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The Illinois Legislature overcorrected Section 12.56(f) of the Illinois Business Corporation Act's forced buy-out provision for close corporations

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Introduction

In 2005, a little-noticed amendment to the Illinois Business Corporation Act dramatically weakened the election remedy set out in 805 ILCS 5/12.56(f), preventing a shareholder of a closely held corporation, sued in a derivative lawsuit, from forcing a buy-out of plaintiff's shares. Section 12.56(f) was amended so that the election remedy—where the defendant can elect to purchase all of the plaintiff's shares for fair value—is now applicable only if the plaintiff first asks for a buy-out of his shares. Prior to the 2005 amendment, a defendant could force a buy-out of the plaintiff's shares when the plaintiff filed an action seeking any relief afforded in § 12.56. In order to once again give force to § 12.56(f), that provision needs to be re-amended to allow the defendant to petition to purchase plaintiff's shares where the plaintiff's derivative action

seeks the appointment of a custodian or a receiver or seeks dissolution of the closely held corporation.

The Overall Structure of § 12.56

Illinois generally is considered a pro-shareholder state. Murdock, Charles W., "Squeeze-Outs, Freeze-Outs, and Discounts: Why is Illinois in the Minority in Protecting Shareholder Interests?," 35 Loy. U. Chi. L.J. 737, 737 (Spring 2004). The Business Corporation Act of 1983 provides a shareholder and the court with various remedies in derivative actions involving a closely held corporation. Specifically, 805 ILCS 5/12.56 identifies various forms of relief that a court may order in an action where there is deadlock, oppression, or the corporate assets are being wasted or misapplied. 805 ILCS 5/12.56(a) (West 2007). Those items of enumerated relief include:

- (1) The performance, prohibition, alteration, or setting aside of any action of the corporation or of its shareholders, directors, or officers or of any other party to the proceedings;
- (2) The cancellation or alteration of any provision in the corporation's articles of incorporation or by-laws;
- (3) The removal from office of any director or officer;
- (4) The appointment of any individual as a director or officer;
- (5) An accounting with respect to any

matter in dispute;

- (6) The appointment of a custodian to manage the business and affairs of the corporation to serve for the time and under the conditions prescribed by the court;
- (7) The appointment of a provisional director to serve for the term and under the conditions prescribed by the court;
- (8) The submission of the dispute to mediation or other forms of non-binding alternative dispute resolution;
- (9) The payment of dividends;
- (10) The award of damages to any aggrieved party;
- (11) The purchase by the corporation or one or more other shareholders of all, but not less than all, of the shares of the petitioning shareholder for their fair value and on the terms determined under subsection (e); or
- (12) The dissolution of the corporation if the court determines that no remedy specified in subdivisions (1) through (11) or other alternative remedy is sufficient to resolve the matters in dispute. . . .

805 ILCS 5/12.56(b) (West 2007).

These provisions of § 12.56(b) were once aptly described by a jurist as a "tool box" of remedies available to the court in a closely held corporation shareholder dispute. The remedies,

IN THIS ISSUE

- The Illinois Legislature overcorrected Section 12.56(f) of the Illinois Business Corporation Act's forced buy-out provision for close corporations 1

however, are not exclusive of other legal or equitable remedies that a court may impose. 805 ILCS 5/12.56(c) (West 2007).

Section 12.56(f) Prior to the 2005 Amendment

Prior to the 2005 amendment, § 12.56(f) provided as follows:

At any time within 90 days after the filing of the petition under this Section, or at such time determined by the court to be equitable, the corporation or one or more shareholders may elect to purchase all, but not less than all, of the shares owned by the petitioning shareholder for their fair value. An election pursuant to this Section shall state in writing the amount which the electing party will pay for the shares.

805 ILCS 5/12.56(f) (West 2004).

Thus, pursuant to the former version of that subsection, a defendant in a shareholder dispute of a closely held corporation could force a buy-out of the plaintiff's shares when the plaintiff had initiated an action under § 12.56, irrespective of the relief that the plaintiff had requested.

