SFS LAW GROUP OCCASIONAL PAPERS

Dissolution Litigation Alert

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REPRESENTING THE COMPANY AND THE CONTROLLING SHAREHOLDERS IS RISKY FOR BOTH THE COMPANY AND THE LAWYERS

The Charlotte Bankruptcy Court recently disallowed the claim of a law firm that represented the debtor in defense of litigation brought by one of its three shareholders (the "Dissenter") for dissolution and damages from the other shareholders (the "Majority Shareholders") for misappropriating corporate opportunities and special injury to the Dissenter. *In re: Protective Systems Technologies, Inc.*, 2014 Bankr. LEXIS 5148 (Bankr. W.D.N.C. Dec. 24, 2014) (the "PST case") the issue before the court was the allowance of the fee claim of the law firm that represented the company and the Majority Shareholders in the litigation. The Chapter 11 case became necessary when Dissenter secured a judgment that required the company to purchase his stock at a price the company could not pay and also included damages against the individuals. The company and the other defendants could not post a bond to stay collection efforts while they appealed. The Sheriff was already at the door when the case was commenced.

Plaintiffs often join the individual shareholders or members as defendants in business divorce litigation. Often, the company defending itself from dissolution will provide and pay the same lawyers to defend its officers and directors under its indemnification policies. Judge

Whitley saw the joint representation as a conflict under North Carolina ("NC") law that could lead to the recovery of money paid to the lawyer and justified disallowance of the remaining claim. He also questioned the legitimacy of the indemnification payments by the company to the law firm in any case.

The company and controlling shareholders usually have a financial advantage over the Dissenter in these cases since the company covers both its own legal expenses and those of the controlling shareholders. Those shareholders use the company's cash flow to finance the litigation. Plaintiffs quite often try to remove that control over the cash flow of the company by seeking a Receiver. They may also pursue other interim remedies limiting the freedom of action of the controlling shareholders.

The company's defense of the officers and directors is predicated on indemnification rights under the corporate by-laws and NC law. However, Judge whitely ruled that when an officer or director knew his actions were in conflict with the best interests of the corporation, NC law denies indemnification. In his view, the Majority Shareholders were not entitled to indemnification and their lawyer would not be paid for his work for them and the company despite the agreement of the company to pay him.

The decision validates the general practice of joining officers and directors as defendants in dissolution litigation. Even if the company believes that the claims against the officers and directors are tactical to create a conflict, if the court awards damages against those officers and directors in a case with the same lawyer representing them and the company, not only will those individuals face personal liability and loss of indemnification rights, but the lawyer in the joint

Independent defense counsel for the target company can focus on dissolution issues while interested lawyers can act more freely for the control group without fear that the dual representation will put them at financial risk and a court would be more sympathetic to appointing a Receiver

THE BUYOUT OPTION

If the court orders a dissolution, the election of the company to buy the Dissenter's stock or interest results in a forced sale to the company at a price fixed by the court.

Think of it as a Judicial Put. If it is too much, the appeal may be useless without a bond.

SAFETY IN BANKRUPTCY?

Chapter 11 will stay the enforcement and allow time to operate and negotiate with the successful Dissenter. It is often the only viable avenue once the Dissenter starts levying on the company assets.

Since the Dissenter's Judgment for the purchase price will be subordinated to general creditors, the survival of the company without him becomes important to him and there may be new incentive to reach an agreement.

representation of all of the defendants may have to disgorge her fees due to the conflict.

That is not what defense counsel expect and it could create some new risks.

The company and the individuals in these cases should have separate counsel so that company counsel will not be vulnerable to the fee disallowance result in the PST case. Conflict counsel will usually piggy back on the company's legal efforts. The special circumstances of the conflict in the joint representation in the PST case is a sufficiently distinguishing factor that should not create the risk that indemnification fees paid to separate counsel for the losing officers would be vulnerable to recovery.

Chapter 11 is very useful for a company ordered to purchase a dissenter's stock at a price that the company cannot afford. In the PST case, the judgment rendered the company insolvent. The only prudent course for a company with such a judgment was to protect the going concern value of the company from destruction in the collection process through a reorganization that would protect the general creditors and the continued operation of the business.

In bankruptcy, the judgment ordering payment would likely be

subordinated to the claims of general creditors so that, unless the creditors are paid in full plus interest, the successful plaintiff will get nothing unless it is under an agreed plan.

Since state law dissolution litigation generally provides for a forced buy-out if the company elects to purchase the dissenter's shares rather than go through a liquidation without regard to the impact of the outcome of the case on the company's other creditors, in a case such as PST in which the Dissolution payment obligation rendered the company insolvent, management felt it has a duty to its creditors due to the insolvency to use Bankruptcy to avoid the elevation of a shareholder interest to that of a general creditor in addition to the necessity of protecting the assets from seizure that would destroy the company's business.