AN INTRODUCTION TO
HEALTH LAW LITIGATION BASED ON CONTRACT AND GOVERNMENT CLAIMS

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PARTNERSHIP AND CLOSELY HELD CORPORATION DISPUTES

Aaron Krauss

The call always seems to come late on a Friday afternoon. A doctor[1] is calling you to say that she is done with her partners and that someone has to go. And it isn't going to be her. She demands that you come over and meet with her immediately so that you can put together a plan of action that will allow her to change the locks on Monday morning. Aside from being amused by a doctor asking you to make a house call, and wondering if she will still make you wait once you get to her office, what should you do?

Ideally, the doctor was wise enough to come to you when she set up her business and you drafted the appropriate shareholders' agreement.[2] If you drafted the shareholders' agreement, you will have included a mechanism for allowing one doctor to extricate herself from the company. If you did so, you can dust off the shareholders' agreement, bring a copy to your meeting with the doctor, and tell her that you will follow the procedures—whatever they may be—that are outlined

1. This call might not come from a doctor. It could come from a drug or device salesman, an owner of a billing company, or anyone involved in the healthcare industry. The issues tend to be the same, and the calls always tend to come late on Friday afternoons. But it is traditional for lawyers to make jokes at the expense of doctors, and this book is about healthcare litigation, so a doctor it is.

2. I'm going to assume that the doctor's business is a professional corporation. Doctors tend to like PCs. Not only does it have a traditional ring to it, PCs provide for limited liability. Even if doctors are (usually) wise enough to consult with lawyers when they set up their businesses, doctors usually don't really like lawyers. Not only do we make jokes at the expense of doctors, lawyers are more expensive on an out-of-pocket basis than doctors (and few insurers cover legal fees), and at least some of us sue doctors. Doctors don't like being sued. Especially not when they lose. It is possible that the doctor's business is set up as a limited partnership, but a limited partnership has to have a general partner that has unlimited liability. That means that the general partner usually ends up being a corporation. Given that the general partner makes the decisions for the limited partnership, the analysis of claims involving a limited partnership tends to be the same as it does for a corporation, with the exception that the analysis for a limited partnership takes place "one level up" in the structure. LLPs and LLCs tend to function in the same way as corporations. As a result, the analysis of claims involving an LLP or LLC is the same as it is with respect to a corporation. While it is possible that a doctor would practice in a traditional partnership, the first thing any lawyer (or financial advisor) would suggest is changing that structure to provide for asset protection. As a result, even if there is a doctor somewhere practicing in a traditional partnership, he is unlikely to call you—or any other lawyer—with a problem. Because he obviously doesn't know any lawyers.

in the document.[3] When she complains that those procedures are not favorable to her under the current circumstances you can explain that when she signed the shareholders' agreement, she couldn't be sure what position she would occupy if and when she wanted to leave the corporation, so she agreed to procedures that were balanced and provided protection to both the doctors who wanted to, and who did not want to, depart. You can also remind her that she is bound to what she signed, even if she no longer likes what she signed. If it helps (which it probably won't), you can tell her to take two aspirin, think about it overnight, and call you in the morning.

If in the morning the doctor still refuses to follow the procedures set forth in the shareholders' agreement, ask for a very large retainer. While it is theoretically possible to convince a court to override the terms of a contract a party signed, it almost never happens. Instead, courts generally say that a party is bound to the terms of the contract. If a party claims not to have read or understood the terms of the contract, courts tend to say things like the party is guilty of "supine negligence" and cannot expect aid from the court.[4] Courts say this even if the party claims to have been plied with alcohol and otherwise "distracted" when presented with the contract.[5]

Ah, but you say that you weren't the one who drafted the shareholders' agreement. And the shareholders' agreement either doesn't have a provision governing a doctor's exit, or it has a provision that you think is unclear.[6] In that case, you will need to advise your client as to the general rights and responsibilities of members of a closely held company. But before you do, it is usually worth exploring whether your client can buy out her partners, or vice versa.