2005 Amendment to § 12.56(f)

The 2005 amendment, however, eliminated the ability of a defendant to cause a buy-out, except when the plaintiff first seeks a buy-out in the complaint. Effective August 1, 2005, the following words were added at the beginning of the provision: "When the relief requested by the petition includes the purchase of the petitioner's shares. . . ." P.A. 94-395 (S.B. 533). Accordingly, the amendment made clear that a forced buy-out can only occur when the plaintiff specifically requests a buy-out of his shares in the complaint.

Under both versions, the electing shareholder must indicate the amount by which he is willing to pay for the shares (805 ILCS 5/12.56(f) (West 2004 & 2007)), or a formula by which that amount can be readily determined. *Midkiff v. Gingrich*, 355 Ill. App. 3d 857, 824 N.E.2d 1144 (5th Dist 2005). If the parties cannot reach an agreement as to the shares' fair value, the court may upon motion of any party, stay the proceeding to determine the fair value. 805 ILCS 5/12.56(f)(6) (West 2004 & 2007).

One practitioner has posited that the purpose for the 2005 amendment was to prevent absurd results that could have occurred under the old version. An example would be if a plaintiff sought an accounting pursuant to § 12.56(b)(5), a defendant could have defeated the complaining shareholder's statutory rights by electing to purchase the plaintiff's shares. The practitioner concluded that the 2005 amendment could have been a response to the potential, drastic remedy of a forced buy-out when a shareholder asks for relatively benign relief. See Jenkins, David M., "The Election Remedy Under Section 12.56 of the Illinois Business Corporations Act Has Been Destroyed as an Effective Defense in Shareholder Oppression Suits or Corporate Dissolution Proceedings," 18 D.C.B.A. Brief 14, 16 (January 2006). It should be noted, however, that none of the reported cases applying the pre-2005 version of § 12.56(f) illustrate any such troublesome factual situation. See *Midkiff v. Gingrich*, 355 Ill. App. 3d 857, 824 N.E.2d 1144 (5th Dist. 2005); *Witters v. Hicks*, 338 Ill. App. 3d 751, 790 N.E.2d 5 (5th Dist. 2003) and 335 Ill. App. 3d 435, 780 N.E.2d 713 (5th Dist. 2002); *Advanced Images Center of Northern Illinois Ltd. Partnership v. Cassidy*, 335 Ill. App. 3d 746, 781 N.E.2d 664 (2nd Dist. 2002); and *Hamlin v. Harbaugh*, 324 Ill. App. 3d 612, 755 N.E.2d 993 (3rd Dist. 2001). Thus, the 2005 amendment could have been an attempt to correct an anticipated but not realized failing of § 12.56(f).

Effect of the Amendment on Closely Held Corporation Shareholder Dispute

Since the 2005 amendment, there have not been any reported cases applying § 12.56(f). A case in my practice, however, has illustrated the downside of the 2005 amendment of this provision. I represent a 50 percent shareholder of a close corporation, sued derivatively by the other 50 percent shareholder. The petitioning shareholder sought, among other things, removal of the defendant as an officer and director; an accounting; the appointment of a receiver to manage the company's affairs; and the appointment of a provisional directors, all of which are relief that a court may order under § 12.56(b). The plaintiff, however, did not ask for his shares to be bought

out.

At the time suit was filed, the plaintiff was no longer an officer, director, or employee of the corporation, and was not involved in the day-to-day running of the corporation. The corporation itself was in troubled financial condition, and my client was interested in seeking "investors" or purchasers of the corporation to provide the needed infusion of capital for the corporation's continued existence.

