The Business Divorce

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A Painful Experience

One of the most painful events any business owner can experience is a "business divorce." What is this? It's when partners split up, a key partner dies or leaves on less than cordial terms, or perhaps even when a partner leaves and takes the company's confidential and proprietary information. [1] Most people who have been through one of these experiences will agree that it was just like a matrimonial divorce, only without the china and silverware.

As with a matrimonial divorce, a business divorce can be rife with acrimony, egos, emotions, accusations, and expensive and protracted litigation. Often at the conclusion of the business divorce, when the collective balance sheet is tallied up, the divided parts equal far less than the pre-divorce whole.

No matter how well documented the partner's business relationship is, a business divorce can still be nasty and expensive. Partners look for loopholes in the buy-sell agreement,[2] they assert that key provisions are ambiguous, claim financial irregularities, and the richer partner tries to overbear the financially weaker partner. Sometimes partners attempt to destabilize or divert relationships with important third parties in order to ramp up the pressure on the other side. And these actions are frequently undertaken with no strategic plan in mind.

The Challenge

Even the most well-drafted agreement is sometimes not enough to prevent strife. But all practitioners will agree that without an effective agreement and barring the rare occurrence of a cordial business split-up, the partners can expect the worst in a business divorce.

So how can this worst-case scenario be eliminated or ameliorated before the fact? With a thoughtful, well-drafted agreement that clearly addresses all of the inflection points of the partners' business relationship and accounts for all of the predictable "life events" in a company's existence. And whether an agreement exists or not, what are the key issues that should be addressed to make the business divorce as painless as possible?

Let's look first at the agreement. While some lawyers say that any written agreement is better than no agreement at all, this is not true in all cases. With no agreement, the parties will default to the applicable provisions of the California Corporations Code. [3] Although there are provisions in the Code that can spring some nasty surprises (see, e.g., Code § 1670(i), which requires suit to be filed no later than 120 days after an inadequate buyout amount has been tendered in cash to the withdrawing partner), the statutory law at least furnishes an outline of the parties' rights and obligations and deadlines for certain actions. Some of the Code provisions do not provide absolute precision—for instance, Code § 16701 (buyout of a dissociated partner) requires a valuation without getting into great detail about how the valuation will be conducted. But even in such instances, there is enough case authority to provide guidance to the parties.

A bad agreement, on the other hand, can be a disaster in a business divorce. Poorly drafted provisions can inject uncertainty into negotiations and in any ensuing litigation. An ambiguous buyout provision, for example, can itself be the root cause of a fatal division among the partners, and lead to litigation because conflicting interpretations may leave one side with no practical alternative to accepting what he perceives to be an unfair result. [4]

An agreement for a limited liability company partnership or Subchapter S corporation may have no gross-up or minimum distribution provisions for taxes on distributable income, resulting in the partners having to pay tax on money they never receive. Buyout trigger concepts like "disability" may be poorly defined, which can leave in place a key partner who is no longer able to contribute to the business. An agreement may omit a "bad acts" trigger and as a result, a disruptive partner can remain in the business and the partners have no way to expel him short of an extortionate payment, dissolution, or other unattractive option. A recurring defect in agreements is a provision that specifies the buyout price to be the partner's percentage share of the adjusted "book value" of the company. The agreement often requires this amount to be determined every year on the anniversary of the agreement. But, the subject is often never addressed again after the agreement is signed.

Considering the significance of the agreement—protection of the entity, protection of the remaining partner(s), and a predictable outcome for all involved—lawyers continue to marvel at the frequency with which they encounter poorly drafted agreements.

