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CHAPTER 3

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Disputes Among Owners

Janissa Strabuk, Tousley Brain Stephens, PLLC
Paul Moomaw, Tousley Brain Stephens, PLLC

DISPUTES AMONG OWNERS OF CLOSELY-HELD BUSINESSES

Janissa A. Strabuk
Paul W. Moomaw

Tousley Brain Stephens PLLC
1700 7th Avenue, Suite 2200
Seattle, WA 98101
(206) 682-5600
jstrabuk@tousley.com
pmoomaw@tousley.com

Janissa A. Strabuk is a member of Tousley Brain Stephens PLLC and serves on the firm's management committee. She focuses her practice on complex civil litigation, including securities, minority shareholder oppression, shareholder derivative, class action, and commercial litigation. She has significant experience representing both minority and majority shareholders and closely-held corporations in shareholder disputes and litigation. Janissa is admitted to practice in the state and federal courts in Washington and in the Ninth Circuit Court of Appeals. She received her B.A. degree, *cum laude*, from Georgetown University, her M.S.J. degree, with honors, from Northwestern University and her J.D. degree, *magna cum laude*, from the Sandra Day O'Connor College of Law. Before entering private practice 17 years ago, Janissa was a law clerk to the Honorable Eugene A. Wright, Ninth Circuit Court of Appeals, and a television news reporter and anchor.

Paul W. Moomaw concentrates his practice on commercial litigation, including extensive experience in disputes involving members, shareholders, and partners in closely-held businesses. Mr. Moomaw's practice extends to transactional work, including entity formation, negotiating and drafting contracts, and advising clients in the purchase and sale of business interests. He graduated with honors from the University of Washington School of Law in 2002, where he served as managing editor of the *Washington Law Review*. He has been recognized as a "Rising Star" in *Washington Law & Politics*.

I. SOURCES OF DISPUTES

A. There are a number of common factual scenarios lending themselves to disputes amongst shareholders, owners, members, or partners of closely-held businesses:

1. Second generation family business — sibling disputes

2. Closely held business in which one owner/partner has a more active role and asserts more control (sometimes resulting in that owner/partner paying him or herself more)

3. Failure to observe corporate formalities (e.g., meetings, minutes, etc.)

4. Failure to understand law

5. Failure to understand affairs of corporation

- Lack of knowledge or experience is not a defense to a claim for breach of fiduciary duty. *Senn v. Northwest Underwriters, Inc.*, 74 Wn. App. 408, 875 P.2d 637 (1994) ("Just as ignorance of the law is no excuse for the violation of a law, ignorance of the affairs of a business to which one owes a duty of diligence, care and skill does not excuse a director from liability for her colleagues' fraud or malfeasance.").

6. Lack of buy-sell agreement

a. Owners of closely-held businesses are usually constrained from transferring their interest in the company, either because the governing documents place restrictions on transfers, or because there is simply no market for an interest in the closely-held business, or both.

b. Having a buy-sell agreement — and, thus, giving the shareholders, owners, members, or partners an out — may go a long way toward avoiding disputes and litigation in the future.

c. A buy-sell agreement may specify certain events (e.g., termination of a shareholder's employment) that trigger the buy-sell provisions.

d. It may also contain valuation provisions (e.g., an agreed-upon value) that serve to avoid valuation disputes later on.

B. Likewise, there are certain common wrongful acts a majority or controlling shareholder, owner, member, or partner may engage in, resulting in a claim by a minority or non-controlling shareholder, owner, member, or partner:

1. Squeeze out/freeze out

    a. Removal of minority shareholder as employee, officer, director and cutting off payment for such roles

    b. Withholding of information

    c. Making decisions without consulting minority shareholder

    d. Paying excessively high compensation to majority shareholders

    e. Non-payment of dividend

    f. Changing locks to bar shareholder from corporate premises

    g. Transferring corporate assets to a new business in which minority shareholder has no interest

    h. Taking corporate earnings through loans to majority shareholders and leases/contracts with companies they own

2. Usurpation of corporate opportunity

    a. Shareholder (often the majority shareholder) takes for herself a business opportunity that belongs to the corporation (e.g., opportunity within the existing or prospective business of the corporation; opportunity in which the corporation has an interest or expectancy)

    b. Shareholder dissolves old corporation and takes clients to new corporation

    c. No usurpation where corporation is financially unable to take advantage of opportunity or corporation has abandoned the opportunity

3. Conflict of interest transaction

    a. Transaction by corporation in which director benefits himself or a related person

b. Examples include: lease at above-market rates with corporation controlled by director and director receipt of no-interest or below-market interest loans from corporation.

4. Use of corporate funds/assets for own benefit

a. Use of corporate credit card/funds for personal/family benefit

b. Excessive benefits such as using corporate funds to insure personal property

c. Paying salaries to family members who do not work for the corporation

d. Inflation of expense accounts

II. COMMON LEGAL CLAIMS

A. Breach of fiduciary duty is the catchall claim in suits involving shareholders, members, or partners of closely-held businesses. As Judge Cardozo famously stated: "Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." *Meinhard v. Salmon*, 249 App. Div. 663, 229 N.Y.S. 345, 164 N.E. 545, 546 (1928).