The subtext of the lawsuit was that the personal relationship between the plaintiff and defendant had disintegrated, leaving only discord and mistrust. The group of potential investors assembled by my client quite naturally demanded as a condition of their participation that the plaintiff sell his shares, which would have rid the corporation of him and deprived him of standing to prosecute his derivative claims. Thus, the lawsuit would have gone by the wayside. The plaintiff, however, refused to entertain any offer for his shares.

Had the version of §12.56(f) prior to the amendment been in existence, the defendant could have made an offer to purchase plaintiff's shares within 90 days after plaintiff filed the derivative action. If the parties themselves were unable to agree on a purchase price, the court would have stayed the derivative lawsuit to determine the fair value of plaintiff's shares. Once the sale was effectuated, my client then would have had the ability to negotiate with the purchasers/investors so they could take the corporation forward.

However, because the lawsuit was filed after the 2005 amendment to § 12.56(f), the defendant did not have any ability to force a buy-out of plaintiff's shares. No agreement was ever amicably reached regarding the purchase of plaintiff's shares, the investors faded out of the picture, and the corporation languished. The only tool that would have afforded my client the ability to potentially save the corporation was the prior version of § 12.56(f). The 2005 amendment prevented my client from utilizing the buy-out provision because the plaintiff did not make a buy-out request in his complaint.

Recommendation for Remodification to § 12.56(f)

In order to resurrect § 12.56(f) and protect against absurd results where

a forced buy-out follows a harmless request for relief, § 12.56 should be amended to afford a defendant in a close corporation the ability to request a buy-out when the plaintiff seeks the appointment of a custodian or receiver pursuant to common law or the Illinois Business Corporation Act (see, e.g., 805 ILCS 5/12.56(b)(6) and 12.60 (West 2007)), or seeks dissolution of the closely held corporation. Specifically, I recommended that §12.56(f) again be re-amended as follows:

(f) When the relief requested by the petition includes *the appointment of a custodian or receiver to manage the business and affairs of the corporation pursuant to the common law or other provisions of this Business Corporation Act, or dissolution of the corporation*, then at any time within 90 days after the filing of the petition under this Section, or at such time determined by the court to be equitable, the corporation or one or more shareholders may elect to purchase all, but not less than all, of the shares owned by the petitioning shareholder for their fair value. An election pursuant to this Section shall state in writing the amount which the electing party will pay for the shares.

(Proposed language in italics).

When plaintiff seeks the appointment of a custodian or receiver or seeks dissolution, the plaintiff makes clear that he is not interested in maintaining further control over the corporation or that he is not interested in the corporation going forward. In those instances, the relief requested by the plaintiff, if granted, would have a drastic effect on the corporate entity, as contrasted with benign relief, such as submitting a dispute to alternative dispute resolution, the payment of dividends, or a request for an accounting. Accordingly, a re-amendment to § 12.56, where a buy-out would be available when the plaintiff seeks the appointment of a custodian or receiver or seeks to dissolve the corporation, would again give weight to that subsection and prevent a drastic result when relatively innocuous relief is requested by the complaining shareholder.

Triggering a forced buy-out when a plaintiff seeks dissolution is consistent with the purpose of the legislature's enactment of the original version of § 12.56(f), which was to give the nonpetitioning shareholder the option of filing a notice of election to avoid the harsh remedy of corporate dissolution. *Midkiff v. Gingrich*, 355 Ill. App. 3d 857, 862, 824 N.E.2d 1144, 1149. See also Quinlan, William R. and Kennedy, John F., "The Rights and Remedies of Shareholders in Closely Held Corporations Under Illinois Law," 29 Loy U.Chi. L.J. 585, 613 (Spring 1998) (§ 12.56 was enacted to increase the remedies available to minority shareholders and to enlarge the discretionary authority of the circuit courts to award relief in situations which do not warrant dissolution but which do warrant some other, less severe remedy). The statutes of Minnesota, California, and New York (and likely others) allow a forced buy-out in a closely held corporation as a lesser alternative to dissolution. Minn. Stat. § 302A.751(2) (West 2007); Cal. Corp. Code § 2000(a) (West 2007); N.Y. Bus. Corp. Law § 1118(a) (West 2007).