The Key Provisions

Does all of this mean that the agreement must be a work of art in order for it to be an effective tool in a business divorce and a deterrent to mischief? No, it does not. But, as noted above, there are certain "inflection points" that should be addressed in the agreement and drafted with clarity and precision. Some key points follow:

Control Features: The partners should be clear about governance of the company. Especially in companies with an even number of partners, an agreement with no mechanism for surmounting a deadlock is a recipe for expensive disputes. A deadlock breaking mechanism can also be critical if one partner dies or becomes disabled and the other partner now has a new "partner"—a conservator, trustee, executor, or administrator. A deadlock breaking feature can take several forms. One mechanism is an optional buyout if the deadlock cannot be remedied through negotiation. Without a deadlock breaking provision, the partners can be left with simmering animosities, which impact the health of the company. The absence of such a provision can also lead to a court petition to appoint a tie-breaking director (effectively making the court a new business partner) or a dissolution, which can lead to the company's assets yielding less than they are worth as a going concern and surprising tax liabilities.

Estate Planning Provisions: Many agreements contain a provision that permits the company or the other partners to buy a deceased partner's interest in the company. These same agreements also permit a partner to transfer his or her interest to an estate planning vehicle, such as a living trust, where the trustee then effectively becomes the partner. What happens when the partner who transferred his interest to a trust dies? There is often no compulsory sale of "his" shares because the trustee who became the new partner has not "died." The company is then left with a shareholder or partner who is a mere stakeholder and plays no productive role in the company. Hence, care must be taken to connect all of the dots in an agreement's estate planning provisions.

Buy-Out Triggers. Death and disability are the obvious triggers and routinely appear in agreements. But these two triggers may not be enough. What about a partner's divorce or bankruptcy? What if the partner is charged with or convicted of a moral turpitude felony? What happens if the partner is also an employee and is not performing? The latter trigger—poor performance—is frequently omitted from agreements, in part, because it is an unpleasant subject and also can be very difficult to craft with enough precision to give the provision the requisite bite. The company can fire the partner/employee but is stuck with him as a stakeholder, where the other partners continue to owe him fiduciary duties and must respond to inspection rights if they are asserted. Whatever the reason, it is the lawyer's job to explain the consequence of not including all appropriate buyout triggers in an agreement.

Valuation and Payment Mechanisms: There are any number of valuation methodologies, including adjusted book value, a fixed price, a formula, and fair market valuation with a discount for lack of control or illiquidity. Why is it then that valuation causes so many problems? Sometimes, it is because the mechanism adopted provides a patently unfair or unworkable result. In other cases, the valuation provision is ambiguous or vague. Sometimes the parties do not foresee that the company may not have enough cash to effect the buyout in one lump sum or is prohibited from doing so by Code § 500 (limiting distributions to stockholders), and the parties did not include a provision for a cash down payment and a promissory note or some other mechanism for adjusting payment terms based on the financial condition of the company. Partners also need to address funding mechanisms other than the company's cash flow, such as life insurance, which if purchased early enough in the company's life when the partners are young(er), can be a cost effective way to provide for the purchase of a deceased partner's interest. Attention also should be paid to who will foot the expense of the valuation process, which can be costly. Too often, only cursory thought is given to the valuation and payment provisions. When considering what kind of provision to use, it is always a good idea to "dry run" various scenarios to make sure the provision that is chosen actually works seamlessly in practice and is suitable for all concerned.

Protection from Former Owners: Partners often overlook the need to protect the company from a partner once he or she is expelled from the company. It surprises business owners to discover that when a partner is bought out or pushed out and he is paid a pre-negotiated (fair) value for his interest, he can compete with the company in the absence of an effective non-competition provision. The absence of a post-buyout competition restriction can be ruinous for the company when the expelled partner is a skilled operative and may have the ability to quickly start a competing business or contribute his expertise to an existing competitor. While Business & Professions Code § 16600 *et seq.* generally prohibits any agreement that restricts a person from engaging in a lawful trade or business, it does not prohibit a non-competition provision in an agreement when attached to the buyout of all of a partner's interest in an entity.

