Bloomberg Law

Professional Perspective

Avoiding Liability During Corporate Dissolution

Robert A. Muckenfuss, Elizabeth Zwickert Timmermans, J. Michael Wilson, and Natalina DePina, McGuireWoods

Avoiding Liability During Corporate Dissolution

Contributed by Robert A. Muckenfuss, Elizabeth Zwickert Timmermans, J. Michael Wilson, and Natalina DePina, McGuireWoods

This article will focus on the liability and litigation considerations of closely held companies going through corporate dissolution. In the age of Covid-19 and its associated economic challenges, corporate dissolution may be a cost-effective option to bankruptcy for some companies looking to wind down their business in an orderly fashion. However, it is critical to consider the litigation hurdles during this process and how liability and litigation can shape the path of dissolution. This article focuses on corporate dissolutions, but similar issues arise with dissolutions of partnerships and limited liability companies.

Fiduciary Duties

The decision to choose corporate dissolution and then execute on winding down the company is one that cannot be made lightly. In general, the majority vote of the shareholders or members of a closely-held company can elect corporate dissolution. It may then be left to the officers or directors of the company to execute on winding down the company and distributing assets. In many instances, one or more shareholders are also directors and officers of the company. The fiduciary duties of officers and directors are an important consideration for dissolution and winding down the company.

Officers and directors generally owe fiduciary duties of care and loyalty to the company and shareholders. See, e.g., *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986).

The winding down of the company and liquidation of assets can bring a set of significant corporate decisions depending on the complexity of the company. For example, a closely held company may have ongoing operations with significant assets, and there often can be disagreement among the members, directors, and officers on whether to engage in the dissolution process at all and how the process should proceed once elected.

Ultimately, the decision to elect dissolution and execute on it will be guided by fiduciary duties owed to the company. *In re Transamerica Airlines, Inc.*, No. CIV. A. 1039-N, 2006 BL 30729 at *8 (Del. Ch. Feb. 28, 2006) . Additionally, Delaware law requires that officers and directors comply with the dissolution procedures set forth in 8 Del. C. §§ 280-282. The timing of how and when corporate assets are disposed of and distributed can present a certain set of challenges.

The threat of fiduciary duty litigation may present itself in two ways: direct shareholder litigation or derivative litigation. In direct shareholder litigation, a minority owner of the company may sue other owners, directors or officers for breach of fiduciary duties owed to the minority owner. See, e.g., *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009); *Rubenstein v. Rubinstein*, 816 N.Y.S.2d 700 (Sup. Ct. 2006).

In a derivative litigation matter, a shareholder may sue the other members, directors and officers for a breach of fiduciary duty owed to the company after demonstrating that a demand on the company's board was ignored or that such a demand would be futile. See *Rafiy v. Javaheri*, 927 N.Y.S.2d 554, 558 (Sup. Ct. 2011).

A single shareholder lawsuit may assert both direct and derivative claims. For example, in *Rubenstein,* minority shareholders sued controlling directors and officers of a closely held corporation, individually and derivatively, concerning the mismanagement of the corporation. Prior to winding down and dissolving the corporation, the shareholders voted to sell all of the assets of the corporation and distribute the proceeds among the shareholders on a pro rata basis. The shareholders alleged misconduct resulting from the sale and distribution, including breaches of fiduciary duties owed to the shareholders and owed to the company.

The trial court dismissed the direct conversion claim, finding that the allegations related to corporate funds and therefore the claim belonged to the corporation—not the individual shareholders. The court denied the motion to dismiss the derivative claims, holding that the plaintiffs had sufficiently pleaded claims for breach of fiduciary duty, misappropriation, waste, and conversion on behalf of the company and sufficiently pleaded futility of demand to the board.

Post-Dissolution Lawsuits and Claims

Lawsuits may be filed and served against a dissolved corporation whether the claim arose before or after dissolution. See e.g., *In re RegO Co.*, 623 A.2d 92, 95 (Del. Ch. 1992). The corporation may remain liable to the extent of its undistributed assets or available insurance. The power of a dissolved company to defend and prosecute claims continues as necessary to wind up its affairs. Shareholders may be liable for claims against dissolved corporations whether arising before or after dissolution.