Such an additional amendment to § 12.56(f) would make the Illinois closely held corporation shareholder statute consistent with but stronger than those of Minnesota, California, and New York. Specifically, in those states, the buy-out is a specifically enumerated option in lieu of dissolution. The proposed revision would make the Illinois statute "stronger" because it would also apply to situations in which a custodian or receiver is sought by the complaining shareholder, which remedies themselves have been identified as "extraordinary and drastic." *Witters v. Hicks*, 335 Ill. App. 3d at 440, 780 N.E.2d at 718. In sum, the proposed correction to § 12.56 would parallel the original purposes behind the enactment of the election provision, which is to afford the nonpetitioning shareholder the option of filing a notice of election when faced with a drastic request for relief.

It should be noted that § 12.56(f) is not the only provision of Illinois' closely held corporation statute that relates to a purchase of the complaining petitioner's shares. Section 12.56(b)(1), contained in the "tool box" of rem-

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OFFICE

Illinois Bar Center
424 S. 2nd Street
Springfield, IL 62701

Phones: (217) 525-1760 OR 800-252-8908

Web site: www.isba.org

Editor

William T. Kaplan
111 N. Ottawa
P.O. Box 943
Joliet, IL 60434-0943

Managing Editor/Production

Katie Underwood
kunderwood@isba.org

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edies, specifically contemplates that a court could order the corporation or a shareholder to purchase plaintiff's shares. 805 ILCS § 12.56(b)(11) (West 2007). In addition, the "catch-all" provision of § 12.56(b) also arguably allows a court, on its own initiative, to order a buy-out short of dissolution. Section 12.56(b)(12) provides that the relief that a court may order includes, "[t]he dissolution of the corporation if the court determines that no remedy specified in subdivisions (1) through (11) or other alternative remedy is sufficient to resolve the matters in dispute. . . ." 805 ILCS 5/12.56(b)(12) (West 2007) (emphasis added). Arguably, an "other alternative remedy" that a court may consider before determining to dissolve a closely held corporation could include a buy-out of the complaining shareholder. See *Witters v. Hicks*, 338 Ill. App. 3d at 758, 790 N.E.2d at 511-12 (5th Dist 2003) (reporting that the chancery court had consid-

ered a buy-out of one shareholder by the others as an "alternative remedy" under § 12.56 prior to the order of dissolution, in addition to evaluating a shareholder-requested buy-out under § 12.56(f); however, the chancery court had correctly determined that the one shareholder's request for a § 12.56(f) buy-out was not timely), citing *Witters v. Hicks*, 335 Ill. App. 3d at 445, 780 N.E.2d at 722.

Nevertheless, there is no deadline on the court's action in those circumstances, and in reality, it is likely that such a remedy would only be forthcoming, if at all, after significant time and energy is spent by both sides respectively prosecuting and defending the derivative suit. A modification, such as proposed above, would afford the defendant the ability to force the buy-out within 90 days of the complaint's filing, without waiting for the court to do so and without expending extensive time and money in defend-

ing the derivative charges.

Conclusion

In the case example above, if the proposed re-revision to § 12.56(f) had been enacted, within 90 days after the plaintiff filed his complaint seeking the appointment of a custodian, the defendant could have forced a buy-out of plaintiff's shares. Significant time, energy, and personal resources spent in defending the lawsuit would have been saved, allowing the defendant to focus on a buy-out and then the investors. As the statute stands today, however, a defendant's hands are tied in forcing a buy-out unless the plaintiff first requests a buy-out in the complaint. Under §§ 12.56(b)(11) and (b)(12), a court may order a buy-out, but in those instances the remedy would likely be too little, too late. To again bring teeth to the buy-out provision, § 12.56(f) needs to be amended.



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