PARTNERSHIP DISPUTES AKA "BUSINESS DIVORCE"

I. Business Disputes as "Partnership Disputes" and "Business Divorce."

Regardless of the form of business, i.e. whether it is a corporation, or limited liability company or general partnership, the business owners are both colloquially, and often at law, referred to as "partners." Disputes between and among the business owners are referred to as "partnership disputes." And where the dispute leads to separation of ownership, then the matter is often called a "business divorce." In fact business owner disputes can have many of the same kinds of transactions and occurrences ("acting out") that a personal divorce does, e.g. the wrongful seizure of space, money or property.

II. Causes of Partnership Disputes and Business Divorce.

Partnership disputes can occur for a number of reasons, including lack of money, false expectations, personality conflicts, or differences of style and vision. Where the company was founded by one majority owner, often that founder can be so dominant in terms of operational control that the practical and legal rights of other owners, even of significant owners, can be ignored.[1] This is particularly bound to occur where the minority owners come later in the company growth curve. The problem with "founder dominance" is that (1) it may ignore and violate the rights of the other owners to be informed and have input into company governance and (2) it may result in a "sole proprietor" (i.e. single owner) management style being imposed on, say, a $5,000,000.00 company. More than once I have seen a company experience rapid growth from virtually nothing only to implode internally due to the lack of policies, procedures and job descriptions (i.e. standard operating procedures) which are essential if the company is going to continue its upward projectory. For one thing the lack of policies and procedures encourages cronyism, which in turn causes

[1] This is what I call the "mini-van" problem. The founder is in the driver's seat; everyone else is in the back.

resentment for favoritism and, again, the lack of input by parties who are affected by the decision but were not given the chance to provide input before the decision was made.

III. Operating, "Shareholder's" or Buy-Sell Agreements.

In the event of a partnership dispute, especially one leading to a business divorce, where an owner is leaving the company, it is good to have an agreement that tells the parties what happens in that event. Continuing the marriage analogy, the purpose of this agreement is to serve as a "business prenuptial." It sets forth the events which will, or can, trigger a buy-out of the departing owner's ownership interest in the business, the price or method to determine the price, and the terms upon which payment of the purchase price can be made. Buy-outs may occur in the event of divorce where the departing spouse agrees in advance to sell his or her shares to the company and/or to other owners. This rids the company of an angry and often non-productive spouse and the spouse gets money in return for the interest.

Buy-sell provisions like the above can be in the Operating Agreement of a limited liability company ("LLC"), a "Shareholders' Agreement" among the owners of a corporation, or in a document simply entitled the "Buy-Sell" Agreement. Often death events are funded by insurance; non-death events may be funded by payment terms written into the agreement.

Obviously, one major issue for a buy-out is the price. Often "buy-sell agreements call for the price to be determined annually (does not happen) or by appraisal (a lawsuit waiting to happen). Sometimes the buy-out occurs according to an "earn out" where the departing owner receives what he or she would have received as a dividend or distribution on his or her interest for and over a certain time period, say five-to-seven years. Even where imperfect the Buy-Sell Agreement is instrumental in avoiding some major problems which can occur without it.

IV. Business Divorce in the Absence of a “Buy-Sell” Agreement.

The key point to know here is that, absent the “business pre-nuptial” or some agreement to buy, as discussed above, neither the company nor the remaining owners have any duty to buy out the ownership interest of a departing “partner.” This means that a year or more can be spent operating under one or both of the following scenarios: The angry “ex-spouse” or the “free ride.”

A. The Angry Spouse. “Angry ex-wife” (or “ex-husband”) describes the scenario where the departing owner has no offer to buy his or her shares, so must proceed by making the company and its owners so miserable that they want to buy his or her shares. This can be done by reminding the company through legal counsel that until the buy-out occurs, the partner is still an owner of the company (they are still “married”); thus, by statute (and case law in Arizona) the absent owner has a legal right to all of the company’s books and records and to a “seat at the table” for major business decisions. And, of course, not working in the business every day the “newly departed, but still alive” partner (hereinafter “departed partner”) wants to have regular meetings and feedback. Psychologically, this is hard on the remaining owners who want to forget the one who’s gone and run the business. So, this is a strategy to be bought out.

B. The Free Ride. In this situation the departed owner is not necessarily confrontational but rather can simply remind the company and remaining owners that, until he or she is bought out, then the departed partner is still an owner of the company. And, as with the value of any other investment, the value of that interest does not depend on the owner being there, but on the appreciation in the value of the shares of stock, or membership interest, caused by the time and efforts of the remaining owners. In short the one who has left may actually or in effect announce that “I’m going to Tahiti for five years. I’ll check in on the value of my ownership interest when I get back. (Thank you very much.).”

This scenario is about as bad on the non-confrontational side as the "ex-spouse" confrontational approach was on the other. And, as stated, the approaches are not necessarily mutually exclusive. The departed one may be on the beach while his or he attorneys keep the former partners busy with requests for information, etc. So, while the company and its remaining owners have no duty to buy out the departing partner they often do to avoid these outcomes.

V. Legal Claims.

One could write a book about the legal claims that surround business divorce. The claims, among others, include breach of contract, "squeeze out," and sometimes conversion (civil theft) of assets. A breach of contract claim would occur where, for example, one was fired from company employment without cause or in some other manner not in conformance with the company agreements.

