

# Owner Disputes in Privately-Held Pennsylvania Entities

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## Introduction

- Both corporate entities and unincorporated entities (LLC's and Partnerships) encounter owner disputes that threaten their success and survival.
- Despite different forms, originators start with a common goal: success.
- "All for one, one for all" mentality does not always last forever!
- Owner Disputes arise and can be caused by many things including goals, interests, resources, perceptions of reality, and personalities.

## Overview

- **Avoiding the Dispute:**
    - Strategic organization planning can prevent litigious ownership disputes.
  - **Creating and Framing the Dispute:**
    - Determine the “issues” at hand. These are both legal and practical issues.
  - **Taking Up the Dispute:**
    - Determine your rights and take appropriate steps. Similar for different entities.
  - **“Litigating” the Dispute:**
    - Select the arena and seek the remedies most appropriate for your circumstances.
- Resolving the Dispute:**

## Statutory Overview

- Corporations are governed by the **Pennsylvania Business Corporations Law of 1988**
  - Has remained largely intact since inception and substantial case law remains valid.
- **Act 170 of 2016** has substantially modified the laws for unincorporated entities including the Pennsylvania Uniform Partnership Act of 2016, the Pennsylvania Uniform Limited Partnership Act of 2016, and the Pennsylvania Uniform Limited Liability Company Act of 2016.
  - Act 170 incorporates some principles of the Business Corporations Law while leaving certain other provisions in tact.

# Avoiding the Dispute

Plan, Communicate, and Agree

## Planning to Avoid Disputes

- Strategic planning can prevent disputes or manage them once they arise.
- As entity form is chosen, remember corporations have more statutory mechanisms, and LLCs allow more flexibility in Operating Agreement.
- Non-voting interests are useful tools to limit conflicts.
- Owner agreements can include provisions to avoid unmanaged conflict, including employment agreements, leases, and estate and succession planning.

## Corporations: Bylaws

15 Pa.C.S. § 1504

- A corporation's bylaws may contain "any provisions for managing the business and regulating the affairs of the corporation."
- Shareholders, or the Board of Directors of a Corporation if authorized by the Bylaws, may adopt or amend the bylaws of the corporation.
  - Directors **MAY NOT** adopt or change any bylaw on a subject committed expressly to shareholders by statute. 15 Pa.C.S. § 1504(b) lists these statutes.
  - The limitations forbid director changes of bylaws involving selection of directors, removal of directors, action by shareholders, voting rights of shareholders, etc.
- Although bylaws are not statutorily required, it is highly advisable that they be carefully crafted, understood, and complied with.

## Corporations: Bylaws (Continued)

- Shareholders, Directors, Officers—Clients Should know the difference
- Regular Shareholder and Director Meetings (At Least Annual)
- Notice Provisions
- Voting (Cumulative Voting permitted)
- Action by Unanimous or Partial Consent
- Principals must understand basics and comply.

## LLCs: Operating Agreements

15 Pa.C.S. § 8815-8817

- An LLC's operating agreement, like Bylaws, can be drafted to govern:
  - relations among the members and between the members and the limited liability company;
  - the rights and duties of a member or manager;
  - the activities and affairs of the company and the conduct of those activities and affairs;
  - the means and conditions for amending the operating agreement.
- Like bylaws, operating agreements are not required by law, but must be carefully drafted, understood, and followed.

## Drafting Tips for Bylaws and Operating Agreements

- Keep things simple, understandable and capable of being followed
- Notice is important, but unrealistic provisions will hinder operation
- Amendment is key—Bylaws need not be by majority. Agreements need not be unanimous.
- Bylaws may be changed by Directors, Shareholders or both. LLC's extremely flexible.
- Buy-Sells usually not in Bylaws. In LLC's, may be in separate agreement
- Challenge: Have Principals focus on and understand foundational rules.

## Owner Agreements (Shareholder and LLC Member Agreements Containing Buy/Sell Provisions)

- Agreements that govern transfer or disposal of ownership interests if a member wants out, dies, becomes insolvent, leaves employment, etc..
- Highly recommended wherever there is more than one owner.
- Both Corporations and LLCs can adopt these agreements.
- Permit controlling owners to transfer some or all ownership, subject to certain conditions.
- Provide for continuation of the business upon the occurrence of certain events within the company or on the behalf of individual stakeholders.

