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Involuntary Dissolution: The Nuclear Option

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Business lawyers frequently (and seemingly more frequently when times are tough) find themselves representing closely held business owners whose relationships with the other owners have soured to one degree or another. In some instances, the parties' exit strategy, or exit options, are laid out in the written agreement governing their relationship, whether it be a Shareholders' Agreement, Operating Agreement, or Limited Partnership Agreement. In other instances, however, a writing may not exist. Frequently, even when it does exist, it may not provide a clear path for the contending owners to resolve their differences.

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Often, each contending faction of owners wants to keep the business. In many cases, however, there may be no mechanism for one owner or faction to buy out the interest of the other owner or faction. Tensions can be magnified when owners cannot agree on governance or business strategy. Sometimes, for example, a majority owner, although unable to force the departure of a minority owner, may hijack effective control of the entity by virtue of its superior voting power.

In a frustratingly large percentage of cases, the operative documents were entered into long before the client had engaged a lawyer to help solve the problem. At that point, there often seems nothing to do but negotiate, until one of the contending factions outlasts the other or gives up in exhaustion. In a situation where neither party is compelled to sell its interests by the terms of the governing document, it can seem as though there is no way out. In many instances, the governing document even provides that neither party nor faction will dissolve the entity.

Where the owners of a business entity are deadlocked or cannot agree on an exit strategy, the ultimate safety valve may be the involuntary dissolution statute (also called "judicial dissolution"). Importantly, contractual provisions prohibiting dissolution refer to voluntary dissolution. For example, limited liability company operating agreements frequently include an agreement by the majority member that it will not take any action to dissolve the limited liability company. This is necessary to protect the investment and expectations of the minority member. However, these provisions do not apply to bar a judicial dissolution, which always remains available as an option when the statutory grounds are met.

The chart below sets forth the involuntary dissolution statutes for corporations, limited liability companies, and limited partnerships in California and Delaware. For each business entity, the chart identifies the applicable involuntary dissolution statute, the party or parties authorized by the statute to initiate involuntary dissolution, the statutory grounds for involuntary dissolution and, finally, whether and upon what terms the other owners of the business entity can avoid dissolution by purchasing the interest of the moving party. As shown by the chart, California permits the non-moving owners of its business entities to avoid dissolution of the entity by buying out the moving party at an appraised value.

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Entity	Judicial Dissolution Statute	Who Can Initiate	Grounds	Avoidance
(1) California Corporation	Cal. Corp. Code § 1800 et seq.	½ of Directors in office Shareholders holding at least $33^1/_3$% of the shares	1) Business abandoned 2) Board deadlocked 3) Internal dissension and deadlocked shareholder factions 4) Fraud, mismanagement or abuse of authority 5) If 35 or fewer shareholders, liquidation reasonably necessary to protect complaining shareholder 6) Term expired	§ 2000 – Purchase at fair value (liquidation value)
(2) California Limited Partnership	Cal. Corp. Code § 15908.02	A Partner	Not reasonably practicable to carry on the activities in conformity with the Partnership Agreement	§ 15908.02(b) - Purchase at fair market value
(3) California Limited Liability Company	Cal. Corp. Code § 17351	Any Manager or Member	1) Not reasonably practicable to carry on the business in conformity with Articles of Organization or Operating Agreement 2) Dissolution reasonably necessary for protection of rights or interests of complaining members 3) Business has been abandoned 4) Management is deadlocked or subject to internal dissention 5) Fraud, mismanagement, abuse of authority	§ 17351(b) – Purchase at fair market value
(4) Delaware Corporation	Del. Gen. Corp. Law § 284	Attorney General	Abuse, misuse or nonuse of corporate powers, privileges or franchises	No
(5) Delaware Limited Liability Company	Delaware Limited Liability Company Act, Del. Code Ann. tit. 6, § 18-802	Any Member or Manager	Whenever it is not reasonably practicable to carry on the business in conformity with the LLC Agreement	No
(6) Delaware Limited Partnership	Delaware Revised Uniform Limited Partnership Act, Del. Code Ann. tit. 6, § 17-802	Any Partner	Whenever it is not reasonably practicable to carry on the business in conformity with the Partnership Agreement	No

Involuntary Dissolution of California Corporations

Pursuant to California Corporations Code section 1800, an involuntary dissolution of a California corporation may be commenced by filing a verified complaint in superior court by either (a) one half (½) or more of the directors in office; or (b) a shareholder or shareholders who hold shares representing not less than 33 1/3 % of the outstanding shares.[1] For purposes of section 1800, the term "shareholder" includes a beneficial owner of shares who has entered into a shareholder's agreement or a voting agreement. The requirement that the complaint be verified indicates the significant nature of the action. The truth of the factual allegations in a verified complaint must be sworn to under penalty of perjury by the plaintiff.

