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Dissolution Petition Can Unwittingly Trigger Stock Buyback

Shareholders' agreements commonly employ stock transfer restrictions in the form of a right of first refusal (RFR) to maintain continuity and control over the ownership of the business.

Drafters tend to define broadly the trigger events for a buyback of the offered shares, by requiring a shareholder who desires to sell "or otherwise dispose" of his or her shares first to offer them for sale to the corporation or to the other shareholders. In many instances, the shareholders' agreement fixes the buyback price at a percentage of book value or some other discounted measure of value, and provides a long-term payout to avoid a cash drain on the company.

The Appellate Division, First Department's recent decision in *Matter of Johnsen (ACP Distribution, Inc.)*[1] adds new and, some may argue, unintended potency to such RFRs by holding that a shareholder petition for involuntary dissolution constitutes a proposed share disposition, thereby pulling the buyback trigger. It thus is critical that counsel contemplating the commencement of a dissolution proceeding, or drafting a shareholders' or operating agreement, understand *Johnsen's* impact on their client's rights.

The concept that a dissolution petition can trigger a buyback under an RFR traces back to the Appellate Division, Second Department's 1986 decision in *Matter of Doniger (Rye Psychiatric Hospital Center, Inc.)*.[2] In *Doniger*, three stockholders together owning 50 percent of the company's stock brought a dissolution proceeding under §1104 of the Business Corporation Law (BCL) alleging deadlock and internal dissension involving a private psychiatric hospital.

The remaining shareholders sought to compel a buyout, however, unlike in proceedings under BCL §1104-a for minority shareholder oppression, they could not elect to purchase petitioners' shares for fair value under BCL §1118. Instead, they argued that under the RFR in the shareholders' agreement, petitioners' commencement of the dissolution proceeding triggered their obligation to offer their shares at the agreement's formula price.

The RFR in *Doniger* consisted of three clauses,

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the first of which provided:

> An offer shall be made not less than sixty (60) days prior to *any proposed passage or disposition of shares whatsoever,* including but not limited to passage or disposition by sale, delivery, assignment, gift, exchange, transfer, distribution by any executor or administrator, or distribution by a trustee….[3]

The next two clauses in the RFR dealt with required offers, first, by the estate representative of a deceased shareholder and, second, by the purchaser or other stock transferee

> [i]n case of the passage or disposition of shares *in any voluntary or involuntary manner whatsoever, including but not limited to …under judicial order, legal process,* execution, attachment, enforcement of a pledge, trust, or encumbrance, or sale under any of them….[4]

Both the lower court and, on appeal, the Second Department agreed with the respondents that the dissolution proceeding triggered a buyback under the RFR's first clause. The petitioners argued that the offer requirement was limited to the specific circumstances described in the second and third clauses of the RFR. The Appellate Division disagreed, concluding that the "unambiguous" first clause

> negates any inference that the parties intended to exclude any possible method whereby their ownership interests would be affected, including a proceeding for judicial dissolution. The examples following the [first clause] are illustrative only and do not limit the broad scope of the terms employed.
>
> …For this court to now find that the parties did not intend to consider a proceeding for judicial dissolution as one of the means by which the buy-out provisions…would be triggered would be to destroy the fair meaning of their words.[5]

The petitioners received $660,000 under the RFRs formula price, or about one-third of what they likely believed their 50 percent interest was worth as a going concern.[6] Perhaps to temper this seemingly harsh result, the Second Department noted that the formula price still paid approximately $40,000 more than each petitioner's equity and at least quadruple the distributions they would have received upon liquidation. In any event, it's fair to say that the *Doniger* petition backfired.

Post-'Doniger,' Pre-'Johnsen' Decisions

Only a few reported court decisions applied *Doniger* in the two decades separating it and *Johnsen*. The decisions for the most part narrowly read *Doniger* as requiring an express reference to share disposition by judicial process. In none of them did the court enforce an RFR.

