition of section 1104(a)(3), requiring only that internal shareholder dissension cause such division that dissolution will be beneficial to the shareholders. The reviser's note to section 1104 reveals that this section was added to make clear relief should be granted when there is internal dissension in a closely-held corporation. Hopefully, in determining what is beneficial to shareholders, the court will consider the type of corporation with which it is dealing and recognize that in a close corporation the owners regard themselves basically as partners.<sup>36</sup> The courts, however, will likely retain their reluctance to order dissolution of a solvent corporation.<sup>37</sup>

In dealing with more specific issues which may arise, cases decided before the B.C.L. will give a foundation for decision. Stalemate caused by the veto of a minority shareholder will continue to be a basis for dissolution because of deadlock.<sup>38</sup> If the petition is based on director deadlock, the minority shareholder will not automatically have his petition denied because the majority has avoided paralysis and made the corporation prosper by operating the corporation in violation of the minority's veto power under the statute.<sup>39</sup> If the petition is based on the inability of shareholders to elect directors, the petitioner must

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35. *Id.* at 15, 119 N.E.2d at 569 (dissent).

36. One case decided prior to the passage of the B.C.L., contra to other cases, expressly recognized that a closely-held corporation should be treated like a partnership. *In re Pivot Punch & Die Corp.*, 15 Misc. 2d 713, 182 N.Y.S.2d 459 (Sup. Ct. 1959), *modified* 9 App. Div. 2d 861, 193 N.Y.S.2d 34 (4th Dep't 1959) (modified to the extent that hearing should be before court and not referee).

37. The one case decided after the B.C.L., though based on the prior statute, intimates that the substance of the prior case law will be carried over under the B.C.L. *In re Sheridan Const. Corp.*, 22 App. Div. 2d 390, 256 N.Y.S.2d 210 (4th Dep't 1965), *aff'd*, 16 N.Y.2d 680, 209 N.E.2d 290, 261 N.Y.S.2d 300 (1965); *See also* *Nelkin v. H.J.R. Realty Corp.* (N.Y. Ct. App. Dec. 11, 1969).

38. *In re Hy-Lite Plastics, Inc.*, 8 Misc. 2d 101, 165 N.Y.S.2d 888 (Sup. Ct. 1957); *In re Bankhalter*, 128 N.Y.S.2d 81 (Sup. Ct. 1953).

39. *Nelkin v. H.J.R. Realty Corp.*, (N.Y. Ct. App. Dec. 11, 1969); *In re Bankhalter*, 128 N.Y.S.2d 81 (Sup. Ct. 1953).



show an occasion or attempt to elect a board of directors accompanied by a failure to do so.<sup>40</sup> However, once such an attempt is established, the petition will not be denied where the board of directors is functioning because the directors are holding over after the expiration of their terms.<sup>41</sup> Section 1104 cannot be avoided by the directors filling the vacancies themselves, rather than by election of shareholders.<sup>42</sup> But, if it is fairly certain that the deadlock will be broken in the near future, such as by the issuance of additional stock, the petition will be denied.<sup>43</sup>

#### 4. *Equitable Relief*

The majority shareholder filing his petition must establish his own good faith.<sup>44</sup> Even where grounds for equitable intervention are established, however, the court will grant an application of other shareholders for a *denial* of dissolution.<sup>45</sup> The difficult question is whether equitable relief granting dissolution because of deadlock will be available to a minority shareholder. Where there is disagreement, but it does not rise to the dissension necessary under section 1104, equitable relief will be available under the circumstances discussed above.<sup>46</sup> The sparse authority on the subject in New York intimates that the deadlock statute is exclusive, with no equitable relief available to a minority shareholder where the dissension rises to the status of deadlock within the meaning of section 1104, but where the shareholder otherwise does not qualify under that section.<sup>47</sup> Other states have increasingly held that deadlock is itself an independent ground for dissolution in equity.<sup>48</sup> Presumably, in New York, if a minority shareholder establishes grounds other than deadlock for equitable relief, equity will not deny his petition simply because deadlock within the meaning of section 1104 is also present.

#### CONTRACTUAL PROVISIONS DEALING WITH DISSENSION AND DEADLOCK

When forming a closely-held corporation, the parties should consider advance planning to deal with the problem of dissension and deadlock. Although this article is concerned with methods of governing dissension once it arises, it should be emphasized that the parties should also adopt provisions to avoid

40. *In re Williamson*, 85 N.Y.S.2d 93 (Sup. Ct. 1948); *In re Landau*, 183 Misc. 876, 878, 51 N.Y.S.2d 651, 653 (Sup. Ct. 1944).

