Inspection Rights of Employee Stockholders

To retain valuable employees without expending a lot of money, business owners often reward employees with stock in the company. The thinking goes, 'If the employee shares in the success of the company, the employee will stay and work hard for the company.' There are significant compromises, however, that the business owner makes upon transferring stock to an employee.

The case of *Pagett v. Westport Precision, Inc.*, provides such an example. Joseph Greco, the majority shareholder of Westport Precision, fired Pagett for self-dealing in the company products to the company's disadvantage. Pagett brought suit claiming that he was fired from his executive position because he complained about smoking in the workplace. Pagett held 20% of the stock of the company. Pagett brought a second suit requesting all company financial statements, income tax returns, ledgers, profit/loss statements, bank account statements, and balance sheets of the business from the time he became a shareholder. He also asked for any documentation of distributions or payments of corporate moneys to shareholders. At the time of trial, the company's assets were also up for sale.

As a minority shareholder in a closely-held corporation, Pagett testified that he had not received any financial reports since the termination of his employment and had requested the documents to assess the value of his shares in the company. Westport Precision denied the request because it was in the middle of employment litigation with Pagett.

Section 33-946 of the Connecticut General Statutes allows a shareholder to inspect accounting records as long as a written request is submitted five days in advance, it occurs at a location that the company designates, the shareholder's demand is made in good faith and for a proper purpose, the shareholder describes with reasonable particularly his purpose and the records he desires, and the records are directly connected with the shareholder's purpose. The right of inspection granted by this section cannot be abolished or limited by a corporation's certificate of incorporation or bylaws. In effect, Westport Precision's argument was that Pagett's suit claiming wrongful termination made the statute inapplicable to Pagett's request.

The court noted that the commentary from the Model Business Corporation Act indicates that a desire to determine the value of shares, to communicate with fellow shareholders, or to determine whether improper transactions occurred constitutes a "proper purpose." Because Pagett sought corporate records to apprise himself of the value of his shares, he stated a proper purpose. The court also ruled that a single valid purpose is enough, and also that the shareholder does not have to state specifically why he wants to value the stock. The court recognized that the parties were engaged in a lawsuit involving Pagett's firing, but found no evidence of a bad faith reason underlying Pagett's request to inspect financial records.

The court also ruled that the documents were directly connected to Pagett's stated purpose. The company's accountant admitted that to value Pagett's stock an appraisal of the company was needed. An appraiser would have to analyze the same documents that Pagett requested. With the company up for sale, Pagett had a right to determine the value of his shares. The court ruled that Westport Precision violated the law when it denied Pagett access to the documents requested.

Not only was Westport Precision ordered to allow Pagett to inspect the documents, the court ordered it to pay Pagett's attorneys fees and costs to obtain the order. Section 33-948 states that the corporation must pay the shareholder's costs of seeking corporate records, including reasonable attorneys' fees, unless the corporation had a reasonable basis for doubt about the shareholder's right to inspect the records demanded. Greco testified that he relied on his attorneys' advice in denying access to the company records because the company was in litigation with Pagett. But no testimony was offered from the company's attorneys that they advised against denying Pagett access to company records. Consequently, the Appellate Court remanded the case to the trial court to determine the amount of attorneys fees the company owes Pagett.

Lessons Learned from Pagett v. Westport Precision, Inc.

Giving stock to employees means giving up some control of the company. If the company needs to terminate the shareholder-employee, the employee may delve into company records for a proper reason, even if doing so also gives him other negotiating leverage for the sale of shares. In hindsight, Westport Precision may have avoided this problem if Pagett had signed an agreement when he received his shares stating that upon termination he will tender his shares back to the company for a price unrelated to the value of the business. As an alternative to giving company stock to a key employee, it may make more sense to reward employees with bonuses. Yes, that requires some cash outlay. But if the employee's work has truly helped the business make money, the cash should be there. Consider using additional vacation time if the company does not have sufficient cash flow. Finally, well-run retirement plans with many investment options can give key employees an incentive to stay, especially if the business owner matches a certain percent of employee contributions.

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