Section 1800(b) lists the grounds for involuntary dissolution as follows: (1) the corporation has abandoned its business for more than one year; (2) the corporation has an even number of directors who are equally divided and cannot agree as to the management of its affairs, so that its business can no longer be conducted to advantage or so that there is danger that its property and business will be impaired or lost, and the shareholders are so divided into factions that they cannot elect a board consisting of a non-even number; (3) there is internal dissention and two or more factions of shareholders are so deadlocked that the corporation's business can no longer be conducted with advantage to its shareholders, or the shareholders have failed at two consecutive annual meetings at which all voting power was exercised, to elect successors to directors whose terms have expired or would have expired upon election of their successors; (4) those in control of the corporation have been guilty of, or have knowingly countenanced, persistent and pervasive fraud, mismanagement or abuse of authority, or persistent unfairness toward any shareholders, or the corporation's property is being misapplied or wasted by its directors or officers; (5) in the case of any corporation with 35 or fewer shareholders, liquidation is reasonably necessary for the protection of the rights or interests of the complaining shareholders; and (6) the period for which the corporation was formed has expired.

These requirements are detailed and specific, and a review of the cases decided under section 1800 makes clear that courts will not involuntarily dissolve a corporation lightly.

In *Bauer v. Bauer*, 46 Cal. App. 4th 1106 (1996), two minority shareholders of a closely held corporation brought an action for involuntary dissolution, alleging fraud and mismanagement by the majority shareholder. The trial court found the minority shareholders had not presented sufficient proof to support dissolution. The Court of Appeal's First Appellate District (Division Three) affirmed, finding that the minority shareholders had not met their burden, under section 1800(b)(4), of demonstrating persistent and pervasive fraud, mismanagement, abuse of authority, waste of corporate property, or persistent unfairness toward shareholders. The *Bauer* court also held that the plaintiffs had not shown that dissolution was necessary under the more liberal provisions of section 1800(b)(5), which protects the rights and interests of minority shareholders, because they presented no evidence that the minority shareholders had been "squeezed out." In finding no basis for dissolution under section 1800(b)(5), the court concluded: "It would be tantamount to sanctioning abuse to permit minority shareholders acting in bad faith to use subdivision (b)(5) as a coercive tool to force an involuntary dissolution." *Bauer*, 46 Cal. App. 4th at 1117.

In *Stumpf v. C.E. Stumpf & Sons, Inc.*, 47 Cal. App. 3d 230 (1975), a leading decision on the predecessor statute to Section 1800, the court emphasized that "the statute does not authorize dissolution at will. The minority must persuade the court that fairness requires drastic relief [under subdivision (b)(5)]; involuntary dissolution is not an automatic remedy, but rather, a matter for the court's discretion." *Id.* at 235. *See also, Stuparich v. Harbor Furniture Mfg., Inc.*, 83 Cal. App. 4th 1268 (2000) (finding sisters not entitled to corporate dissolution under section 1800 (b)(5) where brother could outvote them on any issue, but sisters played no role in daily operations).

Finally, in *Belio v. Panorama Optics, Inc.*, 33 Cal. App. 4th 1096 (1995), the reviewing court emphasized that involuntary dissolution under section 1800 (b)(3) requires a showing of *both* internal dissension and shareholder deadlock. Accordingly, the Second Appellate District found the trial court properly denied involuntary dissolution where there was uncontroverted evidence of internal dissension, but no shareholder deadlock because one shareholder held 54 percent of Panorama's stock and there was no evidence of a super-majority provision or unanimous voting requirement on important issues.