B. But there are various species of breach of fiduciary duty claims:

1. Minority shareholder oppression (a.k.a. "freeze out" or "squeeze out")

a. In Washington, majority or controlling shareholders are liable to minority shareholders for oppressive conduct. Oppression has been defined as follows: "[B]urdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely." *Robblee v. Robblee*, 68 Wn. App. 69, 76, 841 P.2d 1289 (1992).

b. "The court in [*Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973)] summarized what it would consider to be oppressive conduct: '[A]n abuse of corporate position for private gain at the expense of the stockholders is "oppressive" conduct. Or

the plundering of a "close" corporation by the siphoning off of profits by excessive salaries or bonus payments and the operation of the business for the sole benefit of the majority of the stockholders, to the detriment of the minority stockholders, would constitute such "oppressive" conduct as to authorize a dissolution of the corporation....'" *Scott v. Trans-Sys., Inc.*, 148 Wn.2d 701, 713–14, 64 P.3d 1 (2003) (quoting *Baker*, 507 P.2d 387).

c. The corporate form "supplies an opportunity for the majority stockholders to oppress or disadvantage minority stockholders. The minority is vulnerable to a variety of oppressive devices, termed 'freeze-outs,' which the majority may employ." *Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505, 513 (Mass. 1975) (citing Note, Freezing Out Minority Shareholders, 74 Harv. L. Rev. 1630 (1961).

d. "An authoritative study of such 'freeze-outs' enumerates some of the possibilities: 'The squeezers (those who employ the freeze-out techniques) may refuse to declare dividends; they may drain off the corporation's earning in the form of exorbitant salaries and bonuses to the majority shareholder-officers and perhaps to their relatives, or in the form of high rent by the corporation for property leased from majority shareholders . . .; they may deprive minority shareholders of corporate offices and of employment by the company; they may cause the corporation to sell its assets at an inadequate price to the majority shareholders . . . .'" *Id.* (quoting F.H. O'Neal and J. Derwin, Expulsion or Oppression of Business Associates, 42 (1961)).

e. "Here are a few illustrations [of freeze-out techniques]. The squeezers may cut off a flow of income to the minority by refusing to declare dividends or they may deprive minority shareholders of corporate offices and of employment by the company. At the same time, the squeezers can protect their own income stream from the business by exorbitant salaries and bonuses to the majority shareholders-officers and perhaps to their relatives . . . by unreasonable payments under contracts between the corporation and majority shareholders. They may cause the corporation to sell its assets at an inadequate price to the majority shareholders or to companies in which the majority are interested; they may organize a new company in which the minority will have no interest,

transfer the corporation's assets or business to it, and perhaps . . . bring about the merger or consolidation of the corporation under a plan unfair to the minority." F. Hodge O'Neal & Robert B. Thompson, Oppression of Minority Shareholders and LLC Members (Rev. 2nd ed. 2009), at § 3:2.

f. A non-fraudulent reverse stock split that eliminates a minority shareholder's interest in a corporation is not a "freeze-out" or oppressive conduct. *Sound Infiniti, Inc., et al. v. Snyder, et al.*, 169 Wn. 2d 199, 209, 237 P.3d 241 (2010). In *Sound Infiniti*, the Washington Supreme Court rejected a claim that the majority shareholders' implementation of a reverse stock split that reduced the minority shareholder's interest in the company to a fractional share "breached the fiduciary duty of good faith and fair dealing by violating his 'reasonable expectations as a minority shareholder.'" *Id.* Washington law allows majority shareholders to oust minority shareholders against their will as long as the majority's actions are not fraudulent and meet corporate and statutory procedural requirements. *Id.* at 207-10. Any claims a minority shareholder has for damages and equitable relief must be brought in the appraisal proceeding set forth in RCW 23B.13.020, where they can be considered in determining the fair value of the minority shareholder's interest. *Id.* at 210-12.

2. Usurpation of corporate opportunities

a. "[W]hen there is presented to a corporate officer a business opportunity which the corporation is financially able to undertake, and which, by its nature, falls in the line of the corporation's business and is of practical advantage to it, or is an opportunity in which the corporation has an actual or expectant interest, the officer is prohibited from permitting his self-interest to be brought into conflict with the corporation's interest and may not take the opportunity for himself." *Noble v. Lubrin*, 114 Wn. App. 812, 818–19, 60 P.3d 1224 (2003) (quoting *Equity Corp. v. Milton*, 221 A.2d 494, 497 (1966)).

b. "[W]hether a particular business opportunity belongs to the corporation or is personal to an individual depends upon the facts and circumstances of each case." *Id*.

c. In *Noble*, the Washington Court of Appeals adopted the line of business test to determine whether a corporate officer has usurped a corporate opportunity: "We adopt the line-of-business test derived from the rule in *Equity Corporation*. The first question is whether the complainant has shown the business opportunity is within the 'line of business' of the corporation or whether the business already has an actual or expectant interest in the opportunity. The second question is whether the corporation has the financial ability to seize the opportunity." *Id.* at 820–21 (citing *Equity Corp. v. Milton*, 2221 A.2d at 497).