## Texas Shoot-Out Provisions

- Unique buy/sell arrangement; commonly included in entities where ownership is a 50/50 split.
- Structure: At any given time, one owner can approach the other with a price to sell his/her interest to the other; the non-selling owner, in every case, becomes either a buyer or a seller.
- Different events may transpire during the course of the buyout, but in the end, one owner will be out.

## Redemption, Cross-Purchase

- **Redemption:** the interest of the decedent or withdrawing owner is purchased by the business itself.
- **Cross-Purchase:** the other owner(s) buy the interest of the former owner.
- The buyer will need funds to pay for the purchase. So, agreement often provides for option to be selected at the time, particularly where there are just two or three owners.
- Possible funding sources: internal or external capital, outside financing, or life insurance.

## Valuation is Key to Viable Buy/Sell

- Buy/Sell is done in advance, but must provide for a fair valuation. There are multiple ways to do so...
  - Annually value company per bylaws or operating agreement;
  - By formula;
  - Qualified Appraiser at the time of triggering event. Common today.
- Remember: There is a big difference between what something is worth and the ability of any given buyer to pay for it. Not viable if Buyer cannot pay.
- Issues arise over payment options as well.
  - Payment over time v. Lump-Sum Payments.
  - Purchaser's ability to obtain capital or, if necessary, financing.
  - Seller needs security (collateral), but this may hinder financing.

## Note on Valuation

- Valuation is always the issue, but it is easier to deal with up front, rather than in heat of battle. All the issues above are harder once conflicts arise. Easiest breakups are where value (or valuation method) is agreed up front.

## Alternative Dispute Resolution Agreements

- Preventative drafting in bylaws or operating agreement can address minor disputes before they become major, disruptive issues to the organization.
- Bylaws or operating agreement can provide for an Alternate(Tie Breaker) Director or Manager or other method to break deadlock in decision-making process.
- Option to redeem or to be bought out at any time can provide simple dispute resolution, if parties agree to it up front.



## Alternative Dispute Resolution Agreements

- Operating Agreements can also provide that certain disputes among owners will not be litigated in the court system, but rather get handled in arbitration.
- Arbitrations can be conducted in a variety of manners and the Operating Agreement can provide specifics such as...
  - What types of disputes must go to arbitration
  - Number of arbitrators
  - Location of arbitration
  - Rules that will apply (e.g. procedural, evidentiary)
  - Whether the arbitration will be appealable

## Alternative Dispute Resolution Agreements

- Operating Agreements can also provide for mandatory conciliation or mediation of certain disputes before taking other steps.
- Mediation can be useful to facilitate discussion among owners in dispute.
  - Often it is helpful to hear perspective through the “filter” of a mediator.
  - Mediator may suggest avenues to resolution that escaped the parties.
- Mediation also has pitfalls:
  - Nonbinding process can be used for cheap discovery and waste time.
  - Timing is key. If you go there too soon, party may misperceive or not properly use its leverage.

## Employment Agreements

- Owners often are employed. This creates distinct but parallel issues.
- Ability to terminate employment and to resolve employment issues is critical.
- If employment and ownership is linked, say so clearly.
- Employment Agreements generally are separate, and cross-referenced, but sometimes may be found in owner agreements.
- Remember: Employment is sometimes element of ownership. Termination may bring oppression claim. (Also, discrimination?)

## Covenants Not to Compete and Nondisclosure Agreements

- The entity likely wants assurance that a departing owner will not immediately start competing with the organization immediately after being bought out.
  - Covenants not to compete must be reasonable in duration and geographic scope and must be reasonably necessary to protect the company's interests.
  - These covenants are often major points of contention when an owner wishes to withdraw or sell his/her interest.
- Nondisclosure agreements are used to protect sensitive information that may be a trade secret, such as customer lists, business methods, and formulas.
- Found in both Owner and Employment Agreements. May be longer where tied to ownership interest.