If the basis for the involuntary dissolution complaint is deadlock on the board of directors, section 1802 authorizes the court to appoint a provisional director. Note, however, that if the corporation is a professional corporation, the professional corporations law limits the availability of a provisional director as a solution. Cal. Corp. Code § 13401.5. For example, directors of California medical corporations must be licensed physicians, psychologists, nurses, optometrists, marriage and family therapists, clinical social workers, physician assistants, chiropractors, acupuncturists,

or naturopathic doctors. Any provisional director for a medical corporation must, therefore, satisfy those statutory qualification requirements for a director elected by the shareholders.

The code also provides for the appointment of a receiver if, at the time the complaint for involuntary dissolution is filed or any time thereafter, the court has reasonable grounds to believe that the interest of the corporation and its shareholders will suffer pending the hearing and determination of the complaint unless a receiver of the corporation is appointed. In an appropriate case, section 1803 empowers the court to appoint a receiver to take over and manage the business and affairs of the corporation and to preserve its property pending the hearing and determination of the complaint for dissolution.

If the court determines that dissolution is warranted, the court may decree a winding up and dissolution of the corporation. California Corporations Code section 1805(b) provides that the corporation's Board of Directors is to conduct the winding up, subject to the supervision of the court, unless the court appoints other persons to wind up the corporation. When an involuntary proceeding for winding up has commenced, the corporation must cease to carry on business except to the extent necessary for the beneficial winding up of the corporation and except during any period that the Board deems necessary to preserve the corporation's good will or going-concern value pending a sale of the business or assets. During the pendency of an involuntary proceeding for winding up, the court has broad jurisdiction over the corporation. Cal. Corp. Code § 1806. Under section 1806(f), the court may fill any vacancies on the Board that the directors or shareholders are unable to fill. The court may remove any director if it appears that the director has been guilty of dishonesty, misconduct, neglect, or abuse of trust in conducting the winding up or if the director is unable to act. The court may stay the prosecution of any suit, proceeding, or action against the corporation and may require the parties to present and prove their claims in the manner required of other creditors. The court even has the authority under section 1806(l) to make orders bringing in new parties if the court considers them necessary for the determination of all issues before it.

Thus, under section 1806, if grounds for an involuntary dissolution are proven, the superior court appears to have the authority to act as a state court bankruptcy forum, at least as far as an action for liquidation is concerned. For example, under section 1807 of California's Corporations Code, creditors and claimants are required to present claims and proofs as the court directs, and can be barred from participating in any distribution if they fail to make and present claims and proofs. As to secured claims, if holders want to realize on any deficiency, they must submit proof of the whole debt under section 1807(c). If secured creditors fail to present their claims timely or fully, they are limited to the amount realized on their security.

California's Corporations Code permits avoidance of dissolution in section 2000. It provides that in any suit for involuntary dissolution the corporation or, if it does not elect to purchase, the holders of 50% or more of the voting power of the corporation (the "purchasing parties"), may avoid the dissolution of the corporation and any appointment of a receiver by purchasing, for cash and at their fair value, the shares owned by the plaintiffs or by the shareholders so initiating the proceeding (the "moving parties"). The fair value is determined based on the liquidation value as of the valuation date but takes into account the possibility, if any, of sale of the entire business as a going concern in a liquidation. The corporation's election to purchase may be made by the approval of the outstanding shares, excluding shares held by the moving parties.

If the purchasing parties elect to purchase the shares owned by the moving parties and are unable to agree with the moving parties upon the fair value of the shares, the court must stay the winding up and dissolution proceeding and then proceed to ascertain the fair value of the shares owned by the moving parties.

In order to do so, the court is directed to appoint three disinterested appraisers to appraise the fair value of the shares owned by the moving parties and to prescribe the time and manner of producing evidence if evidence is required. The award by the appraisers, or by a majority of them, is final and conclusive upon all parties when confirmed by the court. If the purchasing parties do not make payment for the shares within the time specified by the court, judgment is entered against them and the dissolution proceeds. If, on the other hand, the purchasing parties desire to prevent the dissolution, they pay the moving parties the appraised value of the shares and the moving parties transfer their shares to the purchasing parties.