In general, the shareholders of dissolved companies do not cease to exist as shareholders and continue to have responsibilities of shareholders for the dissolved company. Their liability for post-dissolution claims is typically limited in two ways: amount and duration. In Delaware, for example, shareholder liability is limited to the pro rata share of the claim or amount distributed to shareholder, whichever is less. 8 Del. C. 1953, § 282(a). A shareholder may not be liable for any claim against the corporation on which an action, suit or proceeding is not commenced prior to three years from the date of dissolution or the expiration date of its own limitations, whichever is earlier. 8 Del. C. 1953, §§ 278, 282(b). Additionally, "the aggregate liability of any stockholder of a dissolved corporation for claims against the dissolved corporation shall not exceed the amount distributed to such stockholder in dissolution." 8 Del. C. 1953, § 282(c).

Similarly, in California, shareholders' liability is limited to the amount recoverable and the duration of the liability. Cal. Corp. Code, § 2011 (a)(1)(B), (a)(2). Specifically, liability extends to the amount of a shareholder's distributed assets or their pro rata share of the claim, whichever is less. As to the duration, liability extends to the expiration of the statute of limitations, or four years after the effective date of the dissolution of corporation, whichever is earlier. In New York, however, shareholder liability post-dissolution extends further than a shareholder's pro rata share and because New York laws do not provide a statute of limitations for breach of fiduciary duty of claims, the applicable period depends on the substantive remedy sought by the petitioner. NY Bus Corp L § 1006.

Safe-Harbor Provisions and Receiverships

In Delaware, there are safe harbor and non-safe harbor dissolution procedures. 8 Del. C. §§ 280-81(a), 281(b). The non-safe harbor process is generally the least expensive and most efficient way for a company to dissolve. In the non-safe harbor process, there is no court oversight and the company liquidates its remaining assets and adopts the plan for dissolution and distribution. However, the non-safe harbor process does not insulate shareholders, officers and directors from liability.

The safe harbor process involves court oversight and provides shareholders, officers, and directors with some liability protection. For example, in Delaware a company must petition the Delaware Court of Chancery to approve its proposed reserve for contingent and unknown claims. If the court approves the reserve, any contingent and future claimants may only look to the reserve for the satisfaction of their claims. Directors and officers cannot incur any personal liability, and shareholder liability shall not exceed the amount distributed to the shareholder under the plan.

Under either procedure, a company may also petition the court to appoint a receiver to manage the company's assets during the dissolution process. The receiver steps in the shoes of the company's management to manage and liquidate the assets. Under this process, the officers and directors have additional protection from shareholder and derivative litigation for any claims for breach of fiduciary duty.

Tax Considerations

Careful attention needs to be paid to the tax consequences of dissolution as well. Appropriate amounts should be set aside to cover any known tax liabilities of the company and to pay for preparing and filing any tax returns that are due post-dissolution. Directors and officers face potential personal liability for so-called "trust fund" taxes of the company, such as employment taxes withheld from employees' pay and sales taxes withheld from customers. See 26 U.S.C.A. § 6672(a).

Generally, U.S. shareholders of a dissolved corporation will recognize gain or loss depending upon the cash they receive and their tax basis in the shares of the dissolved corporation. If the stock has been held for more than 12 months, the gain will generally be a capital gain (subject to favorable federal tax rates in the case of individuals) or a capital loss (which would be subject to restrictions on deductibility). Different results could occur in the case of certain shareholders, such as non-U.S. shareholders and shareholders that do not hold the stock as a capital asset. And finally, in the case of "flow through" entities such as Subchapter S corporations, partnerships, and limited liability companies, the tax results can vary widely among the shareholders/partners/members depending upon such items as prior losses, tax basis, cancellation of indebtedness income and negative capital accounts.

Conclusion

In this uncertain economic time, corporate dissolution can be a cost effective and efficient path to winding down a company short of bankruptcy. However, the potential for liability during this process and dealing with existing or threatened litigation must be considered and anticipated to avoid further complications. A thorough understanding of the corporate dissolution laws of the relevant jurisdiction is essential in navigating these hurdles and achieving the best result possible.