3. Most shareholders' agreements contain a provision requiring the company to repurchase an owner's interest if the owner is separated from the company for any reason. Sometimes the provision gives other owners an option (or even an obligation) to purchase the departing owner's interest. The terms of the buyout may be dependent on the reason for the separation. For example, it is not unusual for there to be a different price for a termination for cause, a "regular" termination or resignation, a resignation with cause, a retirement, a disability, or a death. Leaving aside the varying incentives for paying different amounts under these circumstances, the purchase of an ownership interest upon the death of the owner can be—and often is—funded by life insurance. Other purchases must be funded out of either the company's treasury or the other owners' pockets.

4. *See, e.g.*, General Refrigerator and Store Fixture Co. v. Fry, 393 Pa. 15, 18-21, 141 A.2d 836, 838–39 (1958).

5. *See, e.g.*, Tose v. First Pennsylvania Bank, 648 F.2d 879, 900 (3d Cir.), *cert. denied*, 454 U.S. 898 (1981).

6. It is, of course, possible to admit—and even to argue to a court—that a document you drafted is unclear. Leaving aside the potential malpractice implications (especially if the other side did not have a lawyer who was making changes for you to blame for introducing the ambiguity either intentionally or as a result of a compromise in drafting), if you drafted the document a court is likely to construe it against your client. As a result, it is probably better to argue that the document does not address the particular situation that arose. After all, not even the best lawyer can foresee every possible outcome. These arguments are, of course, very dependent on both the facts of the case and the terms of the document.

Voluntary Buyouts

Assuming the shareholders' agreement does not contain a buyout provision,[7] it may be possible for one side to agree to buy out the other. There are usually three obstacles to negotiating a buyout. First, the parties have to decide who is buying and who is selling. Although your client insisted that she was not leaving, her partners might feel the same way. In some instances, the question of who is leaving and who is staying can be settled by a bidding war.[8]

Unfortunately, the second obstacle in negotiating a buyout—valuing the company—makes a bidding war less likely. Difficulty valuing the company makes a bidding war less likely for two psychological reasons. If a shareholder is unsure as to the value of her shares, she will be less likely (and less willing) to either buy or sell. The resulting paralysis can derail a transaction. Experienced practitioners are all too familiar with the client who simply cannot commit or come to a decision. If getting a client to commit wasn't hard enough, studies have shown that people value what they have more than what they can acquire.[9] It is therefore not uncommon for a shareholder to refuse to sell her shares for $100 (because she thinks that price is too low) but also refuse to acquire someone else's shares for more than $50 (because she thinks that price is too high). Believe it or not, in the context of a closely held company, this can be a rational attitude. This is because, in a closely held company, it is common for most of the company's earnings to be distributed as salary. As a result, unless buying a greater ownership interest will put the owner over the magical 50 percent threshold, owning more of a closely held company does not always—or even often—put more money in the owner's pocket. The purchaser

7. Buyout provisions usually fall into one of three categories: a price, a formula, or an appraisal. A price is usually either the original purchase price of the shares or an "agreed upon value" that the owners are supposed to restate on a periodic basis. Unfortunately, owners in a closely held company tend to forget that they are supposed to agree on the price of the company on a periodic basis. Instead, they tend to wait until they either want to claim that the company has a high value (so they can justify purchasing large amounts of life insurance) or a low value (so they can pass interests in the company to family members without incurring significant tax liabilities). They rarely try to set the price at the true "market price" of the company. Formulas avoid these problems, but they are ultimately based on the company's books and records (i.e., its "book value" or a certain multiple of revenue or earnings before interest, taxes, depreciation, and amortization). It is not uncommon for one or more selling owners to believe that one of the other owners has "cooked the books." An appraisal allows the parties to make these arguments to a trained professional who can evaluate them and make any necessary adjustments. Naturally, the party whose arguments are not accepted often thinks the appraiser was "bought" by the other side. The bottom line, therefore, is that at least one party is always unhappy with the application of a buyout provision. The transaction costs of using a buyout provision are lower, however, and a buyout provision provides some certainty. It is therefore usually preferable to use a buyout provision, despite the inherent problems with such a provision.

8. The owner who is more dissatisfied with the status quo many not have an incentive to bid higher. The dissatisfied owner could, however, have an incentive to accept a buyout package. When both owners are equally dissatisfied, neither has a strong (or strong enough) incentive to "get off the dime" and get a deal done.