d. Washington courts have not yet delineated what actions fall within a corporation's line of business. However, courts in other states have adopted a test in which the opportunity must be a logical extension of the corporation's business:

"[C]ourts have expressly stated or recognized that an opportunity is in the line of a corporation's business where the corporation is engaged in a certain business and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience, and the ability to pursue, which, logically and naturally, is adaptable to its business having regard for its financial position, and which is consonant with its reasonable needs and aspirations for expansion." James L. Rigelhaupt, Jr., <u>What business opportunities are in "line of business" of corporation for purposes of determining whether a corporate opportunity was presented</u>, 77 A.L.R.3d 961, at § 2[a] (rev. 2008) (citations omitted).

e. Likewise, Washington courts have not defined what constitutes an "actual interest or expectancy." However, a Minnesota court addressing this issue has stated that the interest or expectancy test "precludes acquisition by corporate officers of the property of a business opportunity in which the corporation has a 'beachhead' in the sense of a legal or equitable interest or expectancy growing out of a preexisting right or relationship." *Miller v. Miller*, 222 N.W.2d 71, 79, 77 A.L.R.3d 941 (Minn. 1974).

f. When corporate officers or directors wrongfully usurp for themselves an opportunity properly belonging to the corporation, those officers or directors are deemed to hold the opportunity in trust for the corporation. *Arneman v. Arneman*, 43 Wn.2d 787, 799–800, 264 P.2d 256 (1953); *see also Mile-O-Mo Fishing Club, Inc. v. Noble*, 210 N.E.2d 12, 16 (Ill. Ct. App. 1965).

3. Conflict of interest transaction

a. Under RCW 23B.08.700, a directors' conflict of interest transaction is one in which a corporate director or someone related to the director has a financial interest in the transaction. In order for such a transaction to be valid, it must be approved by a majority of disinterested directors or, if there are none, a majority of disinterested shareholders. RCW 23B.08.710. Such approval must be given after full disclosure to the disinterested shareholders not only of the directors' conflict of interest but also of the impacts the transaction would have on the business.

b. A "conflicting interest transaction" is a "transaction effected or proposed to be effected by the corporation . . . respecting which a director of the corporation has a conflicting interest." RCW 23B.08.700(2).

c. In turn, a director has a "conflicting interest" if "the director knows at the time of commitment that the director or a related person is a party to the transaction or has a beneficial financial interest in or so closely linked to the transaction and of such financial significance to the director or a related person that the interest would reasonably be expected to exert an influence on the director's judgment if the director were called upon to vote on the transaction." RCW 23B.08.700(1)(a).

d. Such transactions, however, are not per se impermissible: "A director's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions, in a proceeding by a shareholder or by or in the right of the corporation, because the director, or any person with whom or which the director has a personal, economic, or other association, has an interest in the transaction if . . . the transaction, judged according to the circumstances at the time of commitment, is

established to have been fair to the corporation." RCW 23B.08.710.

e. Often, it is not possible to have disinterested shareholder or director approval. Thus, the question is whether the transactions were "fair to the corporation." If they were, they will not be set aside. There is no case law in Washington dealing with the issue of whether a conflicting interest transaction is fair to a corporation. However, as one Colorado court has explained, "[i]n most jurisdictions, the test for fairness in cases involving both interested director and controlling shareholder transactions 'is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.'" *Kim v. Grover C. Coors Trust*, 179 P.3d 86, 91 (Colo. Ct. App. 2007) (citing *Pepper v. Litton*, 308 U.S. 295, 306–07 (1939)).

f. "Under this approach, courts may consider several factors, including 'whether the corporation received full value in the transaction, whether the transaction was in the corporate interest, whether the corporation needed and was able to finance the transaction, whether the interested director or officer siphoned off corporate gain, and whether there was full disclosure.'" *Id.* at 92 (quoting 3 William Meade Fletcher, *Fletcher Cyclopedia of the Law of Private Corporations* § 919, at 501 (perm ed. 2002)).

4. Corporate waste

a. "Corporate waste is defined as 'an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade." *In re Cray, Inc.*, 431 F. Supp. 2d 1114, 1135 (W.D. Wash. 2006) (quoting *Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997)).

b. "The essence of a claim of waste of corporate assets is the diversion of corporate assets for improper or unnecessary purposes." *Michelson v. Duncan*, 407 A.2d 211, 217 (Del.1979).

c. "To recover on a claim of corporate waste, the plaintiffs must shoulder the burden of proving that the exchange was 'so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.' A claim of waste will arise only in the rare 'unconscionable case

where directors irrationally squander or give away corporate assets.' This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'" *Schwartzman v. McGavick*, 2007 WL 1174697, at *5 (W.D. Wash. 2007) (quoting *In re the Walt Disney Co. Deriv. Litig.*, 825 A.2d 275, 286 (Del. Ch. 2003)).