"Squeeze out" refers to the situation where an owner, usually a minority owner, invests in the business with the anticipation of owning, having management input and drawing a salary from the company but the owner finds him- or her-self with little or no input into the company operations and usually without employment. Often all or most of this owner's net worth is invested in the company. And, in many cases having been a victim of this scheme the wronged party has no financial means to afford the attorneys to right the wrong.

But a corporate squeeze out is a form of breach of fiduciary duty and a fiduciary duty is the highest duty imposed at law; it is the duty of highest loyalty, honesty and trustworthiness. And, each partner of a business owes the others this duty. Where it is breached punitive damages may be awarded.

Conversely, because the departed owner is still an owner until a court or a purchase and/or settlement agreement says he or she is not, the departed partner may not work for a competitor until the buy-out occurs. This is one reason for the "ex-spouse" stratagem discussed above. So, not only may the departing owner have a breach fiduciary duty claim against

the company and its remaining owners but also the company may have a claim against the one who has left. The rationale is that one cannot be "married" to the company and cheat. In this regard corporate law is more "prudish" than domestic relations law.

A conversion claim may occur where one owner makes a grab for company property, like the funds in the bank account. This would be a crime as well. But in many states, like Arizona, the police or other law enforcement officials typically will not handle claims where the party has a "civil remedy;" that is, can hire his or her own lawyer and sue.

VI. Great Frustrations.

The interplay between the wrongful conduct and legal claims in the partnership dispute and business divorce situation can be maddening to the client. For example, some questions and answers:

A. "Does the fact the business is "blowing off" or "stonewalling" the departed partner by being totally non-responsive, say, to a request for a buyout and at a fair price or to establish a procedure for determining same, allow the "departed partner" to compete by starting his or her own company or working for a competitor? *

Answer, probably not. Even on these facts the competing partner still owes a fiduciary duty to the company, even if he was kicked out of the company. In general the fiduciary duty would prohibit any kind of "disloyal" behavior, like working in the industry in the territory. (There may be counter-arguments for wrong-doing by the company, but the essential point here is that there are no clear answers, everything is an issue, and arguing and negotiating the legal issues costs time and money.) This provides the company with the opportunity to act with impunity, subject to the hassle of the ex spouse scenario or unpalatability of the freed ride.

* Of course, if there is a duty to buy under a buy-sell agreement, then the situation might be managed to come out differently. Still, you would start with a situation of offsetting claims and no clear, risk-free course of action.

B. If the departing partner “acts out” by taking money, computers, equipment or client files (collectively, “misconduct”) does the business still have to buy out the departed partner to turn the partner into an ex-partner?

Answer, probably yes. The purchase price might be reduced, especially if there is a buy-sell agreement which contemplates a reduction in price for misconduct. But the partner who has left may be able to sue for specific performance and seek summary judgment (i.e. earlier judgment without trial) to enforce the duty to buy under a buy-sell agreement while the company’s claim for conversion (civil theft) and misconduct might have to go to trial, which could be six-nine months later (all claims do not have to be adjudicated at once).

If the departing partner uses the client files to solicit clients, then the company may be able to obtain a restraining order to prevent that.

C. If the departed partner engaged in misconduct and is stonewalling the company in response to buy-out offers may the company simply dissolve the company and pay the ex-partner his or her share of the proceeds?

Answer, probably not. Courts will generally not dissolve a profitable company. (One reason for this is that the liquidation value of a company – i.e. basically an asset sale of tables and chairs, etc -- may be one/tenth the price of the company as an operating company. (Think of a company with a million dollars in sales with $40,000 in hard assets) So, in that case an action for a judicial dissolution will typically fail. The remedy is buy-out, which of course the company has already tried to do.

D. Can the company not even file for judicial dissolution (which is a court lawsuit) but unilaterally dissolve by just filling out the paperwork at the Corporation Commission (takes about five minutes)?

Answer. No. The reason why not depends on the ownership stake of the departed partner and any governing documents. But, in the common case of 50/50 owners the answer is “No” because there is deadlock. And, both in that 50/50 ownership case and even where the departed partner is

a minority owner, the answer is No, not without facing substantial legal claims (for damages and punitive damages). The majority owners owe a fiduciary duty to the departed minority owner, and assets or revenues into a new company would be fraudulent transfer, etc. Thus, the company would face compensatory damages equal to the ex-partners share of the new company plus punitive damages for doing the liquidation and starting over.

VII. Conclusion.

These are just some of the joys associated with a business break up in Arizona. The best way to deal with a partnership dispute or business divorce is to contemplate and prepare for it in advance – like, say, Donald Trump might with his wives – by using a business “pre-nuptial.” (More than that, choose your future “business spouse” wisely because, to quote the song, “Breaking up Is Hard to Do.”)

With or without the buy-sell agreement in place I counsel my clients, and remind the other side, that there are two ways to handle a business divorce: the relatively short, easy way or the long, hard way. The short, easier way is to agree on a method to proceed: For example, a buy-out with a neutral appraiser used to determine purchase price and a negotiation of the payment terms.

The long way is to go through litigation; that is, pleadings, experts, depositions and other manifestations of Hell on earth. This process may be more thorough but, as implied, between angry ex-partners it can be as emotionally draining, time-consuming and expensive as a hostile personal divorce. Sometimes the two (personal and business divorce) go together. Be thankful if that is not you.