In *Matter of Cohen (Safe Coach, Inc.)*,[7] the trial court held that commencement of dissolution proceedings did not compel the sale of petitioner's shares where the RFR stated that "[i]n the event any stockholder desires to dispose of his shares during his lifetime, he shall first offer in writing to sell said shares to this corporation at a price" fixed by the shareholders' agreement. The court found that *Doniger* did not govern the RFR because it lacked "the unique language in *Doniger* which refers to a '…passage or disposition of shares in any voluntary or involuntary manner whatsoever, including but not limited to…judicial order, legal process….'"[8]

The trial court in *James Mirabito & Sons, Inc. v. Mirabito*[9] took a different tack but reached the same result without ever citing *Doniger*. The case involved dissolution proceedings under BCL §1104-a and an RFR with trigger language almost identical to that in *Cohen*. Finding that the RFR was "designed to prevent the unilateral action of a stockholder in transferring stock to outsiders," the court held that the commencement of dissolution proceedings was not an attempt to "dispose of" the petitioner's shares as intended in the RFR.[10]

In re BBS Norwalk One, Inc.,[11] a bankruptcy case, presented the question whether a shareholder who

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filed for bankruptcy and offered a liquidation plan was required under an RFR to offer his shares to the other shareholder who sought to file a competing plan. The court held that a liquidation, in or out of bankruptcy, was not the equivalent of a shareholders' offer to sell shares to a third party. Citing *Doniger* and quoting from the third clause in the *Doniger* RFR ("including but not limited to passage or disposition… under judicial order, legal process…."), the court stated that "a different outcome might result if the [Shareholders'] Agreement contained express language that a dissolution or liquidation would invoke the right of first refusal."[12]

The New York Court of Appeals weighed in on the issue tangentially in *Matter of Pace Photographers, Ltd.*[13] where it held that the RFR formula price in a shareholders' agreement did not dictate fair value in a valuation proceeding under BCL §1118. *Pace* cites *Doniger* with approval for the proposition that "shareholders can agree in advance that an 1104-a dissolution proceeding will be deemed a voluntary offer to sell, or fix 'fair value' in the event of judicial dissolution, and that their agreement [will] be enforced."[14] The court continues:

> But in the absence of explicit agreement a shareholders' agreement fixing the terms of a sale voluntarily sought and desired by a shareholder does not equally control when the sale is the result of claimed majority oppression or other wrongdoing —in effect, a forced buyout.

It is against this backdrop that *Johnsen* was decided.

'Johnsen'

Johnsen involved an HVAC (heating, ventilating and air-conditioning) supply distributor whose voting shares were owned equally by a retired uncle for whom a conservator (his daughter) was appointed, and by his nephew who ran the business. The conservator offered to sell the uncle's shares to the nephew for $2 million, failing which she threatened judicial dissolution. The nephew responded by "accepting" her offer to sell but only at the formula price under the RFR in the shareholders' agreement, equal to 70 percent of book value payable over 10 years. The RFR provided:

> Except as otherwise expressly provided for herein, no Stockholder shall at any time during the term of this Agreement donate, hypothecate, pledge, transfer *or otherwise dispose of his Stock in any manner whatsoever,* without first offering the same for sale first to the Company….[15]

The conservator rejected the nephew's position and petitioned for dissolution based on deadlock under BCL §1104. The nephew counterclaimed for an injunction requiring the conservator to sell the uncle's shares at the formula price. The nephew contended that the conservator's prelitigation offer to sell and, citing *Doniger,* her subsequent filing of the dissolution petition triggered the RFR.

The lower court denied the nephew's summary judgment motion on his counterclaim. It held that the prelitigation correspondence did not constitute an accepted offer and was not a disposition of shares under the RFR. The court then held that commencement of the dissolution proceeding also did not trigger the RFR because, unlike the RFR in *Doniger,* it did not "expressly refer to a judicial dissolution." As in *Cohen* and *BBS,* the court pointed to the *Doniger* RFR's third clause ("the passage or disposition of shares…under judicial order [or] legal process") in support of its conclusion.[16]

On the nephew's appeal, the First Department reversed and granted specific performance of the RFR, concluding that the case fell "squarely within the holding of *Doniger*."[17] The court found indistinguishable the wording of the *Doniger* RFR's first clause ("any proposed passage or disposition of shares whatsoever, including but not limited to…") and the operative language in the *Johnsen* RFR ("or otherwise dispose of his Stock in any manner whatsoever"). "In both cases," the court wrote, "the parties clearly intended to cover the broadest spectrum of events that would trigger the buyout provisions of their agreement."[18]

'Matter of Johnsen (ACP Distribution Inc.)' adds new potency to rights of first refusal by holding that a shareholder petition for involuntary dissolution constitutes a proposed share disposition and pulls the buyback trigger.