9. *See, e.g.*, Ziv Carmon & Dan Ariely, *Focusing on the Forgone: How Value Can Appear So Different to Buyers and Sellers*, http://people.duke.edu/~dandan/Papers/PI/bb.pdf.

would therefore be paying money "out of pocket" without a realistic expectation of increasing her income. A rational owner therefore has an incentive to "strand" someone else's money in the company, and take advantage of their "sunk costs."

Valuing a closely held company is also complicated by minority and illiquidity discounts. There are two reasons why all shares of a publicly traded company sell for the same price. The first is that no one person controls the publicly traded company. In contrast, one person can—and often does—control a closely held company. A majority ownership stake commands a "control premium." This is because owning a majority of the company allows the owner to control the company and dictate the company's actions and policies. Put simply, if a company issues 100 shares of stock at $1 each, and if two people each own 49 shares, either of them would pay a great deal to acquire the two remaining shares. This is because acquiring 51 percent of the company would allow the owner to become president and (among other things) determine the salary of every employee and make all hiring (and firing) decisions. The exercise—and the value—of this power was best summed up by the brother of a minority owner of a company who explained that "he was born on the wrong side of the ampersand."

The converse of a control premium is a minority discount. This discount reflects the fact that an interest that does not control the company is less valuable than one that does. This discount also reflects the fact that, while owners have a very powerful incentive to acquire a greater ownership interest if doing so will allow them to control the company, they have much less of an incentive to acquire a greater ownership interest if they already have that control. Minority discounts generally range from 5 percent to 25 percent.

In addition to (potentially) a minority discount, the shares in a closely held company are subject to an illiquidity discount. This discount, which generally ranges from 10 percent to 40 percent, reflects the fact that, unlike publicly traded stocks that can be bought or sold at the push of a button, an ownership interest in a closely held company is difficult to sell, for two reasons. First, very few people want to be "locked" into a minority ownership position with someone they do not know. Practicing medicine is difficult enough when the doctors like each other and have similar styles. Doctors are therefore justifiably reluctant to buy into a practice in which they did not "grow up." Second, to the extent there are people interested in buying a minority ownership interest in the company, those people can be very hard to find. Again, this is especially true with respect to a professional corporation, in which the potential buyers are limited to those with the appropriate professional licenses. As a result, often the only potential buyers are the other owners of the company. The other owners (especially if there is only one other owner) have no incentive to "bid up" the price. Hence the illiquidity discount.[10]

10. The minority and illiquidity discounts are applied independently. A 10 percent minority discount would decrease the value of what would be a $100,000 interest to $90,000. An additional 10 percent illiquidity discount would further reduce it to $81,000. As a result, the total discount applicable to an interest in a closely held company usually ranges from 15 percent to 55 percent. Although a discount in excess of 50 percent can be appropriate, such a discount could draw a challenge from the IRS.

Even assuming the owners can decide who is buying and who is selling, and can agree on a price, the buyer has to come up with the cash. This is the third obstacle to a voluntary buyout. Many purchasers of a medical practice lack "outside" sources of cash with which they can fund the transaction. This is especially true in "intergenerational" sales when a (younger) "rising" owner wishes to buy out an (older) "retiring" owner. How can the young doctor, who presumably has massive school loans, a large home mortgage, and often children to support, come up with the cash to buy out her senior partner? Assuming third-party financing (whether as a result of a loan from a relative or a bank) is not possible, the only solution is to allow payments over time.

Payments over time can either be a form of pure seller financing (as if the seller was underwriting a mortgage) or an earn-out. With regard to pure seller financing, although a seller often has a powerful tax incentive to spread payments over time and can often gain psychological benefits from having an income stream even after ceasing to draw a salary, these benefits are often outweighed by the fear of not getting paid. After all, if the business "tanks," there will be no income left to pay off the purchase price. While a seller can "repossess" her ownership interest if she is not paid in full, doing so would require the seller to come back to work and take over (or revive) the practice. Doing so is easier said than done for many reasons. Not only is a retired doctor unlikely to want to come out of retirement, patients (who presumably would have transferred their loyalty and trust to the purchasing doctor) may not want to continue to seek treatment from the seller. This also assumes that there are patients left to treat and that the buyer had not, for whatever reason, driven them away. After all, if there were a large number of patients, presumably the practice would do well enough to allow the buyer to pay off the seller.

