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A look at shareholder rights under New York law

While a "majority interest" (50+ %) shareholder ("majority shareholder") of a New York corporation holds significant rights, including the right to control management, such rights are not without limits. In the absence of a shareholders agreement, the rights of the various shareholders of a New York corporation – including any "minority interest" shareholders ("minority shareholder(s)") – are generally governed by the New York Business Corporation Law ("BCL") and New York common law. These laws provide minority shareholders with significant rights that the majority shareholder must understand. In addition, the majority shareholder should always consider the need for, and the value of putting in place, a shareholders agreement.

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Rights and Obligations of Shareholders under New York Law in the Absence of a Shareholders Agreement

While as a general rule, the BCL and New York common law tend to favor the majority shareholder, minority shareholders are provided with several important rights. In addition, certain important obligations are imposed on the majority shareholder to the extent his majority status puts him in a position to control the corporation. These rights and obligations include:

Fiduciary Duties of Board of Directors: As a general principle, the Board of Directors of a New York corporation is appointed at the direction of the majority shareholder and in most closely-held corporations the Board consists of the majority shareholder and/or his designees. The directors, however, have fiduciary duties to all of the shareholders of the corporation, regardless of their respective ownership percentages. These fiduciary duties include the duty of loyalty and the duty of care. The duty of loyalty requires each director to put the corporation's interest over his own and to avoid self-dealing. The duty of care requires each director to act in good faith and with a reasonable degree of care.

Right to Petition for Judicial Dissolution: Section 1104-a of the BCL provides that shareholders holding at least 20% of a New York corporation's voting stock may petition the court for the dissolution of the corporation if: (a) the directors or those in control of the corporation have been guilty of "illegal, fraudulent or oppressive actions" towards the complaining shareholders; or (b) the property or assets of the corporation are being "looted, wasted, or diverted for non-corporate purposes." The court then determines if involuntary dissolution is warranted to provide the petitioners with a fair return on their investment and to protect the rights and interests of the petitioners or shareholders generally. In fashioning an appropriate remedy, the court may order that the stock valuations of the shareholders be adjusted to impose a surcharge upon a director- shareholder or those shareholders in control of the corporation upon a finding of willful or reckless dissipation of corporate assets without fair consideration. In the event a Section 1104-a action is commended, Section 1118 of the BCL provides that any non-petitioning shareholder may elect to purchase the shares of the petitioner(s) at their fair value and upon such other terms as approved by the court. It is worth noting that, while not common, New York law provides that shareholders below the 20% requirement can bring a common law dissolution action for certain instances of corporate wrongdoing.

Right to Inspect Corporate Books and Records: Under the BCL, any shareholder has standing to review certain documents – such as financial statements, shareholder lists, and the minutes from shareholder meetings. Shareholders may also make copies of these documents, provided the request is for "[a]ny purpose reasonably related to such person's interest as a shareholder." Under New York common law, shareholders also have the right to review the corporation's other books and records, so long as the inspection is sought in good faith and for a purpose consistent with the shareholder's right to monitor his investment in the corporation.

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Right to Annual Meeting: Section 602 of the BCL provides that a shareholders meeting "shall be held annually for the election of directors and the transaction of other business." While a minority shareholder's voting interest may not be sufficient to effect any corporate change, the annual meeting requirement does provide a forum for a minority shareholder to speak directly to management, raise issues and ask questions. A minority shareholder may also authorize his counsel (or some other person) to attend the meeting on his behalf and act for him by proxy.

Rights and Obligations Often Addressed in a Shareholders Agreement

In evaluating the need for, and value of, a shareholders agreement, the majority shareholder of a New York corporation should always consider the following matters:

Restrictions on Right to Transfer Shares: In the absence of a shareholders agreement, a shareholder generally has the right to transfer his shares. In a closely-held corporation, it is almost always contemplated that the ownership of the corporation be tightly controlled, and that shares not be freely transferable. Failure to regulate the transfer of shares could result in the shares ending up in the hands of

an ex-spouse or other family member of the shareholder, a creditor of the shareholder, or worst yet, even a competitor. Some shareholders agreements outright prohibit certain transfers or strictly limit transfers to only "permitted transferees" (e.g., family members for estate planning purposes). It is common for a corporation (or the other shareholders) to have a "right of first refusal" to purchase the subject shares in the event of any proposed transfer.

