



New Jersey Appellate Court Holds Shareholder in Closely-Held Corporation Cannot Bring Direct Claims Against Only Other Shareholder for Alleged Mismanagement, but Can for Breach of Shareholder Agreement

Publication:

Riker Danzig Banking and Corporate Client Alert December 13, 2018

In a decision approved for publication, New Jersey's Appellate Division provides an important reminder as to the crucial distinction between direct and derivative claims in shareholder actions. Specifically, in Tully v. Mirz, the Appellate Division held that one of two shareholders of a closely-held corporation could not bring a direct action against the other shareholder for the other shareholder's alleged mismanagement of the corporation and conversion of corporate funds, but that he had the right to bring direct claims for the other shareholder's alleged breach of contract and breach of the covenant of good faith and fair dealing. See Tully v. Mirz, 2018 WL 6204908 (N.J. Super. Ct. App. Div. Nov. 29, 2018). The facts are as follows.

In 2005, plaintiff and defendant formed Interstate Fire Protection, Inc. ("IFP") and were IFP's only shareholders. In 2009, plaintiff and defendant allegedly entered into a written agreement stating they were equally responsible for IFP's liabilities "unless the losses are occasioned by the willful neglect or default, and not the mere mistake or error, of any of the parties." IFP defaulted on a line-of-credit loan with TD Bank in 2015. In April 2016, TD Bank obtained a \$530,687.40 judgment against IFP and the guarantors on the loan, including plaintiff, defendant, and another company owned by plaintiff. Plaintiff later settled with TD Bank on behalf of himself and his company, and TD Bank released them from the judgment in exchange for a payment of \$300,000. Defendant and IFP remained

liable to TD Bank.

In 2016, plaintiff brought this action against defendant on his own behalf alleging, among other things, that he loaned money to IFP that has not been repaid, that defendant mismanaged IFP, and that defendant converted IFP's funds for personal use. Based on these allegations, plaintiff pled six counts: breach of fiduciary trust (Count One); breach of contract relating to the 2009 agreement (Count Two); mismanagement (Count Three); breach of the covenant of good faith and fair dealing relating to the 2009 agreement (Count Four); conversion (Count Five); and fraud (Count Six). After trial, the trial court dismissed the action for lack of standing, finding that the action was brought improperly as a direct action when it should have been brought as a derivative action on behalf of IFP. It stated: "Although this Court does have the discretion to treat Plaintiff's claim as a direct action since IFP was a closely held corporation, the fact that IFP has creditors who are still seeking recovery from IFP funds precludes Plaintiff's recovery as an individual."

On appeal, the Court affirmed in part and reversed in part. The Court first found that a court has discretion to construe a derivative claim as a direct claim for closely-held corporations so long as it will not "(i) unfairly expose the corporation or the defendants to a multiplicity of actions, (ii) materially prejudice the interests of creditors of the corporation, or (iii) interfere with a fair distribution of the recovery among all interested persons." Here, because plaintiff and defendant were the only shareholders, the Court was concerned only with whether construing these claims as direct claims would materially prejudice the rights of IFP's creditors. Finding that the record did not allow it to determine whether construing these derivative claims as direct would prejudice IFP's creditors, the Court affirmed the trial court's decision and dismissed Counts One (breach of fiduciary trust), Three (mismanagement), Five (conversion), and Six (fraud), all of which "concern IFP's assets and operations rather than plaintiff as an individual." Nonetheless, the Court reversed the trial court on Counts Two (breach of contract) and Four (breach of the covenant of good faith and fair dealing). In doing so, it held that these claims were direct because plaintiff, and not IFP, was the party to the 2009 contract at issue and that plaintiff therefore had the right to bring the claims directly.

This decision is of note for creditors and owners of closely-held companies in reinforcing who has standing to bring certain claims against a company's principals and when principals may sue each other.

For a copy of the decision, please contact Michael O'Donnell at modonnell@riker.com, Michael Crowley at mcrowley@riker.com, or Dylan Goetsch at dgoetsch@riker.com.

Attorneys:

Michael R. O'Donnell · Michael Crowley · Dylan C. Goetsch

Practices:

Financial Services · Corporate Law · Real Estate Law

Headquarters Plaza, One Speedwell Avenue, Morristown, New Jersey 07962-1981 • t: 973.538.0800 f: 973.538.1984

50 West State Street, Suite 1010, Trenton, New Jersey 08608-1220 • t: 609.396.2121 f: 609.396.4578

500 Fifth Avenue, New York, New York 10110 • t: 212.302.6574 f: 212.302.6628

399 Knollwood Road, Suite 201, White Plains, NY 10603 • t: 914.539.3360 f: 914.539.3361

1200 Summer Street, Suite 201C, Stamford, CT 06905 • t: 203.326.6740 f: 914.539.3361

www.riker.com