# Creating and Framing the Dispute

## The Legal and Practical Issues

### After an Ownership Dispute Arises...

- If a dispute arises, the aggrieved party needs to identify the conduct that created the issue: e.g., firing, exclusion from business, self-dealing, etc.
- Such claims include **breaches of fiduciary duties, oppression (squeeze out), procedural violations, and denial of information.**
- Disputes can also be rooted in breaches of provisions of bylaws or of shareholder or operating agreements.
  - e.g. capital expenditures without necessary approvals, dereliction of duties, acting outside scope of authority, etc.
- Oppressive conduct by other owners, or “freezeouts” commonly cause disputes.

## Fiduciary Duties

- **Duty of Loyalty:** the individual (can apply to member, manager, director, or officer depending on org. structure) must make decisions that are reasonably in the best interests of the company.
  - Generally speaking, duty includes no self-dealing, no conflict-of-interest transactions, no competing with the business, no usurpation of business opportunity.
  - Corporation: 15 Pa.C.S. § 1712. LLC: 15 Pa.C.S. § 8849.1-8849.2
- **Duty of Care:** different standards for corporations and LLCs
  - Corporation: the director must exercise the level of care that a reasonably prudent person would exercise under similar circumstances.
  - LLC: refrain from engaging in gross negligence, recklessness, willful misconduct or knowing violation of law. Op. Ag. may further define.

## LLCs and Fiduciary Duties

- **Who is bound?** Under Act 170, members/managers (depending on management structure) owe the company and other members fiduciary duties of loyalty and care.
- **Can the Duties Be Modified?** Act 170 permits various modifications to the duties *if not manifestly unreasonable*. 15 Pa.C.S. § 8815(d).
- What exactly “manifestly unreasonable” entails is unclear, but the statute and comments provide guidance. It is a high standard to meet.

## LLCs and Fiduciary Duties

- 15 Pa.C.S. § 8815 (3) provides that if “*not manifestly unreasonable*,” the operating agreement may:
  - (i) *alter the aspects of the duty of loyalty ...;*
  - (ii) prescribe the standards, if not manifestly unreasonable, by which the performance of the contractual *obligation of good faith and fair dealing* ... is to be measured;
  - (iii) identify specific types or categories of activities that do not violate the duty of loyalty;
  - (iv) *alter the duty of care;* and
  - (v) *alter or eliminate any other fiduciary duty.*
- The Operating Agreement may also contain procedures to approve actions by members/managers that would otherwise violate the duty of loyalty.

## LLCs and Fiduciary Duties

- Much hinges on what “manifestly unreasonable” means, and there is very little guidance in terms of case law.
- Statute states that the court will determine what is manifestly unreasonable “*in light of the purposes, activities and affairs of the limited liability company*” by looking at circumstances *existing at the time “the challenged term became part of the operating agreement[.]”*
- Statutory comments characterize the above standard as “*very demanding*” for persons claiming that a term is manifestly unreasonable.

## Corporations and Fiduciary Duties

- **Who is bound?**
  - In a traditional corporation, directors owe the corporation and shareholders fiduciary duties; 15 Pa.C.S. § 1712.
  - In a closely held corporation, the shareholders may owe fiduciary duties to one another.
- The duties are essentially the same as those outlined before.
- Directors are entitled to justifiably rely, in good faith, on informed officers, committees, and other persons with professional or expert competence.
  - Known as the "**business judgment rule**"; very strong presumption in litigation; 15 Pa.C.S. § 1712.

## Corporations and Fiduciary Duties

- **Can the duties be modified? Technically no, but shareholders may be able to remove liability for some breaches of duty! 15 Pa.C.S. § 1713**
- "If a bylaw adopted by the shareholders ...so provides, a **director shall not be personally liable**, as such, for monetary damages for any action taken **unless**":
  - (1) the director has failed to perform the duties of his office under this subchapter; and
  - (2) the failure to perform constitutes self-dealing, willful misconduct or recklessness.
- Where personal liability remains, the director has the benefit of the business judgment rule if the company or shareholders sue him.
  - If established, it is a very strong presumption for the director.
  - So long as he acted in good faith and on an informed basis.