The intangibles of a doctor-patient relationship also make earn-outs problematic. Under an earn-out, the seller is paid either a percentage of the company's revenue over a certain period of time or according to a waterfall providing for payments if certain thresholds are reached. For example, the seller could be entitled to *x* percent of the company's revenue for the next 5 years, payable at the end of each calendar quarter. Alternatively, the seller could be entitled to $*x* if the company's revenue was less than $*y*, and an additional $*z* if the company's revenue was more than $*y*. An earn-out assumes, however, that the company's business will either remain steady or grow. If the company's business shrinks, for example because patients leave because they do not like the new doctor, the seller will be sorely disappointed. Alternatively, if the company's revenues fall just short of the threshold necessary to trigger an additional payment,[11] the seller will suspect that the buyer "cooked the books," or intentionally deferred revenue to avoid making the higher payment. Earn-outs are therefore difficult to negotiate, especially if (as

11. It is amazing how many companies that are subject to an earn-out fall just short of the threshold, and "turn the corner" right after the end of the earn-out period.

is the case with many closely held companies) the company does not have strong internal controls that would make tampering difficult.[12]

If, for these reasons or others, a voluntary buyout is not possible, you and your client are likely headed to litigation. Whether you wind up as a plaintiff or a defendant depends in part on the particular circumstances and in part on the strategy you and your client adopt.

Fiduciary Duties

Any "exit strategy" in the context of a closely held company must be developed against the backdrop of the fiduciary duties owed to the company. If your client has come to you in a "someone has to go" mood, the last thing she is going to want to hear is a lecture about fiduciary duties. Assuming she does not own an outright majority of the company,[13] your client is likely to assume that she does not owe a fiduciary duty. While that is possible, it is unlikely to be the case. Most owners of a closely held company are also officers, members of the board, or both. Officers and board members both owe fiduciary duties to the company, as well as to all of its owners. Similarly, in closely held companies, a majority owner owes a fiduciary duty to the minority owners even if the majority owner (for whatever reason) is neither an officer nor a director.

While a fiduciary duty would preclude your client from putting her personal interest ahead of the company's interest, a good lawyer can usually find ways in which the owner's interest is aligned with the company's interest. For example, if your client reduces another doctor's hours (and therefore his pay) because of her personal animus towards him, she is likely to open herself up to a breach of fiduciary duty claim. If, on the other hand, your client reduces another doctor's hours because she is worried that his practice (or practices) might be exposing the company to liability, a breach of fiduciary duty claim is unlikely to succeed, even if it is brought.

12. Revenue is the metric that is most difficult to manipulate. Not only is gross revenue easy to calculate, very few business owners will take the risk of deferring revenue because, if the revenue is deferred, it might not come in at all. Additionally, in the healthcare context, there are few opportunities to defer revenue. For example, an insurer will not agree to hold off on paying a doctor's office for a few months until an earn-out period expires. Instead, the insurer will pay—or not pay—based on its own internal policies and procedures. Although it is difficult to manipulate, revenue may not be an appropriate driver for an earn-out. This is because the company may have had to incur disproportionate expenses to earn that revenue. As a practical matter, if the company does not generate profits, there will be no cash to fund the earn-out. Profit, however, is notoriously susceptible to manipulation. Although a current owner will insist that having certain relatives on the payroll (at salaries they would not command if they had a different last name) and attending that medical conference in Hawaii were critically important drivers of business growth, former owners often disagree. It is for this reason that, rather than referring to EBITDA, some experienced practitioners refer to EBITDAS (earnings before interest, taxes, depreciation, amortization, and "shareholder stuff").

13. If your client owns a majority of the company, she is likely to have fired the minority owner who is annoying her.

One reason a breach of fiduciary duty claim is unlikely to succeed under such circumstances is because your client will be able to take advantage of the business judgment rule. The business judgment rule insulates officers and board members from decisions that were made in good faith, and with a rational basis, even if they turned out to be incorrect. In addition to giving officers and directors some leeway, the business judgment rule allows them to rely upon other "experts." For example, the business judgment rule would make it very difficult to prevail against your client on a breach of fiduciary duty claim arising out of the fact that the corporation lacked adequate malpractice insurance (or purchased too much malpractice insurance[14]) if your client had relied on the advice of an insurance broker when deciding how much coverage to buy.

