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LITIGATION REVIEW

A Corporate Dissolution Minefield

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Attorneys who handle business dissolutions and shareholder and partnership disputes know that these cases can often be even more gut-wrenching than marital dissolutions. They often involve friendships or family relations that have gone seriously awry. For the legal strategist, however, these cases frequently present a cornucopia of intricate tactical decisions in a corporate and procedural "chess game."

A case pending in Nassau County's Commercial Division recently presented Supreme Court Justice Leonard B. Austin with an array of issues typically seen in cases of this nature, but in a variety of interesting contexts: (i) whether the grounds for minority oppression have been met; (ii) whether the corporation should be dissolved as a result; (iii) whether the corporation should be liquidated or sold as a going concern, with goodwill valued; (iv) whether an implied restrictive covenant should be imposed; and (v) whether the majority shareholders should be forced to buy out the minority, petitioning shareholder. The court's resolution of these issues is instructive.

The facts in *Autz v. Fagan*, Index No. 3348-06 (NYLJ, Sept. 28, 2007), are as typical as they get. Two physicians formed a professional corporation to provide medical services. The practice started out with no patients and in 12 years had grown to approximately 12,000 patients. After about five years in practice together, the two original shareholder-physicians brought in another doctor, who ultimately became an equal shareholder.

According to the allegations, the relationship between the two original shareholders deteriorated after one of them declined the other's offer to combine his separate medical practices into their joint practice.

Apparently as a result of irreconcilable differences between the two original shareholders, and when two of the shareholders threatened to vote for dissolution, the lone shareholder instituted a proceeding pursuant to §1104-a of the New York Business Corporation Law (BCL) to dissolve the corporation based upon alleged oppressive conduct and diversion of corporate opportunities.

In the motions before the court, the respondents sought an order (i) acknowledging the parties' consent to voluntarily dissolve the corporation, (ii) converting the special proceeding to a judicially supervised liquidation under BCL §1008 and (iii) determining that when liquidated as a result of the dissolution, the corporation should not be sold as a "going concern."

The petitioner cross-moved for an order directing the sale of the corporation, including its goodwill, by a court-appointed receiver at an auction. The petitioner also sought a determination that the sale was "voluntary" for purposes of imposing a restrictive covenant upon the shareholders who did not successfully bid to acquire the corporation. Interestingly, the petitioner moved "in the alternative" to withdraw the special proceeding altogether if the relief he sought by motion was not granted.

The first issue Justice Austin addressed was whether the petitioner had sufficiently established a case for judicial dissolution under BCL §1104-a and, in particular, on the grounds of "illegal, fraudulent or oppressive actions toward the complaining shareholder" and that "the property or assets of the corporation are being looted, wasted, or diverted for non-corporate purposes by those in control."

Justice Austin found that petitioner had made a prima facie showing that the respondents had acted oppressively by ousting the petitioner from significant matters of corporate management, including leasing major equipment and installing a surveillance system at the offices. He further found that the petitioner alleged a prima facie case of looting and diversion of the corporation's opportunities through allegations that one of the respondents had (i) diverted bills to himself for medical services that he rendered through the corporation and (ii) withdrew money from the corporate bank accounts without authority.

On the other hand, the respondents denied those allegations and asserted that it was the petitioner who "no longer invested the time and energy required to maintain [the corporation's] medical practice."

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As a result of the conflicting allegations of fault, the court scheduled an evidentiary hearing, noting that the court had "broad latitude in fashioning relief and, where there has been a complete deterioration of relations between the parties, dissolution is appropriate."

Goodwill as an Asset

Next, Justice Austin noted that BCL §1104-a(b)(1) and (2) also required the court to determine whether liquidation was the only feasible means for petitioner to obtain a fair return on his investment and "reasonably necessary for the protection of the rights and interests of petitioner."

In this connection, while the respondents agreed to the dissolution, they argued that only the hard assets of the corporation (including its receivables) should be liquidated and divided among the shareholders, asserting that "goodwill" was not an asset that could be transferred.