C. Conversion

1. Conversion is "the act of willfully interfering with any chattel, without lawful justification, whereby any person entitled thereto is deprived of the possession of it." *Consulting Overseas Mgmt., Ltd. v. Shtikel*, 105 Wn. App. 80, 83, 18 P.3d 1144 (2001).

2. A claim for conversion in this context is similar to a claim for corporate waste. The essence of the claim is that a majority or controlling shareholder has interfered with property or assets rightfully belonging to the corporation or its shareholders.

D. Declaratory relief

1. "The [Uniform Declaratory Judgment Act] is to be liberally construed and is designed to clarify uncertainty with respect to rights, status, and other legal relations." *Nelson v. Appleway Chevrolet, Inc.*, 129 Wn. App. 927, 121 P.3d 95 (2005) (citing *DiNino v. State*, 102 Wn.2d 327, 330, 684 P.2d 1297 (1984)).

2. "Declaratory judgment is appropriate when the four elements of a justiciable controversy are present. There must be: (1) ... an actual, present and existing dispute, or the mature seeds of one, as distinguished from a possible, dormant, hypothetical, speculative, or moot disagreement, (2) between parties having genuine and opposing interests, (3) which involves interests that must be direct and substantial, rather than potential, theoretical, abstract or academic, and (4) a judicial determination of which will be final and conclusive." *Osborn v. Grant County*, 130 Wn.2d 615, 631, 926 P.2d 911 (1996).

3. Therefore, a declaratory judgment action is an appropriate vehicle to determine matters such as whether a fiduciary duty exists between the plaintiff and defendant, whether a business opportunity taken by an officer

or director was a corporate opportunity, whether a transaction was a conflict of interest transaction that should be set aside, etc.

E. Tortious interference

1. A claim for tortious interference requires: "1. The existence of a valid contractual relationship or business expectancy; 2. That defendants had knowledge of that relationship; 3. An intentional interference inducing or causing a breach or termination of the relationship or expectancy; 4. That defendants interfered for an improper purpose or used improper means; and 5. Resultant damages." *Deep Water Brewing, LLC v. Fairway Resources Ltd.*, 152 Wn. App. 229, 261–62, 215 P.3d 990 (2009).

2. However, a party cannot tortiously interfere with its own contract. *See Calbom v. Knudtzon*, 65 Wn.2d 157, 162, 396 P.2d 148 (1964). A corporation can act only through its agents, including its officers and directors, and when its agents act within the scope of their actual or apparent authority, their actions are the actions of the corporation itself. *See Mauch v. Kissling*, 56 Wn. App. 312, 316, 783 P.2d 601 (1989); *American Seamount Corp. v. Science and Eng'g Assocs., Inc.*, 61 Wn. App. 793, 796–97, 812 P.2d 505 (1991). Thus, as a general rule, an officer or director, acting on behalf of and as the company, cannot be liable for tortious interference with contractual or business expectancies when the company is one of the contracting parties.

3. An exception to this general rule exists when the corporate officer is not acting in good faith, for the benefit of the company. *Olympic Fish Prods., Inc. v. Lloyd*, 93 Wn.2d 596, 599, 611 P.2d 737 (1980). If the corporate officer acts for purely personal reasons, and not to further the best interests of the corporation, he or she may be liable for tortious interference.

4. "So long as the officer or employee acts within the general range of his authority intending to benefit the corporation, the law identifies his actions with the corporation. In such a situation the officer is not liable for interfering with a contract of the corporation any more than the corporation could be liable in tort for interfering with it." *Id.* at 600.

5. As the court observed in *Deep Water Brewing*, "[t]o avoid personal liability [for tortious interference], the corporate officer must have acted in good faith, which 'in this context means nothing more than an intent to benefit the corporation' . . . ." *Deep Water Brewing*, 152 Wn. App. at 26.

III. DEFENSES

A. Business judgment rule

1. "Once overreaching conduct has been demonstrated, the burden shifts to the majority shareholder or shareholders to show there were legitimate business justifications for the conduct. Under the 'business judgment rule,' corporate management is immunized from liability in a corporate transaction where (1) the decision to undertake the transaction is within the power of the corporation and the authority of management, and (2) there is a reasonable basis to indicate that the transaction was made in good faith." *Scott v. Trans-Sys., Inc.*, 148 Wn.2d 701, 709, 64 P.3d 1 (2003) (citing *Nursing Home Bldg. Corp. v. DeHart*, 13 Wn. App. 489, 498, 535 P.2d 137 (1975)).

2. "It is ... fundamental in the law of corporations, that the majority of its stockholders shall control the policy of the corporation, and regulate and govern the lawful exercise of its ... business ... and courts of equity will not undertake to control the policy or business methods of a corporation, although it may be seen that a wiser policy might be adopted and the business more successful if other methods were pursued." *Id.* (quoting *Wheeler v. Pullman Iron & Steel Co.*, 143 Ill. 197, 207–08, 32 N.E. 420 (1892)).