Remedies: Many agreements have no dispute resolution provisions, and those that do either have a short "standard" arbitration provision or a provision that requires all disputes to be resolved in superior court. This shortsighted drafting can often have the effect of pushing the partners into litigation when they should be

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talking. Worse, many partners do not fully understand the consequence of an arbitration provision and the finality of that dispute resolution mechanism. It often comes as a shock that mandatory arbitration of claims with uncertain but potentially high value and unpredictable outcomes will not be subject to appeal. And as popular as arbitration may be, partners typically do not appreciate that alternative dispute resolutions may not furnish timely access to equitable remedies such as temporary restraining orders and preliminary injunctions. Hence, more thought should be given to longer form alternative dispute resolution provisions that are crafted with the specific issues of a business divorce in mind, including even judicial references, which permit a private trial with retired judge and still afford the parties the right to appeal.

Spousal Consents: Despite the impact of community property laws, agreements often have no spousal consents. Such agreements produce interesting consequences in marital dissolution cases when the partner's spouse claims that the agreement is unfair or is a breach of the partner's fiduciary duty to his spouse. The absence of a spousal consent can destabilize an agreement, and the partners' relationship and can be an invitation to the family court to scrutinize the agreement and order actions the partners never agreed to. In today's world, where almost 50% of all marriages end in divorce, the partners cannot ignore the importance of getting written spousal concurrence to the terms of the agreement.

When the Business Divorce is Imminent

Whether or not there is an agreement, what should a partner do if a "business divorce" is imminent? Several steps are advised:

Consult an experienced attorney. While this is a predictable recommendation coming from a lawyer, it is a fact that partners can do a lot of damage on their own without suitable guidance from a lawyer who understands business disputes. And in the world of business divorces, not all lawyers are created equal. Very much like in a family law divorce, the business divorce lawyer must command or have access to a variety of skills—knowledge of contract law, familiarity with the Code, access to sound tax advice, knowledge of competition law and, as important as all the rest, the ability to endure the emotional rollercoaster that a business divorce often becomes. The ability to endure the stress of a business divorce is a key component of the business divorce lawyer's skill set. Without it, the lawyer often will find himself reacting to emotions instead of to the issues and hence risk losing command of what can be a complex legal process.

Become re-acquainted with the agreement, if there is one, and provide a copy to the lawyer. We continue to be surprised by clients who have not read or will not closely read the agreement. Without the partners educating themselves, the lawyer's advice can lack context. Too often, the partner will persist in demanding certain things that are either barred by or not provided for in the agreement. A realistic grasp of the agreement is essential for the partner-lawyer team to be effective in a business divorce. Some lawyers periodically remind their clients to review the agreement and consider whether any changes are appropriate. It may be assumed, for instance, that an agreement entered into in 1976 when the partners were in their 30s may benefit from some adjustments in 2009 when the partners are in their 60s and 70s.

Know where key business documents are and get copies of them. So often, when asked for an essential company agreement a partner will say, "I don't have it." The lawyer then spends an inordinate amount of time trying to assemble documents that the partner should already have or have access to. Sometimes, the partner will tell his lawyer that documents exist but, for whatever reason, they are not important. Worse yet, without the key documents, the lawyer risks taking positions that are undermined by the missing documents and is hobbled from responding appropriately to the other side.

If there is an agreement, determine whether you, your partner, or both of you are in compliance or in breach. In a business divorce, three kinds of arguments are usually made - legal, equitable, and emotional. However strong the emotional overlay may be, attention must be paid to whether your client is in breach of the agreement. For example, a partner may assert that his co-partner has breached a fiduciary duty, only to be told by the other side that he has been in persistent breach of the performance standards in the agreement. Not knowing if you are in compliance with the agreement is a sure way to lose leverage in a business divorce.

Be aware of tax issues. Particularly in alternative business entities such as limited liability companies and partnerships, significant tax issues can arise. A partner's threat to withdraw from the company is all well and good as a strategic threat. But, for example, if he has a significant negative capital account, he will have a recapture tax liability he may not have anticipated. Threatening to dissolve the company might be a good strategy in some cases. But the parties need to know that dissolution could generate significant capital gains liability if there are valuable assets that will be sold or distributed to the partners.