The business judgment rule does not, however, insulate offices or directors from self-interested decisions. The classic example, especially in the context of a closely held company, is a decision to raise your client's salary or benefits. If your client votes on her own salary or benefits package, she will, by definition, be open to a breach of fiduciary duty suit claiming that she overpaid herself. This will be the case even if she hired a salary consultant. Although the consultant's recommendation will be powerful evidence of what is reasonable, both your client and the consultant will be "second guessed" and claimed to be both self-interested and incompetent. If, on the other hand, your client abstained from voting on her own salary, her detractors would not be able to attack the consultant's skill or conclusion. On the contrary, the disinterested board members would be entitled to rely on the conclusions of the salary consultant even if, in this particular case, it turned out that the salary consultant had made a mistake.

Because the business judgment rule insulates an officer or a director's good faith, disinterested decisions, a good set of minutes can go a long way towards defeating a breach of fiduciary duty claim. Naturally, many clients forget that the prerequisite for a good set of minutes is actually having a board or an owners' meeting. Seasoned practitioners are all too familiar with clients who bring in a pristine "corporate kit"—or one that has only the minutes and resolutions from the very first meeting.[15] You should therefore advise your client to start having

14. Minority owners are usually happy to criticize whatever decisions the majority made and are often quick to claim that they could have—and would have—done better. The business judgment rule reduces the opportunity for this type of "Monday morning quarterbacking."

15. Speaking for myself, I have only once had a client come in with a fully filled out corporate kit. He had actually made his coshareholder sign a consent in lieu of a meeting every single year. That form consent contained a standard provision ratifying all of the actions of the corporation, and of the officers, during the prior year. This annual ratification was devastating to my client's adversary's claim that my client had overpaid himself and "cooked the books" for decades. The look on his lawyer's face when he realized that his claims might be limited to those that had arisen within the last year was priceless.

regular board meetings and to keep accurate minutes of those meetings.[16] Those minutes will be essential in demonstrating that your client's actions fall within the scope of the business judgment rule.

Minority Oppression

Absent restrictions in a shareholders' agreement,[17] the actions the majority owner[18] can take against a minority owner are limited only by the majority owner's creativity. Those actions can, however, stray into "minority oppression." What constitutes minority oppression varies from jurisdiction to jurisdiction. Some, such as New Jersey, have well defined minority oppression statutes.[19] Others, such as Pennsylvania, rely on the common law, which may or may not be well developed. Although the courts and statutes use different words, the underlying concept is the same: Minority oppression occurs when the majority owner deprives the minority owner of the reasonable expectations of ownership. Naturally, the majority and minority owners usually disagree over the "reasonableness" of the minority's expectations. Although courts often employ multifactor balancing tests, most cases in which a court finds that minority oppression has occurred involve either a "freeze out" or a "squeeze out."

A "freeze out" occurs when the majority owner takes steps to exclude the minority owner from the company. The most benign form of a freeze out is when the majority owner stops providing information (especially financial information) to the minority owner. Usually, a freeze out involves reducing the minority owner's role in the company. The minority owner may no longer be invited to planning meetings or asked to serve on decision-making committees. As the freeze out escalates, the minority owner may be voted off the company's board of directors or removed as a corporate officer. The majority owner will find increasingly creative ways to make the minority owner's life difficult and make continued employment unpleasant. Even if the minority owner remains as an employee, the minority owner will often find his authority—and his salary—have been reduced.

16. Contrary to popular belief, minutes do not need to be—and in fact should not be—notes of who said what at a meeting. Instead, they should reflect the decisions made at the meeting and the rationale behind those decisions. For example, rather than saying "Sally complained about overtime costs, and demanded that hours be reduced," minutes might say "after a discussion of staffing needs and costs, the board decided to . . ." Not only do such minutes reflect a balanced discussion, it is very difficult to use such minutes to prove that the board failed to consider an important issue.

17. There is no limit to the creative clauses that can be found in shareholders' agreements. One of my personal favorites was one that only permitted the majority shareholder to be fired for "cause," and which went on to define the requisite "cause" as "death or permanent disability rendering the shareholder unable to perform the essential functions of his job." Naturally, "cause" was defined more broadly in the context of firing the minority shareholder.