41. *In re Williamson*, 85 N.Y.S.2d 93 (Sup. Ct. 1948).

42. *Id.*

43. *Id.*

44. *In re Adler*, 277 App. Div. 861, 98 N.Y.S.2d 383 (1st Dep't 1950).

45. See text accompanying notes 13-14 *supra*.

46. See text accompanying notes 15-22 *supra*.

47. *Cachules v. Finkelstein*, 279 App. Div. 173, 109 N.Y.S.2d 272 (1st Dep't 1951), relying on the following dictum in *Hitch v. Hawley*, 132 N.Y. 212, 217, 30 N.E. 401, 403 (1892): "Whether courts of equity have inherent power to dissolve corporations, as has been held in some jurisdictions but denied in others, it is unnecessary for us to consider, as the method for affecting corporate dissolution, when prescribed by statute, as in this state, is exclusive, and must be substantially followed."

48. *Cowin v. Salmon*, 248 Ala. 580, 28 So. 2d 633 (1946); *Levant v. Kowal*, 350 Mich. 232, 86 N.W.2d 336 (1957). See *Hornstein*, *supra* note 11.

dissension. For example, most troubles develop after a shareholder becomes inactive, or his interest is acquired by another party. Buy-out provisions or retirement compensation plans can eliminate, in advance, many of these problems.<sup>49</sup>

Advanced planning to control dissension once it occurs is also necessary, with reliance not being placed solely on the right to dissolve in absence of contractual provisions covering dissension. Continuous dissension which does not attain the status of deadlock is not clearly susceptible of judicial relief as the law stands today, especially for a minority shareholder. On the other hand, use of super-statutory voting requirements for director and shareholder action will increase the possibilities of the circumstances coming within the provisions of section 1104. The parties may well desire the protection of such a veto to avoid the possibility of the majority shareholders exerting "freeze-out" techniques which are not subject to relief in equity. But once deadlock arises because of the exercise of the veto power, the parties may wish to apply techniques other than the drastic one of dissolution to break the resulting deadlock. The parties, therefore, may wish to expand the right to dissolve in some circumstances, but restrict it in others in favor of alternative remedies.

### A. Alternatives to a Dissolution Provision

#### 1. Arbitration

If the future of the corporation looks promising, dissolution may not be an acceptable alternative as a remedy for dissension. Arbitration may be a method of settling disputes and allowing the parties to continue in business. In New York the use of arbitration for settling most disputes in closely-held corporations has won judicial approval, with the courts constantly expanding the areas where arbitration will be sustained.<sup>50</sup> A detailed analysis of what issues are validly subject to arbitration is beyond the scope of this article.<sup>51</sup> However, one important issue is the validity of an arbitration agreement that restricts the statutory right to petition for dissolution. Some of the earlier cases held that such a clause could not restrict the statutory right to dissolve.<sup>52</sup> More recent cases have granted a stay of the petition for dissolution pending an arbitration decision.<sup>53</sup> But the stay will be denied under certain circumstances. In *In re*

49. 2 F. O'NEIL, CLOSE CORPORATIONS § 9.03 (1958).

50. O'Neil, *Resolving Disputes in Closely-Held Corporations: Intra-Institutional Arbitration*, 67 HARV. L. REV. 786, 822 (1954).

51. For an article analyzing the validity of arbitration agreements in New York closely-held corporations, see Kessler, *Arbitration of Intra-Corporate Disputes Under New York Laws*, 19 ARB. J. (n.s.) 1, 85 (1964).

52. *In re Cohen*, 183 Misc. 1034, 52 N.Y.S.2d 671 (Sup. Ct. 1944), *aff'd mem.*, 269 App. Div. 663, 53 N.Y.S.2d 467 (1st Dep't 1945); *In re Gail Kiddie Clothes*, 56 N.Y.S.2d 117 (Sup. Ct. 1945) (court remarked in passing that "[A]n agreement to arbitrate all disputes and controversies that may arise will not prevent a proceeding to dissolve," but no specific issue as to the effect of the arbitration clause on the right to stay the dissolution proceeding seems to have been raised. *Id.* at 119).

53. *In re Myers*, 279 App. Div. 984, 112 N.Y.S.2d 489 (1st Dep't), *aff'd without opinion*, 304 N.Y. 656, 107 N.E.2d 512 (1952) (court required bond posted as condition of granting

*Fulton-Washington Corp.*,<sup>54</sup> the court refused to stay a dissolution proceeding where the evidence disclosed complete deadlock for several years regarding the management of the corporation and a history of continuous litigation between the parties. The court concluded there was a complete lack of any reasonable prospect of future harmonious management. The court was also influenced by the nature of the business: the corporations involved had a limited life, and dissolution was a much less drastic remedy than in a situation where operation for an indefinite period is contemplated.