3. The business judgment rule does not provide absolute protection from liability. The business judgment rule provides no protection where the legislature has specifically expressed the public policy that certain acts subject an individual to personal liability. *Durand v. HIMC Corp.*, 151 Wn. App. 818, 837, 214 P.3d 189 (2009) (holding that the business judgment rule does not apply to a claim for wrongful withholding of wages under RCW 49.52.070). Additionally, the liability of a controlling individual "for his own tort committed within the scope of his official duties is the same as the liability for tort of any other agent or servant." *Consulting Overseas Mgmt. v. Shtikel*, 105 Wn. App 80, 84, 18 P.3d 1144 (2001) (discussing the liability of officers for their own torts).

B. Fairness

1. Many of the issues in disputes involving owners, members, or partners of closely-held businesses are equitable in nature. Thus, the defense that an allegedly "oppressive" act was fair or equitable to the company is legitimate.

2. Indeed, as noted above, the concept of "fairness" is written into the conflict of interest transaction statute: "A director's conflicting interest transaction may not be enjoined, set aside, or give rise to an award of damages or other sanctions, in a proceeding by a shareholder or by or in the right of the corporation, because the director, or any person with whom or which the director has a personal, economic, or other association, has an interest in the transaction if . . . the transaction, judged according to the circumstances at the time of commitment, is established to have been fair to the corporation." RCW 23B.08.710.

3. "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged[,] the burden is upon those who would maintain them to show their entire fairness[,] and where a sale is involved[,] the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character. This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add in the soundest business policy." *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) (emphasis added).

C. Statute of limitations

1. Breach of fiduciary claims are subject to a three-year statute of limitations. *See Delta Dev. & Inv. Co. v. Hsiyuan*, 2002 WL 31748937, at *3 (Wash. App. Div. 1) ("Actions for fraud, breach of fiduciary duty, and conversion must be filed within three years. RCW 4.16.080) (citing *Crisman v. Crisman*, 85 Wn. App. 15, 20, 931 P.2d 163 (1997)); Robert B. Thompson, O'Neal and Thompson's Oppression of Minority Shareholders and LLC Members, § 7:32 (rev. 2nd ed. 2004) ("Since the statute of limitations for an oppression or squeeze-out claim is not usually set out in the statute, courts seek the most applicable statute often applying the limitation applicable to torts.").

2. At least where a breach of fiduciary duty claim alleges concealment and misrepresentation, the discovery rule applies to the statute of limitations. *See Hudson v. Condon*, 101 Wn. App. 866, 874–75, 6 P.3d 615 (2000).

D. Waiver or laches

1. "If a stockholder, with knowledge of wrongful acts on the part of the directors or a majority of the stockholders, stands by for an unreasonable time without taking any steps to set the acts aside or otherwise interfere, and rights are acquired by others, his right to sue is barred by his laches, however clear his right to relief would have been if he had moved promptly." *Federal Home Loan Bank Bd. v. Elliott*, 386 F.2d 42, 54 (9th Cir. 1967).

2. "Notice sufficient to excite attention and put a person on guard or to call for an inquiry is notice of everything to which such inquiry might lead." *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wn. App. 502, 518, 728 P.2d 597 (1986).

E. Unclean hands

1. "It is a well-known maxim that a person who comes into an equity court must come with clean hands. A person may, by his misconduct, be precluded from a right to an accounting in equity by virtue of the maxim stated." *Income Investors v. Shelton*, 3 Wn.2d 599, 602, 101 P.2d 973 (1940).

2. "Equity will not interfere on behalf of a party whose conduct in connection with the subject-matter or transaction in litigation has been unconscientious, unjust, or marked by the want of good faith, and will not afford him any remedy." *Id.*

3. Therefore, an "oppressed" shareholder, member, or partner who is himself or herself guilty of inequitable conduct may be precluded from obtaining relief in equity.

IV. REMEDIES

A. Dissolution

1. Washington law allows a minority shareholder to dissolve a corporation in the event of oppressive conduct by the majority shareholders, as well as in the event of waste or misapplication of the corporation's resources. *See* RCW 23B.14.300.

2. As one Washington court has put it, "[u]nder RCW 23B.14.300(2)(b), the superior courts may dissolve a corporation in a proceeding by a shareholder if it is established that '[t]he directors or those in control of the corporation have acted, are acting, or will act in a manner that is

illegal, oppressive, or fraudulent." *McCormick v. Dunn & Black, P.S.*, 140 Wn. App. 873, 887, 167 P.3d 610 (2007). Whether dissolution is appropriate is a matter for the trial court's discretion. *Id.*

3. However, "the remedy of liquidation is so drastic that it must be invoked with extreme caution." *Scott v. Trans-Sys., Inc.*, 148 Wn.2d 701, 708–09, 64 P.3d 1 (2003) (quoting *Polikoff v. Dole & Clark Bldg. Corp.*, 37 Ill.App.2d 29, 36, 184 N.E.2d 792 (1962)).