## Fiduciary Duties: LLCs v. Corporations

### LLC

- Managers or Members owe duties to company and members.
- Act 170 gives wide latitude to modify these duties.
- “Manifestly Unreasonable” standard is still open to interpretation.

### Corporation

- Directors owe duties in traditional corporation; shareholders owe some duties in closely held corporation.
- Can essentially eliminate duty of care, but very difficult to eliminate duty of loyalty.
- Business Judgment Rule presumption applies.

## Taking Up the Dispute The “Fight” Begins

## First Step in a Dispute is to Identify:

- Who are parties to dispute?
- Who is your client? (Any conflicts of interest?)
- What happened?
- What facts? What agreements? What law?
- What remedies are available?

## The Inconvenient Truth

- “Corporate” law rules are best when self-enforced.
- Disputes are very bad for any business.
- Even asserting rights may be self-defeating.
- Legal Process: Distracting, Disruptive, Expensive
- Legal Remedies: Often inadequate



## Assessing The Problem

- Does the situation require communication and compromise, or divorce?
- Can we avoid drama or must we turn up heat?
- Do we know what we want? Is it realistic?
- Do we know enough to proceed?

## Basics of the Right to Information

- The Association, Corporation, LLC, or partnership “owns” its own information and documents.
- Owners have statutory right to information to protect their interests.
- Directors/Managers have broad right to information needed to manage the business.
- Best to address informally and directly where possible.

## LLCs- Right to Information

- The statute provides steps for information access depending on whether the LLC is member or manager managed.
  - Dissociated members also have access to information.
- Information availability and use can be “reasonably restricted” in the operating agreement, which can establish remedies, including liquidated damages, for any breach of the reasonable usage restrictions.

## LLC- Right to Information

- **In a member-managed LLC: 15 Pa.C.S. § 8850(a)**
  - On reasonable notice, a member may inspect and copy during regular business hours, at a reasonable location specified by the company, any record maintained by the company regarding the company's activities, affairs, financial condition and other circumstances.
  - The company shall furnish to each member, without demand, any information concerning the company's activities, affairs, financial condition and other circumstances *which the company knows and is material to the proper exercise of the member's rights and duties under the operating agreement* or this title, except to the extent the company can establish that it reasonably believes the member already knows the information.

## LLC- Right to Information

- **In a manager-managed LLC: 15 Pa.C.S. § 8850(b)**
  - Similar rules as those applied to the members, apply here to the managers.
  - During regular business hours and at a reasonable location specified by the company, a member *may inspect and copy full information* regarding the activities, affairs, financial condition and other circumstances of the company as is just and reasonable if:
    - the member seeks the information for a *purpose reasonably related to the member's interest* as a member;
    - the member makes a *demand in record form* received by the company describing with reasonable particularity the information sought and the purpose for seeking the information; **and**
    - the information sought is directly connected to the member's purpose.
  - Within 10 days after receiving a demand noted above, the company shall, in record form, inform the member that made the demand of:
    - the information that the company will provide ... and when and where the company will provide the information; and
    - the company's reasons for declining, if the company declines to provide any demanded information.

## LLC- Right to Information

- **Rights of Persons Dissociated as Members; 15 Pa.C.S. § 8850(c)**
- Subject to reasonable restrictions and other minimal requirements, within 10 days after receipt by a limited liability company of a demand made in record form, a person dissociated as a member may have access to information to which the person was entitled while a member if:
  - the information pertains to the period during which the person was a member; and
  - the person seeks the information in good faith.

## Corporations- Director's Right to Information

15 Pa.C.S. § 1512

- To the extent ***reasonably related to the performance of the duties of the director***, ... a director of a business corporation is entitled:
  - at any reasonable time, to inspect and copy corporate books...and, in addition, to inspect and receive information regarding the assets, liabilities and operations of the corporation and any subsidiaries of the corporation incorporated or otherwise organized or created under the laws of this Commonwealth that are controlled directly or indirectly by the corporation; and
  - to demand that the corporation exercise whatever rights it may have to obtain information regarding any other subsidiaries of the corporation.