Rights upon Termination of an Employee-Shareholder: In the absence of an agreement to the contrary, a shareholder generally has the right to continue his share ownership regardless of his death, disability, retirement, or termination of employment with the corporation. In certain termination situations – e.g., termination of an employee shareholder for cause – it is typically not desirable to allow the ex-employee, who perhaps now has an axe to grind with the corporation, to continue to own his shares. Most shareholders agreements contain provisions that define the various rights and obligations of the corporation and the shareholders in the event of a shareholder's death, disability, resignation, retirement, termination of employment for cause or without cause, or the shares becoming subject to an involuntary transfer order (e.g., pursuant to a divorce or bankruptcy). These provisions, sometimes referred to as corporate "pre-nuptial" provisions, can cover both "put" rights and options (the ability of the affected shareholder to force the corporation and/or the other shareholders to buy his shares) and "call" rights and options (the ability of the corporation and/or the other shareholders to buy out the shares of the affected shareholder). The possibilities in this area can get quite complicated and often include a mechanism to value the shares to be purchased and provisions on how the purchase price will be paid.

Drag Along Rights: While a majority shareholder typically can cause the disposition of the corporation's business in an "asset sale" transaction, he typically cannot do so unilaterally in a "stock sale" transaction. Stock sale transactions are often preferred from a seller's perspective as they can be structured on a tax deferred "stock for stock" basis. Therefore, it is often important for a majority shareholder to have "drag along" rights – i.e., the right in the event the majority shareholder wishes to sell his shares to a third party buyer to force (or drag along) the minority shareholder to sell his shares on the same terms and conditions. Such rights can be critical as often a buyer of a closely-held corporation in a "stock sale" acquisition will desire to obtain complete ownership of the corporation and will not want to be saddled with pre-existing minority shareholders. As a counter-balance, minority shareholders often seek "tag along" rights – i.e., the right to participate (or tag along) in any sale by the majority shareholder of his shares.

Confidentiality and Nondisclosure Obligations: As noted above, minority shareholders have certain statutory and common law rights to receive corporate information. In addition, a corporation may choose to provide minority shareholders with additional information from time to time either in connection with their initial investment or for purposes of maintaining good shareholder relations. Much of the information provided to minority shareholders is typically of a confidential, and perhaps even a competitively sensitive, nature. It is always wise to require that all minority shareholders be subject to confidentiality and nondisclosure obligations, either through a provision in a shareholders agreement or a separate nondisclosure agreement. While such contractual obligations do provide the corporation with a measure of protection, the judicial enforcement of the same, if necessary, is often an expensive endeavor. Therefore, it is always best to limit the distribution of truly confidential corporate information. It is worth noting that some shareholders agreements go beyond imposing confidentiality and nondisclosure obligations, and further imposes non-solicitation and non-competition obligations that prevent the shareholder from taking customers and opportunities of the corporation and from competing with the corporation.

Employment Rights: The shareholders agreement should always make clear that a minority shareholder's status as a "company owner" does not entitle him to employment or continued employment with the corporation. The minority shareholder's employment relationship with the corporation, if there is one, should be handled in a simple "at will" employment letter or a more detailed employment agreement, dependent on what is more appropriate under the circumstances.

Capital Contribution Obligations: Absent an agreement to the contrary, there is no obligation for a shareholder to make additional capital contributions to the corporation beyond the shareholder's initial contribution for his shares. If such a further obligation is to exist, a provision in the shareholders agreement or a separate capital contribution agreement will be necessary. Such an agreement should cover the penalties and other corporation rights (e.g., buyout rights) that are triggered by the failure of the shareholder to make any required additional capital contribution.

This article attempts to enumerate many of the common issues that every majority shareholder should consider at the outset of the participation of a minority shareholder or shareholders in a New York corporation. Of course every situation is unique and a majority shareholder should examine all of his concerns about having minority shareholders so that his expectations can be protected.

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