In such instances, the trial court's "fair value" determination for a statutory buyout may itself give rise to further litigation. For example, in *Cotton v. Expo Power Systems, Inc.*, 170 Cal. App. 4th 1371 (2009), minority shareholders filed an action for involuntary dissolution of a closely held corporation under section 2000. The trial court confirmed an appraisal of shares, but the appraisal failed to account for the value of the minority shareholders' derivative claims. The appellate court reversed and remanded with

directions to obtain an appraisal taking into account the effect of the derivative action on the fair value of the corporation. *Id.* at 1383. Likewise, in *Ronald v. 4-C's Electronic Packaging*, Inc., 168 Cal. App. 3d 290 (1985), the court reversed a trial court's valuation under CAL. CORP. CODE section 2000 because it found the trial court erred in relying solely on the price-earning method to determine the value of closely held shares. *See also, In re Marriage of Hewitson*, 142 Cal. App. 3d 874, 878 (1983) (finding price-earnings ratio approach may not be sole method relied upon to value closely held shares).

Despite the potential for valuation disputes, where the dispute between shareholder factions relates to the price at which one party would buy the other party out, the section 2000 appraisal procedure can help break the log jam in instances where no shareholders agreement provides a mechanism for expelling a shareholder or setting a price for the shares. Although expensive and cumbersome, it is a potentially powerful weapon in the hands of a shareholder or shareholders who do not desire to continue with the corporation. Obviously, the procedure is of limited value to the shareholder who wishes to continue the business. Once that shareholder initiates a proceeding for involuntary dissolution, either the corporation will be dissolved or that shareholder will be bought out. Short of a negotiated settlement, there is no provision allowing the shareholder who initiates a dissolution to be the purchasing party.

It is not clear under the Code whether dissolution can be avoided in the case of a complaint filed by directors, if such directors are not shareholders. Section 2000 states that "in any suit for involuntary dissolution...the corporation or, if it does not elect to purchase, the holders of 50% or more of the voting power of the corporation may avoid the dissolution of the corporation and the appointment of any receiver by purchasing for cash the shares owned by the plaintiffs or by the shareholders so initiating the proceeding at their fair value." It is common, but not mandatory, that the directors of California corporations be shareholders. Recall that section 1800(a)(1) permits one half (½) or more of the directors in office to file a verified complaint for involuntary dissolution. It is therefore possible that an involuntary dissolution could be initiated by directors who have no shares. It would, then, be impossible under section 2000 for the corporation or any shareholder faction to avoid the dissolution by a purchase.

California Limited Liability Companies

California Corporations Code section 17351 governs judicial dissolution of California limited liability companies. In many respects, this involuntary dissolution statute is similar to that for corporations. However, there are a few significant differences. First, the complaint initiating the dissolution need not be verified. Second, the complaint can be filed by "any manager or by any member or members." This makes it easier to commence a judicial dissolution of the limited liability companies because owners of less than 33 1/3% can initiate the dissolution.

The grounds for dissolution are: (1) it is not reasonably practical to carry on the business in conformity with the articles of organization or operating agreement; (2) dissolution is reasonably necessary for the protection of the rights or interest of the complaining members; (3) the business of the limited liability company has been abandoned; (4) the management of the limited liability company is deadlocked or subject to internal dissention; and (5) those in control of the company have been guilty of or have knowingly countenanced persistent and pervasive fraud, mismanagement, or abuse of authority. CAL. CORP. CODE § 17351.

The other limited liability company members may avoid the dissolution by purchasing, for cash and at their fair market value, the membership interests owned by the members initiating the proceeding. If the grounds for the dissolution are those set forth under (1) or (2) above, and the dissolution is wrongful under the operating agreement, the purchase price for the interests can be reduced by the damages resulting from the wrongful dissolution.

As with corporations, the court is charged with staying the dissolution proceeding while it ascertains the fair market value of the membership interests owned by the moving parties. The court, again, is directed to appoint three appraisers, and the award of the appraisers (or a majority of them) is the final and conclusive price for the membership interests when confirmed by the court. Unlike section 2000 (applicable to corporations), the limited liability company statute refers to "fair market value" as opposed to "fair value" and does not describe the value as determined "on the basis of the liquidation value as of the valuation date but taking into account the possibility, if any, of the sale of the entire business as a going-concern in a liquidation." The absence of the liquidation language in the limited liability company statute could leave open the possibility of higher valuations in the limited liability company context.

