THE RIGHTS AND DUTIES OF SHAREHOLDERS IN A CLOSELY HELD BUSINESS IN NORTH CAROLINA

By: Fred B. Monroe[1]

At the outset of many business ventures, the plan is definite. The predominant purpose of the venture is either to bring a product to market, hold assets for investment purposes, or offer better services than any other competitor. The vision is clear and the business's organizers see no potential for conflict in the future. Many times closely-held corporations and limited liability companies are formed with a clear vision of how to split the pie, but no real consideration of what to do if either the business, or the owners' relationships, turn sour. Down the road the minority investor in a closely-held business realizes that the controlling owners hold all of the cards when it comes to the management and operations of the business. In addition, unless the majority is guilty of inequitable conduct or the company dissolves, minority shareholders generally have no right to get paid the proportionate value of their shares. Realistically, a minority shareholder trying to liquidate an investment without a prior agreement will usually incur a discount of forty percent or more.[2] It is important to have a well thought-out shareholder agreement if a minority shareholder wants to realize the proportional value of his or her shares.

Unlike an investment in publicly traded companies, the minority investor in a closely held corporation cannot readily liquidate his investment and simply call it quits. For this reason, and others, the law recognizes certain rights to even the playing field between the minority owner and those in control.

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[2]Applying a "fair market value" standard, the shares of a 40% owner of a company are worth far less than 40% of the company's stock value and the law recognizes this in almost every context.

In my experience, increases in disputes among closely-held business owners are often correlated to changes in the economy and the performance of the company. Issues between owners that have festered for some time tend to come to light during such times. This article shares my understanding of several of the rights of, and duties owed to, minority shareholders of a closely-held corporation under the North Carolina Business Corporation Act (the "Act").[3] Understanding these rights and duties are fundamental to a resolution of most ownership battles that are headed to litigation.

What is a "Minority" Shareholder?

A "minority shareholder" is a person owning less than 50% of the stock in the corporation.

What Rights Do Minority Shareholders Have?

Minority shareholders in a corporation have the following rights:

- **The right to vote**

While the ownership of shares in the corporation does not vest the shareholder with the right to participate in the operation or management of the business, it does vest the shareholder with the right to vote. This right is limited. The shareholders elect the directors of the corporation and can vote on certain material changes in the corporation such as the sale of all of the corporation's assets other than in the ordinary course of business, voluntary dissolutions, and certain amendments to governing documents. *See* N.C.G.S. §§ 55-12-02, 55-14-02, 55-10-03. Generally, unless the shares are specifically designated as non-voting, a shareholder is allowed one vote for every share. *See* N.C.G.S. § 55-7-21.

- **Dissenter's rights**

On rare occasions, the shareholder has the right to "dissent" from actions that the corporation has undertaken. *See* N.C.G.S. § 55-13-03. Actions allowing for a right to

[3] This article contains a high-level summary of issues that may arise in a dispute between owners of a closely held corporation or limited liability company. The particular application of the law in this area depends upon the specific circumstances of the dispute and the agreements between the parties. Therefore, the contents of this article should not be relied upon for legal advice. Rather, to the extent a reader of this article is involved in a dispute with other owners of a closely held business, he, or she, should consult with an attorney experienced in shareholder rights and corporate governance. This article may contain opinions and views of the author that are not shared by either the law firm of James, McElroy & Diehl, P.A. or its employees.

dissent include the consummation of a plan of merger, share exchange, conversion, a sale or exchange of all of the assets of the corporation that is outside the ordinary course of the corporation's business, and an amendment to the articles of incorporation that affects the dissenter's shares. If a shareholder dissents from such an action, and follows the procedure for the exercise of his rights set forth in the Act, he can demand that the corporation purchase his shares at their "fair value." Although this is a benefit to a shareholder unhappy with corporate action, it also tempers the shareholder's rights somewhat, in that the right to require redemption is provided in lieu of the right to challenge the corporate action itself, unless it is unlawful or fraudulent with respect to the shareholder or the corporation. Note that unless the shareholder agreement provides for redemption of the shares by the corporation, which would be unusual, the exercise of dissenter's rights is the only circumstance under the Act where a corporation can be forced to purchase the shares of a shareholder.

- Dividends

In a corporation with less than 25 shareholders, shareholders who own 20% or more of the shares may demand that one-third (1/3) of the net profits be paid as a dividend[4] if certain conditions are met. *See* N.C.G.S. § 55-6-40(i). This dividend demand right is balanced by the corporation's right, in response, to redeem the shareholder's shares at their fair value. *See* N.C.G.S. § 55-6-40(j). The shareholder can then withdraw its dividend demand to avoid having his shares redeemed.

