

Appointment of a Provisional Director as a Remedy for Deadlock in a Closely-Held Corporation

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Closely-held businesses may face issues of corporate deadlock where control of the business is evenly divided between two owners or two different factions of owners, especially where the owners are also family members. This can often happen after control of a business passes from the founding generation to their children or grandchildren. Yet if the business is still profitable despite the deadlock between the owners, the traditional remedies of an appointment of a custodian or dissolution of the business are typically inappropriate. The appointment of a provisional director—an underutilized and often misunderstood remedy—provides a solution whereby the deadlock can be broken without disrupting the corporation’s day-to-day business.

What Is a Provisional Director?

A provisional director is a neutral third party who is appointed to a corporation’s board of directors for the sole purpose of breaking a stalemate where there are an even number of directors on a board. The provisional director must be a third party who is neither a shareholder

or creditor of the company, nor a relative of an owner, officer, or director, in order to ensure her impartiality. A provisional director has the same rights and powers as an ordinary director of the corporation and does not have the heightened powers of a custodian or receiver to control the company on her own. Instead, the provisional director essentially acts as a tie-breaking director on a board, providing an unofficial “mediating” function between the other directors by participating in board meetings where issues are analyzed. Typically, a provisional director is appointed to decide a particular issue or issues, as specified in the court’s order of appointment. After informing herself about the issue or issues upon which the board is deadlocked, she may cast a vote along with the other directors, creating a majority vote in support of one course of action, at which time her service as a provisional director is no longer needed.

In General, What Can a Court Do to Remedy Deadlock?

Appointment of a provisional director is just one potential remedy for corporate deadlock. Under the Pennsylvania Business Corporation Law (the BCL), a court has various explicit statutory powers to remedy a deadlock. It has the power to dissolve a corporation where “the directors are deadlocked in the direction of the management of the business and affairs of the corporation and the shareholders are unable to break the deadlock and that irreparable injury to the corporation is being suffered or is threatened by reason thereof.” Similar statutes also explicitly authorize a court to appoint a custodian or a receiver as a remedy for deadlock.

Although there is some fluidity in how these terms are used, a custodian is generally a third party who is appointed to run a business in lieu of the

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board of directors, whereas a receiver is a third party who is appointed to liquidate the business. All these remedies for deadlock are extreme measures that either completely end the company's corporate existence or take the corporation's business out of the hands of the owners and give it to a third party.



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Pennsylvania courts, however, have broad equitable powers over companies incorporated in this state, meaning that their authority to alleviate deadlock is not limited to the remedies prescribed by statute. Where the statutory requirements for dissolution are met, Pennsylvania courts have used their equitable powers over the internal affairs of corporations to apply less severe remedies for deadlock where appropriate, such as a forced buy-out of one party's shares in the company. As one court reasoned, "the BCL specifically authorizes the remedies of appointment of custodian or receiver and dissolution ... that the BCL would authorize the court to grant such drastic relief, but forbid the court from affording milder equitable remedies, would make no sense." The Delaware courts, which Pennsylvania courts look to for guidance on issues of corporate governance, similarly support application of a lesser equitable remedy where appropriate, such as appointment of a provisional director, even where not explicitly authorized by statute. Therefore, the "milder" equitable remedy of judicial appointment of a provisional director is permissible relief for deadlock.

Additionally, if your company is registered as a statutory close corporation under Pennsylvania law, Section 2334 of the BCL provides specific statutory authority for the court to appoint a provisional director "if the directors are so divided respecting the management of the business and affairs of the corporation that the votes required for action by the board of directors cannot be obtained with the consequence that the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally."

This provision applies only to Pennsylvania corporations who have affirmatively elected statutory close corporation status in their articles of incorporation.

When Is Appointment of a Provisional Director an Appropriate Remedy to Seek?

Appointment of a provisional director is an appropriate remedy where the corporation is financially successful despite the deadlock between the directors. It makes little sense to seek the dissolution of a successful company where deadlocked, even if that is an available remedy, as that would end the business and put people out of work. Similarly, seeking the appointment of a custodian is also often inappropriate where the business is thriving despite corporate deadlock. Appointment of a custodian is highly disruptive to the business, as the custodian supplants the board of directors in managing the company. Appointment of a custodian may also cause creditors or customers to panic that the business is on the verge of insolvency or is otherwise troubled. Instead, appointment of a provisional director for the limited purpose of resolving the deadlock allows the existing managers and directors to continue managing the business without creating the outward appearance of corporate disarray.

It should be noted that appointment of a provisional director is not an appropriate remedy for a company where the owners are so fundamentally divided on every issue that the provisional director (and the Court that appointed the provisional director) would be permanently enmeshed in the governance of the company. In that situation, a forced buy-out of one party's shares in the company is likely a preferable remedy.

Can the Shareholders Agree to the Appointment of a Provisional Director?

If you are forming a new corporation or limited liability company for a closely-held business, particularly one where the ownership will be divided equally between two individuals or two families, it is a good idea to include a provision authorizing the appointment of a provisional director in the event of corporate deadlock in the bylaws or operating agreement. That way, in the event of later disagreement, the company already has agreed to an effective procedure to end the deadlock, and the shareholders do not run the risk that a disgruntled owner may seek the company's dissolution in the event of deadlock. The BCL specifically directs courts to uphold such provisional director agreements, and not to grant the more drastic relief of dissolution or appointment of a receiver or a custodian if the shareholders have agreed to appointment of a provisional director instead. Although a court would likely enforce a later-authorized agreement to appoint a provisional director, it is a better idea to have it in place before the parties are at an impasse and emotions are running high. If the owners of your company agree to a detailed provisional director procedure in advance, you may be able to avoid litigation altogether in the event of deadlock.

Conclusion

If your closely-held business faces issues of corporate deadlock, but is an otherwise profitable enterprise, you should consider seeking judicial appointment of a provisional director, which is an available equitable remedy under Pennsylvania law. Similarly, if you are an interest holder in a business where ownership is divided evenly between two factions, it is to your benefit to develop a provisional director agreement before any

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issues arise, in order to avoid the risk that an unhappy owner seeks dissolution of the company or another drastic remedy for deadlock.

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