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A Cautionary Message for Closely Held and Family Businesses: Recent Case Reinforces the Importance of Valid Operating Agreements

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Greenbaum, Rowe, Smith & Davis LLP Client Alert

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The firm recently represented the plaintiff in a litigation involving New Jersey's Oppressed Shareholder Statute. The matter was successfully tried before the Superior Court of New Jersey Chancery Division by our partner Alan S. Pralgever, and brings to light a number of issues of particular importance to closely held and family businesses.

The case involved two brothers splitting up two businesses in which both were 50% shareholders. The structure dated back to the transition of ownership from parents who had founded the core business decades earlier. Notwithstanding ownership, each brother served both as president of their own business and as vice president of the other's company. The two businesses operated jointly on a single piece of property, which was controlled by a limited partnership also owned jointly and equally by the brothers, however the brothers operated their respective companies independently. Certain overhead expenses and the handling of other responsibilities, however, were intertwined.

Unfortunately, the brothers did not have a functional operating agreement. Over the course of time, our client began to suffer the consequences of his brother's business losses, which amounted to as much as \$500,000 per year. The brother operating the unprofitable business was offsetting those losses by drawing funds from our client's successful business.

Following lengthy but unsuccessful negotiations, our client had no recourse but to file a lawsuit. His claims invoked the Oppressed Shareholder Statute, as well as allegations of breach of oral agreements, breach of the implied covenant of good faith and fair dealing, breach of fiduciary duty and unjust enrichment.

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On December 22, 2016, the Court ruled wholly in favor of our client. The decision relied on principles Mr. Pralgever first successfully litigated in *Balsamides v. Perle* (in which the New Jersey Supreme Court determined that 50% shareholders could be considered “oppressed minorities”) and was supported by companion cases holding that minority shareholders could be oppressed and that the appropriate remedy for oppression is a forced buy-out.

The Court ruled that our client had been oppressed financially and otherwise by the defendant, and that the defendant had breached his fiduciary duties and acted in bad faith. The ruling granted our client the right to buy out his brother’s interest in the business for the price advanced by our valuation expert. A significant valuation issue was the application of a “marketability discount” to the buy-out of a 50% partner. The Court accepted our argument, and a 25% discount was applied to arrive at the buy-out price. The Court determined that no other remedy or compensation was warranted save for the buy-out consistent with applicable statutory and case law.

This case highlights the nature of court battles that can occur in close corporations, partnerships and LLCs when the Oppressed Shareholder Statute is applicable. The lack of valid operating agreements, not uncommon in closely held and family businesses, gave the defendant the opening to take advantage of the plaintiff because the defendant (as a 50% owner of both business entities) had unrestricted access to the operating capital and bank accounts of both businesses. Carefully drafted and effective shareholders and/or buyout agreements may have regulated the affairs of the business and prevented the dispute from arising altogether, to say nothing of the stress and expense of litigation and trial, and the fractured family relationships.

The author of this Alert, **Alan S. Pralgever**, is a partner in the firm’s Litigation Department. He concentrates his practice in business and commercial litigation, with a special focus on corporate, partnership and LLC split-ups and dissolutions, estate litigation, employment issues, real estate and intellectual property disputes. He has handled a wide variety of complex commercial and corporate litigation in state and federal courts, as well as arbitrations in both New Jersey and New York.