18. Presumably the majority owner is the president and CEO of the company. To the extent the majority owner is not the president and the CEO of the company, she can become the president and CEO whenever she wishes.

19. *See* N.J.S.A. 14A:12-7.

For example, a doctor who has a minority ownership interest in the company may see his hours reduced or may find himself assigned to less desirable "shifts" or locations. A shift can be less desirable for many reasons. It might be at a time (i.e., overnight) when few patients will come in, thereby reducing the doctor's ability to generate revenue. Conversely, it might be at a time or location that is extremely busy, leading to burnout. It could be a time or location in which a high proportion of low-paying (or nonpaying) patients are likely to be seen. It could conflict with time the doctor would rather not be at work (i.e., holidays and weekends). It could even rotate, for example, a week on the "day shift" in one location followed by three days on the "night shift" in another location and then two hours a day in a third location.[20]

Assuming the minority owner does not quit, the minority owner will likely see his salary reduced, either as a result of a direct cut or comparatively as the majority owner gives herself a raise without giving the minority owner a proportionate salary increase. There may be an attempt to justify this new salary differential by pointing to the results of the shift changes (i.e., the minority owner's efforts are now generating less income than the majority owner's efforts because the minority owner is working the overnight shift in an office in a poor neighborhood and the majority owner is working a day shift in a wealthy neighborhood). In other instances, the minority owner simply finds that his salary has been cut without any justification or explanation. In extreme cases, the minority owner will find himself locked out or fired.

A "squeeze out" takes the "freeze out" one step further. If the company is a tax pass through,[21] the owners will have to report their proportionate share of the company's revenue on their own tax returns. If a minority owner is not working for the company, that owner is vulnerable to being "squeezed out" with "phantom income." Phantom income is that portion of a closely held company's income that is earned by the company (and therefore must be reported on the owners' tax returns) but is not distributed. For example, a company might earn $1 million, but retain that income so that it has either working capital or money for improvements. If the majority and minority owners are fighting, the majority owner might

20. This is not to say that every action the minority owner finds unpleasant gives rise to minority oppression. After all, there is some drudge work in any job. College deans are usually masters at making the life of a disliked tenured professor difficult without crossing over into improper behavior. Common examples include relocating the professor to undesirable office space, assigning him to teach classes that meet at 6 p.m. on Monday, Wednesday, and Friday and 8 a.m. on Tuesday and Thursday, and requiring the professor to teach a new class each semester.

21. "S corporations," LLPs, and LLCs do not themselves pay taxes. Instead, their tax burden "flows through" to their owners who report their proportionate share of the company's income on their personal tax returns. The owners pay the applicable tax at their personal tax rate. Although "flowing down" a company's income to its owners for tax purposes requires the owners to file (and pay) taxes in every jurisdiction in which the company does business, doing so avoids the "double taxation" of a "C corporation." Double taxation occurs when the C corporation must pay tax on its income at the applicable corporate rate, and then the shareholders must pay an additional tax at their personal tax rate on the income the C corporation distributes to them in the form of dividends.

decide—in an exercise of her business judgment, of course—that the company should retain the entire $1 million because insurance companies are becoming increasingly slow to pay claims and the company needs additional working capital. Alternatively, the majority owner might decide that the company should retain the $1 million as a reserve against capital improvements, such as buying new medical equipment.

Even though the majority owner has decided to retain the $1 million in earnings in the company, the owners must still pay taxes on that $1 million. Hence the term phantom income—the owners are paying taxes on income they did not actually receive. Traditionally, the company will make a "tax distribution" so that the owners have the cash necessary to pay the taxes on the phantom income. In a squeeze out, the majority owner refuses to make a tax distribution. If the minority owner is not working for the company, the minority owner will be faced with a (potentially very large) tax bill and no cash to pay the taxes.[22] Such a shareholder is vulnerable to being "squeezed out" of the company because he is often willing to sell his interest cheaply rather than be "choked" with tax liabilities arising out of phantom income.

