Navigating Co-Owner Conflict: Deadlock, Freeze-Outs, and Shareholder Oppression in NJ Closely Held Businesses

Client Alert

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What You Need to Know

- Disagreements among business shareholders, partners, or directors frequently escalate into operational deadlock, minority owner exclusion, or claims of unfair dealing.
- Aggrieved parties have recourse through claims for breach of fiduciary duty or minority oppression, which can lead to court-ordered remedies such as buyouts at fair value, receiverships or judicial dissolution.
- Well-drafted operating or shareholder agreements with clear deadlock and buyout mechanisms are the best defense, while proactive pre-litigation actions – such as documenting records and communications – can heavily influence legal outcomes when disputes arise.

The owners of closely held businesses often begin their relationship with a shared vision, mutual trust, and complementary skill sets. However, when disagreements arise, these relationships can quickly deteriorate into deadlock, exclusion, and allegations of unfair dealing.

In New Jersey, disputes among the co-owners of limited liability companies (LLCs) and closely held corporations frequently give rise to complex litigation over fiduciary duties, statutory oppression claims, and court-ordered buyouts or dissolution.

Understanding the legal framework that governs these disputes is critical for any business owner in a closely held company.

Deadlock

Not every disagreement between business owners constitutes a true deadlock; a true legal deadlock occurs when those with voting or management authority prevent the company from taking action on significant matters concerning the management or operation of the company.

Deadlock is especially common in 50/50 ownership structures, where neither owner holds a controlling vote and the governing documents do not provide an effective mechanism for resolving disagreements. Prolonged deadlock can interfere with day-to-day operations, damage relationships with employees, customers, lenders, and vendors, and ultimately threaten the value of the business.

Common triggers for deadlock include:

- Disagreements over the company's direction, strategy, or future
- Disputes concerning distributions, reinvestment of profits, or other financial decisions
- Conflicts over the hiring, compensation, responsibilities, or termination of key personnel
- Disagreements over significant expenditures, financing, or business opportunities
- A fundamental breakdown in trust or working relationships

Freeze-Out and Exclusion

A freeze-out occurs when one or more owners use their control to marginalize or effectively push another owner out, even though the excluded owner continues to hold an ownership interest in the company. Unlike a formal buyout or removal, a freeze-out often occurs through a series of actions that diminish the owner's ability to participate in – or receive the financial benefits of – the business.

Common freeze-out tactics include:

- Excluding an owner from management or significant business decisions
- Denying or restricting access to financial information, books, and company records
- Terminating an owner's employment, salary, benefits, or distributions
- Diluting an owner's ownership or voting interest
- Paying excessive compensation or other benefits to controlling owners while withholding distributions
- Diverting business opportunities, customers, assets, or revenue away from the company or the excluded owner

These disputes can be particularly significant in closely held businesses, where an owner's investment may involve more than simply holding an equity interest. Owners may have entered the business with expectations that they would participate in management, receive compensation or distributions, have access to company information, and/or share in the company's growth and success.

When the actions of controlling owners frustrate these reasonable expectations or unfairly deprive an owner of the benefits of ownership, New Jersey law provides remedies through claims for minority oppression, breach of fiduciary duty, or other relief.

Fiduciary Duties

Business owners and those entrusted with managing a company may owe fiduciary duties to the business and, in certain circumstances, to one another. These duties generally require those exercising control over a business to act in good faith, avoid improper self-dealing, and refrain from using their position to obtain an unfair advantage at the expense of the company or other owners.

In corporations, directors and officers owe fiduciary duties in carrying out their responsibilities, while controlling shareholders may also owe duties that prevent them from using their control to improperly benefit themselves at the expense of minority shareholders.

In closely held corporations, these duties frequently arise alongside New Jersey's statutory protections against minority shareholder oppression.

For LLCs, the New Jersey Revised Uniform Limited Liability Company Act addresses duties of loyalty and care and the obligation of good faith and fair dealing. The nature and scope of those duties may depend on whether the LLC is member-managed or manager-managed, the parties' respective roles, and the provisions of the operating agreement.