- Rights to Maintain Relative Percentage of Ownership

Obviously the shareholder's ownership percentage of the corporation directly affects his right to vote, to obtain records, to demand dividends, and to protect the value of his investment. Under certain circumstances, the shareholder has rights to keep his percentage ownership interest the same. These are called preemptive rights – allowing the shareholder to purchase enough shares to maintain his relative percentage ownership interest, thereby preventing the dilution of his ownership interest. *See* N.C.G.S. § 55-6-30.

[4] The right of a 20% shareholder to make the demand exists if during the immediately preceding fiscal period the corporation has not distributed at least one-third (1/3) of the net profits applicable to the same class of shareholders as the holder making the demand. The right of the shareholder to receive a dividend is not automatic. For example, the corporation will not be required to pay a dividend (a) where it would exceed fifty percent (50%) of the net profits of the current fiscal period in which the demand is made, (b) the net profits are being retained to eliminate a deficit, (c) the payment would breach an agreement with a creditor, or (d) the corporation can demonstrate a business need to retain its earnings.

North Carolina case law has also affirmed awards of damages against majority shareholders in certain situations where they have improperly diluted a minority shareholder's interest. *See Farndale Co., LLC v. Gibellini*, 176 N.C. App. 60, 628 S.E.2d 15 (2006).

- Derivative Actions

Under certain circumstances, the shareholders can sue on behalf of the corporation (known as a "derivative action"), after providing the requisite statutory notice, demanding that the officers and directors take appropriate action. *See* N.C.G.S. § 55-7-42. The theory behind the demand and notice requirement is to allow for the exhaustion of intra-corporate remedies. However, a derivative action can be commenced immediately where irreparable harm may occur.

Under North Carolina law, the lines between a derivative action and a direct action by a minority shareholder for breach of fiduciary duty are somewhat blurred. At times, there is no clear distinction between a controlling owner's breach of duties to the corporation and a breach of his duties to the minority shareholders.

- Access to books and records

Qualified shareholders, meaning shareholders whose ownership interest is greater than 5%, have the right to inspect the records of the corporation on five days written notice. *See* N.C.G.S. § 55-16-02. The demanding shareholder must state a proper purpose, and make his demand in good faith. A shareholder is allowed to inspect those records that are connected to the shareholder's good faith purpose for inspection. While there is a litany of records that the qualified shareholder is allowed to inspect, the shareholder should be allowed to obtain financial information about the corporation if it fits within the good faith purpose for which the records are demanded. Where the corporation refuses to provide access, the shareholder can apply for mandatory injunctive relief to enforce his inspection rights. *See* N.C.G.S. § 55-16-04. The Act authorizes an award of attorney's fees to the prevailing shareholder in such court proceedings. *See* N.C.G.S. § 55-16-04(c). Depending upon the circumstances, the Act also allows the Court to restrict the shareholder's distribution of the corporation's records.

Even if the criteria for a "qualified shareholder" are not present, there are certain documents that a shareholder can inspect – such as the corporation's list of shareholders. In addition, the corporation is required to allow the shareholder annual access to its financial statements.

- **Compelling dissolution**

A shareholder can sue to dissolve the corporation under certain circumstances. *See* N.C.G.S. § 55-14-30(2). The grounds listed in the Act include a deadlock in management or voting control, a showing that dissolution is necessary to protect the rights or interests of the shareholders, a showing that the assets of the corporation are being misapplied or wasted, or the governing shareholder's agreement allows for dissolution. North Carolina appellate decisions also allow dissolution where the minority shareholder's "reasonable expectations" are being frustrated. *See Meiselman v. Meiselman*, 309 N.C. 279, 298, 307 S.E.2d 551, 563 (1983). Such "reasonable expectations" may include the shareholder's expectation of participating in management, or having ongoing employment. However, it is not possible for a shareholder's "expectations" to be frustrated if he himself is at fault (e.g. he cannot contend he had an expectation of continued employment if he refused to show up to work when required). Also an expectation, as a matter of law, cannot be "reasonable" where it is flatly contradicted by the express terms of a shareholder's agreement. *See Classic Coffee Concepts, Inc. v. Anderson*, 2006 NCBC 21, ¶ 120-121 (N.C. Supr. Dec. 1, 2006) (unpublished).

Upon a shareholder's demonstration of the required showing that a dissolution is appropriate, the court has the authority to appoint a receiver, issue injunctions, and take such other actions it deems appropriate to preserve the assets and continue the corporation's business.