The *Johnsen* opinion conspicuously omits mention of the *Doniger* RFR's third clause covering any "voluntary or involuntary" disposition or passage of shares by "judicial order [or] legal process." The *Cohen* and *BBS* courts—and, arguably, the Court of Appeals in *Pace*—relied on this language to distinguish *Doniger* and to deny enforcement of the RFRs before them. *Johnsen* countered the conservator's reliance on *Pace* and *BBS* with the observation that "[b]oth, decided after *Doniger,* state in dicta that the respective outcomes would be the same as *Doniger* if the language in the shareholders' agreement were equivalent to that in *Doniger*."[19]

The response begs the issue. The RFRs in *Doniger, Pace, BBS* and *Johnsen* (as well as in *Mirabito* and *Cohen,* which *Johnsen* does not cite) employ broad language requiring shares to be offered whenever a shareholder wishes to sell or "otherwise dispose" of shares. The *Doniger* RFR—but not the others—in addition has language in its third clause expressly referring to involuntary disposition of shares by judicial order. The post-*Doniger* decisions treated this as determinative in *Doniger.* Now *Johnsen* holds otherwise.

The underlying equities in *Johnsen* may have contributed to the court's expansive reading of *Doniger.* The conservator argued that enforcement of the RFR at the sharply discounted formula price deprived her of the right to seek a sale of her father's stock at full market value. In response the court chastised the conservator for "using this proceeding to avoid the stockholders agreement and as a coercive tool to force respondents to pay a higher price for [the uncle's] stock than the agreement provides." The court further noted that the nephew was not accused of any wrongdoing, and that the RFR's purpose was to provide a mechanism for payment of a buyout without the necessity of selling the business to pay the redemption price.[20]

Conclusion

There are legions of shareholders' agreements new and old containing boilerplate RFR language like that used in *Johnsen.* The same probably can be said about RFR provisions in operating agreements for the rapidly growing ranks of LLCs.

Johnsen alters the legal terrain for such shareholders and LLC members, particularly when the RFR also provides for a discounted buyout. A 50 percent shareholder considering bringing a dissolution proceeding under BCL §1104 as a means of inducing a negotiated buyout, or a LLC member considering dissolution under LLC Law §702 for the same reason, may be deterred completely by the prospect of a compulsory sale to the remaining owners at a heavily discounted price on unfavorable terms.

For the minority shareholder seeking dissolution under BCL §1104-a, *Johnsen* heightens the risk that the majority shareholder will pursue a counterclaim to enforce a RFR buyback instead of electing to purchase the shares for fair value under BCL §1118.

Counsel drafting an RFR or on either side of a potential judicial dissolution therefore must carefully analyze RFR provisions in their client's agreements and must advise their clients whether under *Johnsen* a court will enforce the RFR buyback should a proceeding be filed.

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1. —AD2d—, 814 NYS2d 142 (1st Dept 2006).
2. 122 AD2d 873, 505 NYS2d 920 (2d Dept 1986).
3. Id. at 876, 505 NYS2d at 923 (italics added).
4. Id. at 876-77, 505 NYS2d at 923 (italics added).
5. Id. at 877, 505 NYS2d at 923.
6. Shortly before filing for dissolution the petitioners received an outside offer of $4 million for a 100 percent interest in the hospital. Id. at 874, 505 NYS2d at 921.
7. New York Law Journal, Dec. 22, 1994, at p. 30, col. 3.
8. Id.
9. 137 Misc2d 972, 523 NYS2d 711 (Sup Ct Chenango Co 1986).
10. Id. at 975, 523 NYS2d at 713.
11. 239 BR 440 (D Conn 1999) (applying New York law).
12. Id. at 443.
13. 71 NY2d 737, 530 NYS2d 67 (1988).
14. Id. at 747, 530 NYS2d at 72.
15. 814 NYS2d at 143 (emphasis added).
16. Decision & Order at 5, Index No. 109565/04 (Sup Ct NY Co Feb. 3, 2005) (Richter, J.).
17. 814 NYS2d at 145.
18. Id. at 146.
19. Id.
20. Id. at 143, 146.