When an owner or manager uses control of the business for personal benefit, diverts company assets or opportunities, engages in self-dealing, or otherwise acts contrary to applicable fiduciary obligations, the affected owner may have claims for breach of fiduciary duty, oppression, or other legal and equitable relief.

Minority Shareholder Oppression in New Jersey

One of the most significant remedies available in closely held business disputes is New Jersey's minority shareholder oppression statute, under which a shareholder may seek relief when those in control of the corporation engage in conduct that is oppressive to minority shareholders, is illegal or fraudulent, or misapplies or wastes corporate assets.

New Jersey courts interpret "oppressive conduct" broadly, often focusing on whether controlling shareholders have frustrated the reasonable expectations of minority owners - such as employment within the business, participation in management, or receipt of distributions.

Remedies Available in Deadlock and Oppression Cases

New Jersey courts have significant equitable authority to fashion remedies tailored to the nature of the dispute, the type of business entity, the parties' governing agreements, and the particular harm involved.

Potential remedies include:

- **Judicial Dissolution.** In appropriate circumstances, a court may dissolve a corporation or LLC when persistent deadlock, oppression, or other statutory grounds make continued operation of the business impracticable or inequitable.
- **Buyout of an Owner's Interest.** Rather than dissolve an otherwise viable business, a dispute may be resolved through the purchase of one owner's interest by the company or another owner. Depending on the circumstances, a buyout may arise through statutory procedures, the parties' governing

agreements, settlement, or equitable relief fashioned by the court, with valuation often becoming a significant issue.

- **Appointment of a Custodian or Receiver.** When necessary to protect the business or its assets while a dispute is pending, a court may appoint a neutral third party to oversee some or all of the company's affairs.
- **Injunctive and Other Equitable Relief.** Courts may also enter orders designed to address particular misconduct without dissolving the business, such as restoring access to company information, preventing the transfer or dissipation of assets, restraining improper transactions, or addressing exclusionary conduct.

The ultimate goal of these remedies is not necessarily to end the business. Depending on the circumstances, the court may fashion relief intended to protect the owners' rights and preserve the value of an otherwise viable company.

Valuation Disputes: A Central Issue

In many instances, especially where the resolution involves a buyout, the primary battleground becomes valuation – what the departing or excluded owner's interest is actually worth. Valuation disputes often involve disagreements over minority share ownership discounts, marketability discounts, earnings adjustments, goodwill and intangible value, and whether alleged misconduct should impact value.

New Jersey courts have discretion in determining "fair value," and outcomes can vary significantly depending on the facts and expert testimony.

Preventing Business Disputes

While New Jersey law provides robust remedies for deadlock, freeze-outs, and shareholder oppression, many of the issues that lead to costly lawsuits in closely held businesses can be traced back to one underlying factor: poorly drafted, incomplete or non-existent governing agreements.

Carefully crafted operating agreements (for LLCs) and shareholder agreements (for corporations) play a critical role in mitigating risk. It is critical to clearly define:

- Management structure and voting rights
- Procedures for resolving deadlock, including tie-breaker mechanisms or buy-sell provisions
- Rights to distributions and capital contributions
- Restrictions on transfers of ownership interests
- Exit mechanisms, including voluntary and involuntary buyouts
- Procedures for valuation in the event of a dispute or departure

Incorporating dispute resolution provisions - such as mediation requirements, arbitration clauses, or structured negotiation processes - can help resolve disagreements early and avoid full-scale litigation. Buy-sell provisions, in particular, are often one of the most important tools for preventing deadlock from escalating into a business-ending conflict.

Conclusion

Business divorce litigation outcomes are often driven by early strategic decisions. Actions taken before a complaint is filed – checking recordkeeping, managing distributions, issuing formal notices, and documenting communications – can significantly influence the outcome of a case.

Because business disputes between co-owners are highly fact-sensitive and often turn on both legal rights and business realities, consulting legal counsel early is critical. Experienced counsel can assist not only in litigating or resolving conflicts, but also in proactively structuring agreements designed to minimize the risk of future disputes.

Please contact the authors of this Alert for additional information or to discuss your specific business circumstances.

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