B. But courts are not limited to the remedy of dissolution, and have the power to fashion any number of equitable remedies to fit the circumstances of the case. The following possible remedies are outlined by the court in *Scott v. Trans-Sys., Inc.*, *supra*, and *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973):

1. The entry of an order requiring dissolution of the corporation at a specified future date, to become effective only if the stockholders fail to resolve their differences before that date;

2. The appointment of a receiver, not for the purposes of dissolution, but to continue the operation of the corporation for the benefit of all the stockholders, both majority and minority, until differences are resolved or 'oppressive' conduct ceases;

3. The appointment of a 'special fiscal agent' to report to the court relating to the continued operation of the corporation, as a protection to its minority stockholders, and the retention of jurisdiction of the case by the court for that purpose;

4. The retention of jurisdiction of the case by the court for the protection of the minority stockholders without appointment of a receiver or 'special fiscal agent';

5. The ordering of an accounting by the majority in control of the corporation for funds alleged to have been misappropriated;

6. The issuance of an injunction to prohibit continuing acts of 'oppressive' conduct and which may include the reduction of salaries or bonus payments found to be unjustified or excessive;

7. The ordering of affirmative relief by the required declaration of a dividend or a reduction and distribution of capital;

8. The ordering of affirmative relief by the entry of an order requiring the

corporation or a majority of its stockholders to purchase the stock of the minority stockholders at a price to be determined according to a specified formula or at a price determined by the court to be a fair and reasonable price;

9. The ordering of affirmative relief by the entry of an order permitting minority stockholders to purchase additional stock under conditions specified by the court;

10. An award of damages to minority stockholders as compensation for any injury suffered by them as the result of 'oppressive' conduct by the majority in control of the corporation.

B. Attorneys' fees?

1. A court has discretion to award attorneys' fees in a claim for breach of fiduciary duty. *Green v. McAllister*, 103 Wn. App. 452, 468, 14 P.3d 795 (2000).

2. In *Hsu Ying Li v. Tang*, 87 Wn.2d 796, 557 P.2d 342 (1976), the Washington Supreme Court explained that "where the litigant created or preserved a specific fund for the benefit of others, as well as the litigant," he or she may be entitled to an award of attorneys fees. *Tang*, 87 Wn.2d at 798.

   a. This is known as the "common fund" rule.

   b. Thus, where a shareholder who sues for breach of fiduciary duty benefits other shareholders as well as himself or herself, he or she may be entitled to an award of fees.

3. In *Tang*, even though the plaintiff did not come within the common fund rule, because he did not benefit others, the court held that he was entitled to an award of attorneys fees for the defendant's breach of fiduciary duty: "Petitioner necessarily instituted this lawsuit to compel respondent to carry out his fiduciary duties as manager of the partnership. The lawsuit preserved the partnership assets and prevented respondent from further commingling the partnership with his separate assets. A partner should share the expense of a lawsuit when he breaches his fiduciary duty to the other partners." *Tang*, 87 Wn.2d at 801.

V. RESOLUTION OF DISPUTES

A. The most common resolution of disputes involving allegations of shareholder oppression is a mediated settlement resulting in a buy-out by the majority or controlling shareholder of the minority shareholder's interest in the company.

B. There are advantages to such a resolution:

1. It allows for a clean break between the shareholders. This can be especially important in disputes between family members, where the business dispute disrupts the family relationship.

2. It allows the oppressed shareholder to realize the value of his or her ownership interest.

C. One of the primary issues facing the parties in a settlement involving a buy-out is the valuation of the interest to be transferred.

1. As a starting point (modified by the concept of "fair value," discussed below), the parties need to determine the fair market value of the interest to be transferred. "'Fair market value' means neither a panic price, auction value, speculative value, nor a value fixed by depressed or inflated prices. We have defined it as the amount of money which a purchaser willing, but not obliged, to buy the property would pay an owner willing, but not obligated, to sell it, taking into consideration all uses to which the property is adapted and might in reason be applied." *Donaldson v. Greenwood*, 40 Wn.2d 238, 252, 242 P.2d 1038 (1952).

2. In order to come to an understanding of the fair market value of the interest, it is crucial to retain a good business valuation expert.

a. Typically, the parties each retain their own business appraiser, each of whom will prepare a report containing the expert's analysis of the valuation of the interest.

b. The parties may also jointly retain an appraiser to save costs, but this can raise problems if neither party agrees with the appraiser's conclusions. Also, if the case does not settle and proceeds to trial, each party will need to retain their own independent expert.

3. Business appraisers typically rely on three separate appraisal methodologies:

a. Cost approach – Focuses on the fair value of the company's underlying assets. Not used where a company's value as a going concern exceeds its liquidation value

b. Income approach – Estimates value by applying a capitalization or discount rate to an estimate of the company's net annual cash flow

c. Market approach – Estimates the value of a closely-held company's stock by analyzing prices paid in private or public markets for stock in comparable companies. Sometimes not an option because

i. No comparable companies exist

ii. Information about comparable companies is not available

4. The preferred methodology is to value the entity as a going concern, as opposed to the "liquidation" value of its assets.