Rather than have the courts determine when the conflict has become so severe that dissolution is the better alternative to arbitration, it may be more desirable to cover the situation by contract. The arbitration clause could be drafted so that it will not be applicable in cases of irreconcilable conflict, with reliance placed on a dissolution or buy-out clause, or a combination of both, as a remedy for such conflict.<sup>55</sup> An alternative solution is to have such matters covered by arbitration and to vest the arbitrator with power to determine that the corporation should be dissolved.<sup>56</sup>

## 2. Buy-Out Provision

First option or buy-out arrangements may be used to eliminate one group of dissenting shareholders and thus break a stalemate or deadlock. Such an alternative has the advantage of preserving the corporation as a going concern and at the same time giving the shareholder leaving the business an adequate price for his interest.<sup>57</sup> New York courts have upheld the validity of transfer restrictions in general, and will grant specific performance under such contracts.<sup>58</sup>

As a remedy for dissension, the parties can contract granting an option empowering the corporation, or other shareholders, to purchase the shares of a shareholder in certain circumstances involving dissension,<sup>59</sup> and possibly *require* such a purchase when the dissension results in the majority shareholders resorting to enumerated techniques to "freeze-out" a minority stockholder. The parties may wish to restrict the right of a shareholder to seek dissolution by providing that, upon petition by a shareholder for dissolution in equity or under statute, an option to purchase would arise on behalf of the other shareholders or the corporation. As with an arbitration provision, an issue exists whether such a restriction will be valid. Cases dealing with the legality of options, based on

a stay of the dissolution petition). *Zybert v. Dab*, 276 App. Div. 1070, 96 N.Y.S.2d 374 (1st Dep't), *aff'd mem.*, 301 N.Y. 632, 93 N.E.2d 917 (1950).

54. 3 Misc. 2d 277, 151 N.Y.S.2d 417 (Sup. Ct.), *aff'd mem.*, 2 App. Div. 2d 981, 157 N.Y.S.2d 894 (2d Dep't 1956).

55. See Kessler, *supra* note 51, at 91.

56. The arbitrator's decision was upheld in such circumstances in *Berman v. Eckert*, 31 Misc. 2d 830, 222 N.Y.S.2d 716 (Sup. Ct. 1961).

57. See 2 F. O'NEIL, *supra* note 49, § 9.05.

58. *Bloomingdale v. Bloomingdale*, 107 Misc. 646, 177 N.Y.S. 873 (Sup. Ct. 1919).

59. For example, the contract may trigger the right to exercise the option where disagreement among shareholders or directors causes paralysis for a stated period of time, or if shareholders cannot agree on the election of directors for a stated period.

the decision of the shareholder to sell, have upheld such restrictions if the court finds them "reasonable."<sup>60</sup> By analogy to the validity of restrictions imposed by arbitration clauses, such contractual provisions will presumably be held valid.<sup>61</sup> Although the issue has yet to be raised squarely in the courts, two decisions have intimated that such a restriction would be upheld.<sup>62</sup>

### 3. Other Methods

Pursuant to a voting trust, the parties can agree to transfer their stock temporarily to voting trustees when enumerated conditions of dissension or deadlock occur, with the trustees temporarily managing the corporation until the points of disagreement become moot or are otherwise resolved.<sup>63</sup> As an alternative to formal arbitration, the parties by contract can select an impartial third person to act as director when director deadlock occurs, and to hold the office until voted out by the shareholders. The provisional director may be able to vote on those matters causing deadlock and, once resolved, the parties could then proceed normally. Another alternative is to have the certificate of incorporation provide for a limited life which, when coupled with a high vote requirement<sup>64</sup> for deletion of such a clause and the extension of corporate life,<sup>65</sup> would insure dissolution at the end of a stated period unless all shareholders agreed to extend the life of the corporation.<sup>66</sup>

## B. Contractual Dissolution Provisions

### 1. Validity

When drafting provisions dealing with dissolution, consideration must first be given to the validity of such provisions. A distinction should be made between contract provisions which expand and those that restrict the statutory right to dissolve. Although the power of parties to expand the circumstances under which dissolution can be obtained was unclear before the B.C.L.,<sup>67</sup> such expan-

60. *Allen v. Biltmore Tissue Corp.*, 2 N.Y.2d 534, 141 N.E.2d 812 (1957); *Bloomington v. Bloomington*, 107 Misc. 646, 177 N.Y.S. 873 (Sup. Ct. 1919). *But see Storer v. Ripley*, 12 Misc. 2d 662, 178 N.Y.S.2d 7 (Sup. Ct. 1958). *Cf. In re Schwartz' Will*, 30 Misc. 2d 814, 219 N.Y.S.2d 545 (Surr. Ct. 1961).