There is a catch twenty-two for a minority shareholder who brings a dissolution action. In the event the shareholder brings the dissolution action because "liquidation is reasonably necessary to protect" his, or her rights, the corporation can prevent dissolution by electing to buy out the minority shareholder's interest at "fair value." <u>See</u> N.C.G.S. §55-14-31(d). Similarly, this presents a dilemma for the corporation as well because "fair value" does not necessarily include the typical discounts in value for lack of marketability and lack of control that one would see in a valuation of stock for fair market value. In most valuations that apply the "fair market value" standard, discounts are applied: the rationale being that shares in a closely-held business cannot easily be liquidated, compared to shares traded on a national exchange, and that the shares of a minority shareholder would have less value because the minority shareholder does not have control of the corporation's business affairs.

However, although under some circumstances, discounts in the valuation of the complaining shareholder's shares are considered by the court in determining "fair value," it is generally accepted that most discounts do not apply where a corporation elects to redeem a shareholder's interest where he has instituted a dissolution action and the shareholder's agreement does not establish a valuation method. The corporation needs to be cognizant of this in deciding whether to buy out the shareholder.

- **Rights during the winding up of the business**

After dissolution and during winding up of the corporation, a shareholder has the right to be distributed what is left after paying creditors and satisfying other obligations. *See* N.C.G.S. § 55-14-05. Each shareholder participates pro rata based upon their ownership interest. If the rules governing distributions during winding up are not followed, such distributions may be deemed unlawful. The directors who authorize the unlawful distribution, and the shareholders receiving same, can be held personally liable. *See* N.C.G.S. § 55-8-33.

Usually the right to distributions during the winding up of the corporation is not a win for the shareholders. More often than not, there are limited assets left during a liquidation of a closely-held business.

How Are The Rights of Minority Shareholders Protected?

Minority shareholders' rights are protected by the following:

- **The duties of the controlling shareholders**

Our North Carolina appellate courts recognize that shareholders who are in control of the corporation have a direct fiduciary duty to the minority shareholders. *See Loy v. Lorm Corp.*, 52 N.C. App. 428, 278 S.E.2d 897 (1981). This fiduciary duty is in addition to those duties of officers and directors. In general, the controlling shareholders cannot take actions that are not in good faith and that personally benefit themselves to the detriment of the minority.

In the eyes of the court, where the "minority" shareholder is part of the control group of the corporation, he will likely not be owed a fiduciary duty. In specific, even though a shareholder may own a minority interest in the company, say 10%, he likely cannot claim that a breach of a fiduciary duty by the majority where he condoned or acted in concert with the other shareholders who own 41% of the company.

- **The duties of officers and directors**

Officers and directors owe the corporation the duty to act in good faith, and to exercise due care and loyalty. *See* N.C.G.S. § 55-8-30. Generally, they cannot usurp corporate opportunities or participate in transactions where they would otherwise have a conflict of interest. While shareholders can assert derivative claims based upon the officers and directors' breach of these duties, directors and officers who have simply made errors in business judgment are afforded some protections by the business judgment rule. This rule allows the manager to take legitimate business risks and be immune from individual liability. As an added protection, officers and directors can seek indemnification under certain circumstances. Obviously, there are limits to the rights of officers and directors to invoke the business judgment rule and seek indemnification. An obvious example is when an officer or director receives an undisclosed personal benefit in the transaction which is disadvantageous to the corporation and its shareholders.

- **Unconscionable buyout provisions**

In general, shareholders can enter into restrictive stock agreements that allow for the redemption of shares or that provide for other shareholders to have a right of first refusal. Restrictions on the transfer of stock are enforceable unless they are clearly unconscionable. *See Mechanical Systems and Services, Inc. v. Carolina Air Solutions, LLC*, 2003 NCBC 9 (N.C. Super. Dec. 3, 2003) (unpublished) (agreement that allowed corporation to buy back shares for $1.00 per share held unconscionable). However, it is a steep climb for something to rise to the level of "unconscionable." For example, restrictive stock agreements providing for the right to redeem a shareholder's shares at book value have been upheld. *See Crowder Construction Company v. Kiser*, 134 N.C. App. 190, 193-94, 517 S.E.2d 178, 213 (1999).

Conclusion

The Act and North Carolina common law attempt to balance the power of the controlling owners of the corporation in order to protect a minority owner from unscrupulous behavior. All shareholders, officers, and directors should realize that these checks and balances can be invoked in a court of law when one side attempts to take advantage of the other.