Remedies for Minority Oppression

Although courts routinely say that "there is no right without a remedy," the remedies for minority oppression are often less satisfying than one would like. This is because, absent explicit statutory authorization,[23] a court is unlikely to order the company to repurchase the minority owner's interest. The end result is that an action for minority oppression will leave the minority owner in the corporation. While one would think that a majority owner who has lost a minority oppression case would alter her behavior, that is unfortunately not always true.[24] And even if the majority owner alters her behavior, some minority owners who have won a minority oppression case will go on to see additional oppression behind every rock and tree, even if the majority owner's behavior is permissible. While such an outcome may be a lawyer's dream (or retirement plan), it is unlikely to solve the owners' problems.

Courts can appoint a custodian or a receiver if they believe it is either necessary to wind up the company's affairs or prevent widespread fraud or self-dealing. Courts are reluctant, however, to appoint a custodian or a receiver if they believe

22. It is often a sheer coincidence that the majority owner will pay herself a bonus large enough to pay her share of the taxes. The minority owner will not get a bonus, however, because he is not working for the company. An aggressive majority owner might attempt to squeeze out a minority owner who does work for the company by refusing to make distributions and at the same time refusing to pay the minority owner a bonus.

23. Such explicit statutory authorization can be found, *inter alia*, in N.J.S.A. 14A:12-7(1).

24. In some cases, the majority owner gets smarter about staying on the right side of the line between being annoying and being oppressive. In other cases, the majority owner goes right back to her old ways and dares the minority owner to bring another suit.

there is “merely” a difference of opinion as to how the company should be run. The exception to this general rule is if the company is deadlocked.[25] Courts will generally resolve a deadlock either by appointing another director, or by appointing a custodian (which often amounts to the same thing in the case of a deadlock).

Depending on the oppression, a court can order the company to reverse an action against a minority owner. For example, a court can reinstate a minority owner as an officer, director, or employee. A court can also order a company to reinstate procedures, such as having the minority owner sign checks or review financial information. A court can, if it believes it to be appropriate, order a company to pay a dividend, or resume a prior policy, pattern, or practice of paying dividends.

Finally, a court can award damages for minority oppression. These damages would likely take the form of lost salary, benefits, or distributions. They could also give the minority owner a proportionate share of compensation inappropriately taken by the majority (i.e., the 10 percent owner could be awarded $100,000 if the majority owner improperly awarded herself a $1 million bonus instead of paying the $1 million out in pro rata distributions).

Litigation Strategy

The terms of the shareholders’ agreement (assuming there is one), as well as the majority/minority ownership status of your client, will be the most important factors in determining your litigation strategy. Most shareholders’ agreements include restrictive covenants that limit an owner’s ability to compete or solicit clients upon resignation (or termination) from the company. These covenants, which are often critical to a litigation strategy,[26] are discussed in Chapter 11.

Tactically speaking, it would be unusual for the majority owner to initiate litigation against the minority owner. Instead, the majority owner generally uses her power to control the company to either unilaterally do or take what she wants, or to harass and intimidate the minority owner into selling his interest. In many instances, the majority owner will “ramp up” the pressure and see if the minority owner does anything. If the minority owner does not do something (either quit, sue, or both), the majority owner gets her way without cost. And if the minority

25. A company will only deadlock if its ownership is split 50/50 or if the shareholders’ agreement somehow creates a 50/50 split on the company’s board.

26. To the extent a restrictive covenant precludes a minority owner from quitting and setting up a new practice, the minority owner will have few options other than to either resort to litigation or accept whatever deal the majority owner is willing to offer. It is difficult for a doctor to “wait out” a restrictive covenant, both because a doctor’s skills deteriorate if they are not used, and because patients are unlikely to wait for a doctor to become available. Once patients develop a relationship with a new doctor (and once doctors begin referring patients to others), those patterns are difficult to change. As a practical matter, the only options available to a doctor bound by a restrictive covenant might be changing fields (for example, by going to work for “big pharma,” or—heaven forbid—by going to law school) or relocating.

owner does file suit, the majority owner will almost certainly be able to require the company to pay for her defense.[27]

If you represent the minority owner, before filing suit you should consider whether you should advise your client to quit and simply get another job. In the absence of a restrictive covenant, your client will be able to do so. Depending on the type of business, it may be possible for your client to start a new business (or get a new job) with little up-front investment.[28] Although quitting may "strand" your client's investment in the company that previously employed her, that investment may be stranded anyway.