## Corporations- Director's Right to Information

(Continued)

- **This right to information is NOT absolute:** corporation can deny request if it establishes that the information request is not reasonably related to the performance of the duties of the director or that the director is likely to use the information in a manner that would violate the duty of the director to the corporation.

## Corporations- Shareholder's Right to Information

15 Pa.C.S. § 1508

- **Upon written verified demand** stating the purpose of the request, a shareholder shall
  - have a right to examine, during the usual hours for business for any proper purpose, certain records and to make copies or extracts therefrom.
  - A proper purpose shall mean a purpose reasonably related to the interest of the person as a shareholder.
  - In every instance where an attorney or other agent is the person who seeks the right of inspection, the demand shall be accompanied by a verified power of attorney or other writing authorizing the act.
  - The demand shall be directed to the corporation, which has five days to respond.

## Corporations- Shareholder's Right to Information

15 Pa.C.S. § 1508, Continued

**This right to information is NOT absolute:** corporation can deny request if it establishes that the information request is improper purpose; court may limit the inspection if it deems it just and proper.

## LLCs v. Corporations: Right to Information

- Both entities are subject to statutes that establish rights to information, but limits exist.
- LLCs can restrict rights to information more freely and prescribe liquidated damages for disallowed attempts at access.
- Corporate rights to information are more protected by statute, but corporation can still deny request and try to convince a court to deny the requesting party access.

## How is Right to Information Enforced?

- For Corporations, both § 1508(c) and § 1512(c), under subtitle "Proceedings for Enforcement" provide for expedited procedure and state that "the Court may summarily order . . ."
- Case law provides for writ of mandamus, not requiring responsive pleadings, etc. in corporate context.
- Because there are no statutory equivalents for LLC's, and no case law yet, though writ of mandamus "should" be available, it is less clear.

## Right to Financial Statements

- Corporate statutes provide that “every corporation shall furnish to its shareholders ***annual financial statements***, including ***at least a balance sheet as of the end of each fiscal year and a statement of income and expenses*** for the fiscal year.” 15 Pa.C.S. § 1554. If Corporation has GAAP financials, then it must provide GAAP financials.
- LLC bylaws may establish additional information to be provided to shareholders and on what basis. Operating Agreements may require similar provision of financial statements.
- If organizational documents require financial disclosures to owners, it is important to consider the necessity of nondisclosure agreements pertaining to the information.

## Practical Approach to Information Requests

- Statutes provide legal framework.
- So, if purpose is proper and some confidentiality is agreed to, provide it.
- Note: Association should not withhold to protect directors from derivative suit.

## Taking the Dispute to Court

### LLCs- Remedies Available

- **Members may sue** other members, managers, or the LLC to enforce rights, protect rights, including those in the operating agreements, or those arising independently of the membership interest; Pa.C.S. § 8881.
- Other remedies:
  - Dissociation: member leaving the entity, but entity continues to carry on business; 15 Pa.C.S. § 8861, et. seq.
  - Derivative Suit: lawsuit to enforce a right belonging to the LLC itself; 15 Pa.C.S. § 8882.
- As noted earlier, Operating Agreement may provide that disputes are required to go to mediation or arbitration before exercising right to sue.



## Corporations- Remedies Available

- Shareholders may take actions to rectify disputes or prevent harm to entity or interests.
- Petition court to appoint a custodian; Pa.C.S. 15 § 1767.
  - Especially useful in close corporations for “freezeouts” of >5% owners.
- Suggest voluntary dissolution; 15 Pa.C.S. § 1971.
- Derivative Suit: lawsuit to enforce a right belonging to the corporation itself; 15 Pa.C.S. § 1781, et. seq.

## Last Resort for Corps. And LLC's: Involuntary Dissolution

- In Corporation, shareholder may apply for an ***involuntary dissolution*** of the corporation (directors may also do this); 15 Pa.C.S. § 1981.
  - Available in situations involving:
    - Illegal, oppressive, or fraudulent conduct by directors or those in control.
    - Corporate waste or mismanagement.
    - Director deadlock that has been unbreakable and causing irreparable injury to shareholders.
  - Results in liquidation of corporation and distribution to shareholders.
  - For member of LLC's, §8871(a)(4) is similar but (b) also provides for “other remedies.”