61. *See supra* note 53.

62. *Levine v. Styleart Press, Inc.* 31 Misc. 2d 106, 217 N.Y.S.2d 688 (Sup. Ct. 1961) (Court inferred that if there were a contractual restriction expressly restricting dissolution, it would be valid); *In re Topper's Hamburger of Distinction*, 28 Misc. 2d 626, 213 N.Y.S.2d 117 (Sup. Ct. 1961) (Court seemed to hold that failure to sell pursuant to a transfer restriction is a basis for denying a dissolution petition as not being "beneficial to shareholders").

63. 2 F. O'NEIL, *supra* note 49, § 9.07. Such agreement will apparently be valid in New York. *De Marco v. Paramount Ice Corp.*, 30 Misc. 2d 158, 102 N.Y.S.2d 692 (Sup. Ct. 1950), *aff'd without opinion*, 276 App. Div. 913, 94 N.Y.S.2d 208 (2d Dep't 1950). *See also Barkin, Deadlock and Dissolution in Florida Corporations: Litigating and Planning*, 13 U. MIAMI L. REV. 395, 417 (1959).

64. B.C.L. § 616 (shareholders) and § 709 (directors).

65. B.C.L. § 801(b)(6).

66. Such a clause is permissible under B.C.L. § 402(a)(9).

67. *Israels*, in *The Sacred Cow Of Corporate Existence: Problems Of Deadlock And Dissolution*, 19 U. CHI. L. REV. 778, 792 (1952), argued that *In re Block's Will*, 186 Misc. 945, 60 N.Y.S.2d 639 (Surr. Ct. 1946), and *Leventhal v. Atlantic Finance Co.*, 316 Mass.

sion is now expressly permitted under section 1002(a), if contained in the articles of incorporation<sup>68</sup> and if the provision is noted on the certificate for shares.<sup>69</sup>

Several of the statutory provisions may validly be restricted by contract. The right to non-judicial dissolution under section 1001 may be restricted pursuant to a higher voting requirement by satisfying the requirements of section 1002.<sup>70</sup> The right of majority shareholders to seek judicial dissolution under section 1103 can be subjected to a higher voting requirement in the certificate of incorporation under section 1103(c). Although section 1102, dealing with the right of a majority of the directors to petition, is silent on the matter, presumably it can be modified by a higher voting requirement by satisfying section 709. Under the deadlock provisions of section 1104, the right of shareholders to petition under section 1104(a) may be limited by the certificate,<sup>71</sup> but the right of any shareholder to petition under section 1104(c) is not subject to limitation by the certificate, with the same being true by implication regarding a petition by minority shareholders under section 1104(b). Notwithstanding a statutory prohibition against restriction, the court may uphold restrictions where the parties have, by contract, substituted an alternative reasonable remedy.<sup>72</sup>

## 2. Possible Uses

As considered above, there may be alternatives to dissolution which will be more advantageous to the parties. However, dissolution may be the only answer to dissension in some situations. If the mutual confidence and compatibility necessary to operate a closely-held corporation has been destroyed in a cloud of bitterness, "togetherness by injunction"<sup>73</sup> is rarely if ever secured. Contractual clauses dealing with dissolution should be prepared with recognition of possible dangers. If the right to dissolve is expanded, possibilities are enhanced of a majority "freeze-out" of the minority and the converse problem of "minority blackmail." Restricting dissolution may obviate such problems, but may raise

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194, 55 N.E.2d 20 (1944), were authority pointing to the validity of contracts expanding the right to dissolve in New York. But Hornstein, in *Stockholders Agreements In The Closely Held Corporation*, 59 YALE L.J. 1040, 1047 (1950), argued that this was far from certain, relying on *Flanagan v. Flanagan*, 273 App. Div. 918, 77 N.Y.S.2d 682 (2d Dep't), *aff'd without opinion*, 298 N.Y. 787, 83 N.E.2d 473 (1948).

68. B.C.L. § 1002(b). The clause can be added to the certificate only by a vote of all outstanding shares, or a lesser proportion of shares (but not less than a majority) as is specifically provided in the certificate.