Quitting (or threating to quit) can put the majority owner in a bind. It is quite possible that patients will follow the disaffected doctor, or at least stop coming to the practice after the disaffected doctor quits. Although the loss of patients will reduce the company's revenue, the company's overhead will not change.[29] If the majority owner is unable to carry the overhead alone, and if the majority owner fears she will not be able to "ramp up" the practice's volume after the departure of a minority owner, she will have an incentive to come to terms.

In addition to reviewing the shareholders' agreement, you should ask for—and review—other documents critical to the running of the business. For example, the strategy of "choking the majority owner on the overhead" can only work if the minority owner has not guaranteed the lease, the bank debt, or both. If, on the other hand, your client is the one that "contributed" the building (or some other equipment that is critical to running the business), your client will have some leverage in negotiations with the majority owner. Similarly, you should ask if your client has unique licenses, skills, or admitting privileges. For example, if your client is the only one who can admit patients to a certain hospital, or who is "in network" with a certain insurer, you will have some leverage, at least until the majority owner can gain (or get someone else to gain) similar privileges.

Although your focus will undoubtedly be on the breach of fiduciary duty and minority oppression theories outlined in this chapter, you should not neglect the employment theories discussed in Chapter 8. In addition to being an owner, your client was undoubtedly an employee. Your client may also be a member of one or more protected classes. If that is the case, you will have another theory of recovery.

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27. Most bylaws require the company to advance defense costs to officers or directors who are sued as a result of their work for the company. Although the officer or director usually has to sign an agreement to repay any advances that are subsequently found to have been improper, actual repayments are extremely rare. Bylaws do not require companies to advance legal fees to plaintiffs who are suing the company, and a board of directors is highly unlikely to allow the company to do so.

28. Just as an example, a doctor can quit her private practice and go to work for a hospital. The hospital will provide all the necessary capital: an office, an assistant, a billing clerk, a file clerk, and any necessary medical equipment. A hospital may even agree to defend your client against any claims brought against her by her former employer.

29. The exception is that the company will not have to pay the salary and benefits of the doctor who quit. One would think, however, that a doctor who is not bringing in enough revenue to cover her salary would be unlikely to quit.

One final theory to consider is defamation. When a dispute becomes heated, people often say (or write in e-mails) things that they would not say (or write) if they stopped and thought first.[30] Your client may believe that some of these statements questioned her fitness in her trade or business, and therefore constitute defamation per se. Before bringing a defamation suit, however, you should consider three things. First, although defamation per se entitles a plaintiff to recover nominal damages and potentially punitive damages, in order to recover actual damages a plaintiff must prove—and quantify—the harm flowing from the defamation. Unless there was a dramatic drop off in the doctor's business after the statement, significant actual damages are unlikely. Perhaps more importantly, to prove that defamation caused actual damages, you will have to call a witness in open court to testify that, after hearing the defamatory statement, the witness thought less of your client and refused to do business with her. Is it really in your client's long-term interest to have such testimony on the record? Which leads to the second consideration: Truth is a complete defense to a defamation claim. The majority shareholder will therefore take discovery (very intrusive and potentially expensive discovery) attempting to prove that whatever she said was true. Third, some homeowners insurance policies provide a defense for defamation claims. You might, therefore, trigger insurance coverage by bringing a defamation claim. Allowing a majority owner to shift her defense costs in an entire case to an insurance company (which would, at best, cover that portion of a liability award that arises out of one claim) is probably not advantageous to your client.

Conclusion

The bottom line is that the only way your client can change the locks on Monday morning is if she (1) owns a majority of the company, (2) is willing to live with the staffing and overhead consequences of firing the minority owner, and (3) is willing to come up with the cash necessary to fund a buyout of the minority's ownership interest if there is an agreement requiring the buyout of an owner's interest upon separation from the company. This is not to say that you cannot, by using breach of fiduciary duty, minority oppression, breach of contract, and employment claims, extricate a minority owner from a company. Such a cure would, however, take much longer (and will cost much more) than the doctor would like. While one would think that a doctor would be sympathetic to a cure that took longer, and cost more, than she wanted, not all doctors take their own medicine. In this case, your client might not have a choice.

30. Most experienced human resources managers would pay a great deal to be able to "hold" the e-mails of at least one person in their organization for 24 hours before releasing them. Then again, if it was possible to do so, there would be much less work for lawyers.