a. "The overwhelming weight of authority approves the valuation of the assets of the corporation as a going concern." *Elk Yarn Mills v. 514 Shares of Common Stock of Elk Yarn Mills, Inc.*, 742 S.W.2d 638, 642 (Tenn. 1987) (citing *In re Olivetti Underwood Corporation*, 246 A.2d 800 (Del. 1968)); *In re Application of Delaware Racing Ass'n*, 213 A.2d 203 (Del. 1965); *Sporborg v. City Specialty Stores*, 123 A.2d 121 (Del. 1956)).

b. *See also Chatterton v. Business Valuation Research, Inc.*, 90 Wn. App. 150, 156, 951 P.2d 353 (1998) (in dispute regarding shareholder buy-out agreement, where trial court found business would continue operation, holding valuation as going concern was appropriate); *In re Trans World Airlines, Inc.*, 134 F.3d at 193 ("Because liquidation in bankruptcy was not clearly imminent on the date of the challenged transfer, we concern ourselves with how to achieve a fair valuation of TWA's assets on a 'going concern' basis.") (citing *Moody v. Security Pacific Bus. Credit, Inc.*, 971 F.2d 1056, 1067 (3rd Cir. 1992)); *Hansen v. 75 Ranch Co.*, 957 P.2d 32 (Mont. 1998) ("[C]ourts have noted that unless the corporation is undergoing an actual liquidation, the liquidation method is not an appropriate method of valuing shares of a dissenting shareholder.").

5. The concept of "fair value": In a shareholder oppression case, should the value of the interest be reduced by a "marketability discount" or a "minority discount"?

   a. In dissenter's rights actions, courts determine the "fair value" of the shareholder's interest, as opposed to the "fair market value." *Matthew G. Norton Co. v. Smyth*, 112 Wn. App. 865, 873, 51 P.3d 159 (2002).

   b. "'Fair value' means the value of the corporation's shares determined: (i) immediately before the effectuation of the corporate action to which the shareholder objects; (ii) using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and (iii) without discounting for lack of marketability or minority status." *Id.* at 875–75.

      i. A minority discount adjusts for lack of control of the corporation. *See Advanced Commc'n Design, Inc. v. Follett*, 615 N.W.2d 285, 291 (Minn. 2000).

      ii. A marketability discount adjusts for a lack of liquidity in the shareholder's interest in an entity. The basis for the discount is that an interest in a closely held company cannot be sold as readily as shares in a corporation with securities traded over an exchange or in an established market. Investors tend to pay less for such shares. *Id.*

   c. In Washington, for the purposes of a shareholder oppression suit, it is settled that "fair value" does not include a discount for minority status. *Robblee v. Robblee*, 68 Wn. App. 69, 78–80, 841 P.2d 1289 (1992).

   d. It is not settled in Washington whether, in a shareholder oppression lawsuit, the definition of fair value includes a "marketability" discount.

      i. An unpublished Washington decision holds that, in shareholder oppression cases, fair value does not include a marketability discount. *Prentiss v. Wesspur, Inc.*, 1997 WL 207971, at *3 (Wash. App. Div. 1).

ii. On balance, most courts outside of Washington have declined to apply the marketability discount in oppression cases, but a few have reached the opposite result. "Though most courts in other jurisdictions have held that the application of a marketability discount denies a selling shareholder fair value in either a court-ordered buy-out or a dissenters' rights proceeding, courts have disagreed on this issue, particularly in the buy-out context." *Follett*, 615 N.W.2d at 291. *See also Balsamides v. Protameen Chemicals, Inc.*, 734 A.2d 721, 734 (N.J. 1999) ("There is even less consensus about whether discounts should be applied in oppressed shareholder actions. Although other jurisdictions are divided, the majority reject the use of discounts for lack of marketability or liquidity, and minority discounts.").

D. Should the sale be structured as a purchase by the majority shareholder or a redemption by the company?

1. There may be significant tax ramifications depending on how the transaction is structured.

2. It is critical to have the advice and assistance of the company's accountant in structuring the transaction.

VI. CONFLICT/ATTORNEY-CLIENT ISSUES

A. Representation of both corporation and majority shareholder in litigation against a minority shareholder may give rise to a potential conflict of interest scenario.

1. Washington Rule of Professional Conduct ("RPC") 1.7 prohibits a lawyer from representing a party if the representation involves a "concurrent conflict of interest," unless the party consents in writing. RPC 1.7(a)(2) provides in pertinent part that a concurrent conflict of interest exists if "there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client."

2. In disputes involving owners, members, or partners of a closely-held business, there is a potential for conflict between the majority or controlling owner, member, or partner and the business. For example, a minority shareholder may assert claims on behalf of the company against

the controlling shareholder, owner, member, or partner, pitting her directly against the company.

3. At the outset of the representation, the attorney should obtain the written consent to the representation of both the shareholder and the company, in a letter that explains the nature of the potential conflict of interest and states that if, in the future, the attorney cannot continue to represent both the shareholder and the company in a manner that is consistent with the attorney's responsibilities under the Washington Rules of Professional Conduct (the "RPCs"), the attorney may withdraw from further representation of either or both of them as may be required by the RPCs. Each client should sign the letter, acknowledging their consent to the representation and their waiver of objection to the potential conflict of interest.