## Corporations- Remedies Available

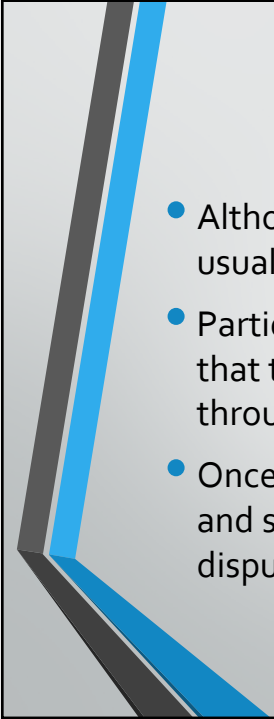
- The Business Corporation Law provides a statutory remedy unique to corporations: in certain transactions **Dissenter's Rights** – 15 Pa.C.S. § 1571 et. seq.
  - **Very significant to closely held corporations, but may be expensive. To enforce.**
  - Does not apply to publicly traded corporations or those with more than 2,000 shareholders.
- Dissenter's Rights allows the holder of a beneficial ownership, in the event of certain proposed corporate actions, to dissent and obtain fair value for their shares.
  - Must give written notice to corporation.
  - Corporation values ownership interest and dissenter may obtain own valuation if there is disagreement and proceedings will decide value.
  - Upon determination of value, dissenter is paid and relinquishes ownership.
- Unincorporated entities DO NOT have an equivalent, although Act 170 now permits operating agreements to include provisions that have a similar effect.

## LLCs and Corporations- Remedies

- LLCs and Corporations have similar remedies available.
- Injunctive Relief: Difficult to get, but may be major lever in dispute.
- Depending on the nature of the dispute, alternative dispute resolution vehicles may be appropriate:
  - Mediation is often helpful. Arbitration is private.
- Relief such as injunctions or declaratory judgments may also be suitable in certain the circumstances.
- Redemption or other buyout is usually the ultimate destination.



## Resolving the Dispute



## Resolving the Dispute

- Although the remedies listed previously are available, situations usually get resolved by some kind of agreement.
- Parties will realize that ending the business is not practical and that the costs of formally proceeding with a legal dispute through the court system is prohibitive.
- Once parties realistically determine their interests, objectives, and suitable solutions, various agreements can resolve the dispute.

## Buyout Agreements

- Buy/Sell Agreements can provide for this in advance.
- If no predetermined plan of action exists, parties can negotiate for an owner's exit and payment.
- Payments can come from various sources:
  - Other owners.
  - The entity itself.
  - Outside investors or sale of interest to third party.

## Buyout Agreements

- Remember the pitfalls:
  - Desire to buy an interest is not always accompanied by the ability to buy the interest.
  - The divisive owner who wishes to sell may nevertheless be vital to operations: who can replace those contributions?
  - Effect on perception by customers, lenders, and other stakeholders: "Why is this happening? Is this organization stable? Who will I be dealing with? Am I better off dealing elsewhere?"
  - Severance obligations.
  - Obligations to third parties such as customers and other business partners.

## Releases

- Vital part of settlement; requires care.
- Particularly useful when employment agreements and related agreements are executed in tandem with receiving ownership interests.
- Selling an ownership interest will not automatically invalidate these ancillary documents and the selling owner will likely want to be released from any binding agreement with the entity.
- May also include indemnities and continuing insurance obligations on behalf of either the entity or departing owner.

## Conclusion

- Draft organizational documents and owner agreements with the thought that “all for one, one for all” does not last.
- If preventative drafting and planning fails to sufficiently handle a dispute, take proactive steps to sufficiently identify the crux of the dispute and know your rights.
- When resolving a dispute, keep in mind the alternative avenues available and make use of them. If ordinary disputes cannot be resolved, buyout is the most common result.