69. B.C.L. § 1002(c).

70. The possibility that § 1002 allows expansion but not restriction has not been raised, and it has been assumed that § 1002 allows restriction by a super-statutory vote requirement. See Kessler, *supra* note 51, at 14.

71. As provided in B.C.L. § 613 (limitations on right to vote).

72. See text accompanying notes 52-56 (restriction by an arbitration clause), 58-60 (restriction by a buy-out provision) *supra*. Cf. *St. John of Vizzini v. Cavallo*, 134 Misc. 152, 234 N.Y.S. 683 (Sup. Ct.), *aff'd without opinion*, 227 App. Div. 782, 237 N.Y.S. 886 (1st Dep't 1929).

73. Chayes, *Madame Wagner and the Close Corporation*, 73 HARV. L. REV. 1532, 1535 (1960).

## DISSOLUTION AS A REMEDY

the difficulty that dissension and deadlock will not be dealt with adequately.

There are several situations in which contractual expansion of the right to dissolve will be desired. For example, where the business is dependent upon special skills of the owners, the corporation may have to be dissolved upon the death or withdrawal of one of the owners, or when such shareholder becomes in any other way incapable of performing his duties. Where the corporation is organized for limited purposes, dissolution can be provided for upon the termination of the particular undertaking for which the corporation was organized. By analogy to their rights while organized as a partnership, the parties may wish the right of one member to dissolve at any time.<sup>74</sup> The right of a minority shareholder to so act could be conditioned upon a prior offering of his shares to other shareholders or to the corporation at a set price,<sup>75</sup> possibly decreased by a specified amount as damages, if the termination was without good cause.<sup>76</sup> It may be desirable to incorporate by reference portions of the B.C.L. For example, inability to elect directors for two years, a ground for petition for judicial dissolution under section 1104(c), could be made a ground for automatic dissolution under section 1002. For the protection of minority shareholders, especially where they do not have a veto under a super-statutory provision for shareholder and director action, they should be given the right to dissolve when there is dissension resulting in action by the majority detrimental to the minority, but which does not give rise to relief for the minority by statute or in equity. A minority shareholder could be given the right to dissolve when the majority shareholders exert enumerated "freeze-out" techniques, such as the nonpayment of dividends for a long period of time.

When the parties deal individually with the situations for obtaining dissolution, it will normally be best to restrict the right to dissolve under any other circumstances. This will especially be true when the parties determine that an alternative remedy for dissension should be employed, such as arbitration or a buy-out provision. The right to seek dissolution should be conditioned upon an offer to sell if a buy-out provision is applied, or a prior arbitrator's determination if an arbitration clause is used.

In the end, the decision concerning restriction and/or the expansion of the right to dissolve, and under what circumstances, will depend on the facts and circumstances of the particular case. Some factors to be considered are the number of shareholders, the size of each shareholder's holdings, the likelihood that one shareholder may use the power to dissolve unfairly, the nature of the business, whether the corporation's assets could be liquidated without expensive

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74. N.Y. PARTNERSHIP LAW § 62(2) (McKinney 1948).

75. See 2 F. O'NEIL, *supra* note 49, § 10.28 (form). Such a right would be analogous to the right of remaining partners to continue the partnership if the dissenting partner's dissolution is in contravention of the partnership agreement. N.Y. PARTNERSHIP LAW § 69(a)(b) (McKinney 1948).

76. Cf. N.Y. PARTNERSHIP LAW § 69(2)(a)(II) (McKinney 1948).

losses, the personalities of the shareholders and how they will likely conduct themselves if conflicts arise, and the effect of dissolution on the shareholders.<sup>77</sup>

CONCLUSION

The shareholder-owners should have methods available to deal with dissension and deadlock in a closely-held corporation. In the absence of contract, substantial help is given by the B.C.L. Nonjudicial dissolution is available to the parties if the holders of two-thirds of the shares can agree on dissolution as the appropriate remedy. The deadlock statute will provide relief in most situations where the dissension is serious, and provide relief to a minority shareholder in limited situations. When a minority shareholder has no statutory remedy, a court of equity will grant relief through dissolution in cases of flagrant abuse by the majority shareholders of their power to control the corporation. In most cases, however, the peculiar facts and circumstances will dictate that the parties rely on contractual provisions to supplement the statutory and judicial remedies for dissension. Various alternative planning devices are available for such purposes. One of the more important remedies to be considered is a contractual provision providing for dissolution.

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77. 2 F. O'NEIL, *supra* note 49, § 9.06.