Respondents also opposed any implied covenant restricting their ability to provide medical services.

On the issue of whether goodwill was a saleable asset of the corporation, the court distinguished between personal, professional goodwill and the goodwill that could be associated with the corporate practice.

Justice Austin noted: "While the good will of a professional practice which depends solely on the name, skill, judgment or reputation of a professional is not a saleable asset, professional good will comprised of continuity of location of a professional office is." Thus, he found that since two-thirds of the patients were "walk-ins" and employees of local businesses constituting "corporate care," the location of the corporation clearly had value. Justice Austin also noted that the shareholders' agreement recognized goodwill as one of the assets to be valued if any of the shareholders voluntarily withdrew from the corporation.

On the other hand, the court did note that to the extent goodwill was based upon "personal relationships," it was not transferable. The court decided that it would resolve these issues and determine the precise extent and value of any goodwill at the evidentiary hearing.

A strategic tactic for the petitioner was to prevent the two other shareholders from competing against the entity that ultimately purchased the corporation upon any ordered dissolution. It might have been assumed that if petitioner convinced the court to value goodwill as a saleable asset of the corporation, the ultimate purchaser would also receive the benefit of an implied covenant from any non-purchasing shareholder to refrain from soliciting the former patients of the practice. Under the context of the involuntary dissolution proceeding under BCL §1104-a, however, the issue was not straightforward.

While Justice Austin recognized the authority of *Mohawk Maintenance Co., Inc. v. Kessler*, 52 N.Y.2d 276 (1981), which requires that a covenant to refrain from competition be implied in a sale of a business that included its goodwill, the court went on to note that "the good will which is the subject of a voluntary sale is 'a different thing from the good will which the owner parts with under compulsion.'"

Thus, the court found that a "transfer under compulsion by manner of dissolution and liquidation does not import the same obligation to refrain from soliciting trade from customers of the old firm, because otherwise those who had been in trade as partners of undesirable associates would constantly find themselves, by the mere fact of the dissolution of the business they desired to leave, disqualified from seeking future business from those who might be their most desirable customers."

The court concluded that "a transfer of shares resulting from an involuntary dissolution proceeding pursuant to BCL 1104-a, without regard to the buyout provisions of BCL 1118, is 'under compulsion,' which does not implicate or include a non solicitation covenant."

The court found that its conclusion was also "compelled" because the corporation was a medical practice and physicians should be permitted to contact and treat any patients whom they had previously treated.

'Alternative' Relief Sought

The most interesting, yet most peculiar, aspect of the motions was petitioner's "alternative" requests for relief.

First, petitioner oddly requested that the court force the two responding shareholders to buy out his shares for "fair value." The court acknowledged that it had no authority to order any of the shareholders to buy out the other in a §1104-a proceeding, but noted that "every order of dissolution gives shareholders the opportunity to elect to purchase the complaining shareholder's stock at fair value," citing *Matter of Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 74 (1984), and BCL §1118.

The petitioner also alternatively asked the court to allow him to withdraw his entire petition without prejudice in the event he was not granted all of the relief he sought in his cross-motion.

Although petitioner may have benefited from having the corporation sold as a going concern, with goodwill valued and with an implied restrictive covenant - as he moved for - the court gave no assurance that petitioner was going to "have his cake and eat it too" after the evidentiary hearing.

Sensibly, the court rejected what it viewed as petitioner's "untenable" request to withdraw his petition if he did not obtain everything he requested in his cross-motion.

Relying on cases that have refused to allow a party voluntarily to withdraw claims if it would result in prejudice to the rights of any other parties, undue delay or some other unfair or inappropriate consequences, the court refused to allow petitioner to withdraw his case altogether in what the court reviewed as an attempt to circumvent adverse rulings of the court.

The *Autz* case is an instructive example of the substantive and procedural issues that arise in the corporate dissolution minefield. As shown by the court's resolution of the various issues, these cases are often "moving targets," requiring careful consideration of all possible outcomes and consequences before and during the corporate chess game is played out.