Be aware of the impact on third parties. A business divorce can be an event of default if a loan agreement contains a covenant relating to or prohibiting material changes in ownership of the company. Likewise, vendors and customers may grow concerned about the stability of the company and its ability to fulfill its obligations if its resources and those of the partners are focused on their internal dispute. Partners need to think very carefully about how an escalation of hostilities will impact the actions and views of key outside business relationships.

Carefully consider the consequences of litigation. Like matrimonial divorces litigating a business divorce can be very costly. The usual standards for estimating litigation expense seem to fall apart in the face of a business divorce lawsuit, which can encompass complex legal and factual issues and emotional pressures that lead the parties to take extreme and hard-ball positions. Too often, partners find themselves hurtling toward a full-blown lawsuit when something short of that might be sufficient. For all entity forms, the Code confers various inspection rights, and these should be considered before filing a lawsuit that could swamp the business. Partners also frequently ignore an inevitable development when they end up in litigation and the court, a receiver or tie-breaking director appointed by the court, or the arbitrator becomes their new business partner. Every action or omission of a partner can be subject to the scrutiny of the court or arbitrator. Control of the business can be lost or reduced as a result of the litigation. A courtroom is not the recommended venue for partners to be accusing each other of tax and other legal irregularities. Most courts will have little tolerance with partners bickering over a diversion of pencils by a partner and the predictable related claim that this theft of key company assets is a fiduciary breach.

Conclusion

Making a business divorce palatable is probably impossible. The name itself implies dispute. There is, however, no question that a well-crafted agreement can take much of the pain out of a business divorce. To achieve a suitable agreement, nothing works better than a structured approach to dealing with all of the company's key "life events" and running various scenarios through the draft agreement to make sure the document works and satisfies the partners' expectations. And when a business divorce is imminent, taking a few rudimentary steps can lay the groundwork for a smoother and less costly dispute resolution process. ■

Endnotes

1 For purposes of simplicity, the term "partner" is intended to refer generically to a partner, shareholder, and member.

2 A buy-sell agreement, shareholders agreement, and operating agreement are generically referred to in this article as an "agreement."

3 All references herein to the "Code" shall mean the California Corporations Code unless specifically noted otherwise.

4 Probably the only instances where any agreement may be better than none is when a partner dies, divorces, or files bankruptcy. In such case, even an unrefined buyout provision is better than having a "new partner" in the form of a deceased partner's spouse or estate, with all of the potential governance, valuation, and buyout complications.

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each constituent partnership into interests or securities of the surviving partnership or other business entity.[38]

iii. Required Filings

In mergers involving only California partnerships, or a California partnership and a foreign business entity other than a partnership, the surviving partnership *may*, but is not required to, file a statement of merger with the California Secretary of State. A surviving partnership may want to file a statement of merger to provide public notice of the merger. Additionally, a surviving partnership should file a statement of merger if it had previously filed any statements of partnership authority because the filing of a statement of merger has the effect of filing a cancellation of any statement of partnership authority.[39] The approved form for the statement of merger is Form GP-6, which is available on the California Secretary of State's website.[40] The approved form must be completed with the requisite statutory information.[41]

In all other mergers involving a partnership and other business entity in California, the parties *must* file a certificate of merger with the California Secretary of State after approval of the merger.[42] The approved form for the certificate of merger in California is Form OBE MERGER-1, which is available on the California Secretary of State's website.[43] The approved form must be completed with the requisite statutory information.[44]

If the surviving entity is a California corporation or a foreign corporation in a merger in which a California corporation is a constituent party, the surviving corporation *must* file with the California Secretary of State a copy of the merger agreement and attachments as required under California Corporations Code section 1113(g)(1).[45]