California Limited Partnerships

California Corporations Code section 15908.02 governs judicial dissolution of California limited partnerships governed by the Uniformed Limited Partnership Act of 2008. Under this section, judicial dissolution can be commenced by any partner on the grounds that it is not reasonably practicable to carry on the activities of the limited partnership in conformity with the part-

nership agreement. The other partners may avoid the dissolution by purchasing, for cash and at fair market value, the partnership interest(s) owned by the partners initiating the proceeding. The limited partnership statute, like the limited liability company statute, provides for court appointment of three disinterested appraisers and fair market value fixed by the appraisers.[2]

Delaware Corporations

The Delaware general corporation law does not have an involuntary dissolution statute for corporations. Rather, section 284 permits the court of chancery to revoke or forfeit the charter of any corporation for abuse, misuse or non-use of its corporate powers, privileges, or franchises. Such action may be initiated only by the Delaware Attorney General upon the Attorney General's own motion or upon the relation of a proper party. Thus, any shareholder of a Delaware corporation who can convince the Delaware Attorney General that he or she is being disadvantaged by the conduct of a corporation's directors, officers, or other shareholders may be able to cause a dissolution proceeding to be commenced. In that instance, the court of chancery has the power, by appointment of receivers or otherwise, to administer and wind up the affairs of any corporations and to make such orders as may be equitable respecting the corporation's affairs and assets and the rights of its stockholders and creditors.

Delaware Limited Liability Companies

Section 18-802 of the Delaware Limited Liability Company Act authorizes the court of chancery, on application by any member or manager, to decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement. The Limited Liability Company Act does not provide for the avoidance of dissolution. Because the Delaware LLC Act is grounded on principles of freedom of contract, courts consistently look first at whether any exist mechanisms afforded under the applicable agreement are sufficient to avoid dissolution. Only if these mechanisms are deemed inadequate under the circumstances will the court consider the propriety of ordering dissolution. *See In re Silver Leaf, L.L.C.*, 2005 WL 2045641 (dissolution granted); and *Haley v. Talcott*, 864 A.2d 86, 97 (Del. Ch. 2004) (noting that section 18-802 plays a role for LLC's similar to the Delaware statute for joint venture corporations with only two members, when those members are deadlocked). Moreover, a recent unpublished decision *In re Arrow Investment Advisors, LLC*, 2009 WL 101682 (Del. Ch. Apr. 23, 2009), highlights that judicial dissolution, an extreme remedy, is never a foregone conclusion. In *Arrow*, the court dismissed a petition for judicial dissolution of a limited liability company where the co-owner's petition failed to demonstrate that the company was not operating in accordance with the purpose for which it was formed.

Delaware Limited Partnership

Delaware Revised Uniform Limited Partnership Act § 17-802 authorizes the court of chancery to decree dissolution of the limited partnership on application by any partner whenever it is not reasonably practicable to carry on the business in conformity with the partnership agreement. *Red Cell Eastern Limited Partners, LP v. Radio City Music Hall Productions, Inc.*, 1992, Del. Ch. LEXIS 224 (Del. Ch. Oct. 6, 1992), holds that a material breach of the fiduciary duty which makes continuation of business impractical may justify dissolution. On the other hand, a limited partnership will not be dissolved where the limited partner who initiated the dissolution proceeding failed to point to specific facts to demonstrate that the continuing business of the limited partnership was no longer reasonably practicable. *Cincinnati Bell Cellular Sys. Co. v. Ameritech Mobile Phone Serv. of Cincinnati, Inc.*, 1996 Del. Ch. LEXIS 116 (Del. Ch. Sept. 3, 1996), *aff'd*, 1997 Del. LEXIS 58 (Del. Feb. 11, 1997).

Conclusion

When business relationships go awry in closely held entities, whether a corporation, limited liability company, or limited partnership, if the business formation agreements do not provide a suitable exit mechanism for dissatisfied non-controlling owners or shareholders, judicial dissolution may indeed be the only recourse for the non-controlling parties to exit the business venture. Where a mutually agreeable buyout cannot be achieved, a dissolution order will bring finality, if not satisfaction, for all concerned. ■

Endnotes

1 A complaint for involuntary dissolution may be filed by any shareholder if the ground for dissolution is that the period for which the corporation was formed has terminated without being extended. CAL. CORP. CODE §1800(a)(3).

2 The authors located no California decisions addressing judicial dissolution of limited partnerships under California Corporations Code section 15908.02. However, in *B.J. Wallace v. G.S. Sinclair* 114 Cal. App. 2d 220 (1952), a decision regarding California Corporations Code section 15032 (under the predecessor statute), the court of appeal affirmed a lower court judg-