B. In litigation with a minority shareholder, the question may arise as to whether he or she is entitled to otherwise privileged communications between the company and its corporate counsel.

1. The question is not settled in Washington.

2. Some courts in other jurisdictions have determined that a corporation may not assert the attorney-client privilege against a former director where the documents were generated during the director's tenure. *See, e.g., Gottlieb v. Wiles,* 143 F.R.D. 241 (D.Colo.1992); *Kirby v. Kirby,* 1987 WL 14862 (Del.Ch. July 29, 1987); *Garner v. Wolfinbarger,* 430 F.2d 1093 (5th Cir.1970); *Neusteter v. Dist. Court,* 675 P.2d 1 (Colo.1984).

3. Other courts have held that the authority to assert and waive a solvent corporation's attorney-client privilege rests with current management, and that former directors or officer who are now adverse to the company cannot have access to the company's attorney-client privileged communications, even if generated during their tenure. *See, e.g., Commodity Futures Trading Comm'n v. Weintraub, supra; Milroy v. Hanson,* 875 F. Supp. 646 (D. Neb.1995); *In re Mktg. Investors Corp.,* 80 S.W.3d 44 (Tex.Ct.App.1998); *Lane v. Sharp Packaging Sys., Inc.,* 640 N.W.2d 788 (Wis. 2002). As the court put it in *Milroy v. Hansen,* "[a] dissident director is by definition not 'management' and, accordingly, has no authority to pierce or otherwise frustrate the attorney-client privilege when such action conflicts with the will of 'management.'" *Milroy,* 875 F. Supp. at 650.

VII. DERIVATIVE ACTIONS

A. Should the plaintiff's action be brought as an individual action, on behalf of the minority owner, member, or partner alone, or should it be brought as a derivative action, on behalf of the corporation?

1. "In a derivative suit, a stockholder asserts rights or remedies belonging to the corporation for the corporation's benefit." *Haberman v. Washington Pub. Power Supply*, 109 Wn.2d 107, 147, 744 P.2d 1032 (1987) (citing 12B W. Fletcher, *Private Corporations* § 5907 (1984)). "Such suits arise in equity to enforce a corporate right which the corporation fails, is unable, or refuses to assert by court action." *Id.* (citing *LaHue v. Keystone Inv. Co.*, 6 Wn. App. 765, 777, 496 P.2d 343 (1972); *Goodwin v. Castleton*, 19 Wn.2d 748, 761–62, 144 P.2d 725 (1944)). But a derivative suit "<u>is not for the individual benefit of the stockholder</u>. It is established that both the cause of action and judgment thereon belong to the corporation." *LaHue v. Keystone Inv. Co.*, 6 Wn. App. 765, 780, 496 P.2d 343 (1972) (emphasis added). Significantly, "[t]he stockholder does not bring [a derivative] suit because *his* rights have been *directly* violated, or because the cause of action is *his*, or because *he* is entitled to the relief sought; he is permitted to sue in this manner *simply in order to set in motion the judicial machinery of the court*." *Goodwin*, 19 Wn.2d at 762 (quoting 4 Pomeroy's Equity Jurisprudence, 5th Ed., 277, § 1095) (emphasis in original).

2. In contrast, "[a]n action that is not for the benefit of the corporation but merely seeks to enforce the rights of one or more shareholders against the corporation is not a derivative action." 7C Wright, Miller, & Kane, *Federal Practice & Procedure* § 1821 (supp. 2006). "If the injury is one to the stockholder individually and not to the corporation, as when it is based on a contract to which the stockholder is a party, on a right belonging severally to him or on fraud affecting him directly, it is an individual action, not a derivative action." *Id.* (citing *Vom Brimer v. Whirlpool Corp.*, 367 F. Supp. 740 (D.C. Cal. 1973), *affirmed in part, reversed in part on other grounds by* 536 F.2d 838 (9th Cir. 1976)).

3. Thus, for example, in *Walters v. Center Electric, Inc.*, 8 Wn. App. 322, 506 P.2d 883 (1973), the court pointed out the difference between a derivative action and an action to compel a corporation to declare a dividend: "Under the former, the corporation is the real party in interest and the minority stockholder who brings the action is at best only a nominal plaintiff seeking to enforce a right of the corporation against a

third party. Under the latter, the stockholder is seeking to enforce a right common to himself and other stockholders against the corporation and not against any third party." *Walters*, 8 Wn. App. at 329 (citations omitted).

B. In a derivative suit, "the complaint shall be verified and shall allege (a) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (b) that the action is not a collusive one to confer jurisdiction on a court of this state which it would not otherwise have." CR 23.1.

- "[S]tanding to bring a stockholder derivative claim requires a proprietary interest in the corporation whose right is asserted." *Sound Infiniti, Inc. v. Snyder*, 169 Wn.2d 199, 212–13, 237 P.3d 241 (2010) (quoting *Haberman v. Wash. Pub. Power Supply Sys.*, 109 Wash.2d 107, 149, 744 P.2d 1032, 750 P.2d 254 (1987)).

C. The complaint must also "allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort." CR 23.1.