College of Commercial Arbitrators

Arbitrating the Business Divorce of The Closely Held Company

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(1) *Overview*

In the United States today, privately owned businesses are a major sector of the economy. They exist in many forms, including sole proprietorships, partnerships, corporations, and limited liability companies (LLCs), and range from start-ups in emerging fields to mature, decades-old enterprises in established industries. Although a single entrepreneur may own and operate a business, this paper addresses arbitration of the "business divorce:" claims and disputes typically arise in a privately held business with at least two owners, leading to termination of the disputants' relationship. As will be discussed, arbitration is a uniquely effective vehicle to resolve claims among members of such businesses because it offers privacy, efficiency of information exchange among the parties, adjudicators with expertise in the industry or subject matter at issue, and relative speed to conclude the proceedings as compared with traditional court litigation.

Regardless of the entity's legal form, the relationship of owners of a closely held business is essentially a partnership.[1] Just as marriages are partnerships between two spouses in which lesser or greater levels of conflict inevitably occur, so are the relationships of closely held business owners. Their business conflicts may arise from such stressors as diverging visions for the company's direction; disputes about further investment of resources, financial or otherwise; imbalance of power between the parties; disagreements over management; decisions and actions by a partner that others consider a betrayal; and/or interpersonal relationships that interfere with the business. Such conflicts breed distrust, and business operations may become dysfunctional or experience constant disruption as a result. When partnerships include or consist of family members, interpersonal dynamics and issues unrelated to the business add complexities to the business disputes.

When partners cannot resolve conflicts themselves or with minimal third party involvement, the conflicts may lead to legal claims and counterclaims that can signal – as in a marital dissolution – "irreconcilable differences" resulting in an "irremediable breakdown"[2] of the relationship. In such cases the parties have exhausted all options and continuing in business together is no longer viable.

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[1] For simplicity, owners in closely held businesses may be referred to as "partners" in this paper notwithstanding the usual titles associated with the legal form of the business (*e.g.*, "members" for LLCs, "stockholders" or "shareholders" for corporations).

[2] "Irreconcilable differences" and "irremediable breakdown" are terms used in California's no-fault divorce statutes (Cal. Family Code §§ 2310(a), 2311), and are similar to formulations of the same concept in other states' divorce laws.

At least one party wants a complete termination of the relationship. Legal proceedings for the business divorce follow, often in arbitration.[3]

2. *Formation of Closely Held Businesses*

The form of entity of a closely held business is determined at the outset, although owners may change entity forms as the business' needs evolve or additional owners are brought in. Many new businesses are started by two or more individuals allocating their ownership interests based on relative contributions of money and/or expertise. Entrepreneurial businesses frequently are formed by a "know how partner" who has technical expertise and contributes "sweat equity" with little or no initial monetary investment, joined by a "money partner" who invests the initial capital but participates to a lesser extent, if at all, in operations. They may receive equal shares or another allocation despite the different natures of their contributions. The disparity in contributions, both initially and over time, may give rise (among other reasons) to conflicts leading to a business divorce.

Individuals may also form partnerships to invest in a business opportunity in which they will not be actively engaged, with the enterprise managed by a third party. In such businesses conflicts may arise due to the company's poor performance or lack of return on the investment, distrust of management, and illiquidity of interests and/or restrictive transfer requirements, that make exit by unhappy owners difficult.

Family-owned businesses, often started by a single member or by a family unit (*e.g.*, spouses, siblings, or a parent and child), may continue into the second, third and even later generations. The founders may plan such expansion for the extended family's future economic security; to provide employment and training in a field for other family members; and to serve as the founders' legacy and passing down of values. The founders may include bringing additional family members in as part of an estate plan to pass the business to the next generation or other relatives while the founders are still living. Family members brought in later as owners may or may not make their own capital contributions, and may not have the passion of the founders or even any interest to actively participate in the business. In other words, such family members may not have "skin in the game" financially or emotionally. Issues in such enterprises that lead to business divorce may arise from disagreements over the new partners' level of participation, commitment of time and resources, talents and abilities (or lack thereof) to meet the demands of the business, and conflicts arising from relationships apart from the business. Family issues may involve sibling rivalries, parents favoring one child over others for roles or greater shares in the business, spouse's ambitions or demands, and

[3] Business divorces may also result from circumstances that do not involve one partner's demand to terminate the relationship. Examples include voluntary mutual agreements to dissolve amicably; involuntary or forced situations, such as insolvency; or a need to liquidate because the business purpose of the company has been met or is no longer viable. These circumstances are not discussed in this paper.

in-law perspectives. Such factors all may contribute to dissension and eventually result in a business divorce of the family enterprise.

3. *Typical Scenarios Leading To A Business Divorce*

The issues that can cause the business divorce and land the parties in arbitration are often grounded in the company's formation. As discussed above, closely held businesses may differ with respect to their nature and degree of initial contributions, continuing obligation to capitalize the company, and restrictions on transferability and/or ability to cash out one's interest. Disputes are often exacerbated by these factors, especially lack of liquidity and possible difficulty in valuing an interest in the business to buy out an unhappy partner.

Not infrequently, founders prepare barebones agreements without the benefit of counsel. In such circumstances, and even with agreements drafted with attorney assistance, conflicts can arise from ambiguity or lack of specific terms on critical issues, including decision-making authority; disagreements about management; succession issues, especially in family-owned businesses; and other issues the parties did not address at the outset. Lack of specificity or omissions on critical points concerning core business operations often gives rise to contention in the business over time, leading to ruptures in the relationship.

As in marriages, fact patterns leading to business divorces are as varied and unique as the individuals and types of businesses involved. Below are a few fact scenarios that illustrate some types of circumstances that can precipitate a business divorce.

(a) *Founder Disenchantment*: Two founders of a manufacturing business with equal equity had a vision for the business' core competencies, product development growth, and branding. The governing documents did not specify expectations for participation in the business or for further capital contributions. Both partners' agreement was required for management decisions. The business failed to thrive after modest initial success. The partners could not agree on its future direction, including whether to borrow additional capital or bring in outside investors, and blamed each other for the business not realizing its potential. At impasse, one partner demanded termination of the relationship. The business was cash poor and the partners disagreed about a buyout price or terms. Both asserted mismanagement and breach of fiduciary duty claims against the other.

(b) *Management Disputes and Minority Owner's Lack of Power*: The founder of an incorporated communications business managed it for 30 years. As part of their estate planning, he and his wife began to gift equal shares of its stock to their son and daughter, with the intent that they eventually would have 50-50 ownership. The founder's succession plan was for the son to take over the management, but the son insisted on a controlling equity interest in order to effectively manage. Therefore the son was gifted 60% of the stock, with the daughter receiving 40% and other assets to equalize the gifting value at the time. With the subsequent explosion in communication technology, the business grew tremendously, in part by the son's reinvestment of all profits into its further development. His sister complained that the company never issued dividends, so that she had no personal return on her holding while he drew a generous salary. She started questioning many transactions and day-to-day operations, and asserted claims against her brother for breach of fiduciary duty, negligent management, majority shareholder oppression, fraud and conversion of corporate assets. She also sought to dissolve the company.

(c) *Misappropriation of Corporate Opportunity*: Three individuals were managing members of an LLC they formed to enter into certain transactions pursuant to a government-sponsored program. From the outset, they operated by consensus. After the business failed to close certain potential transactions, , two managers ousted the third, who handled day-to-day operations, from all management responsibilities under the LLC operating agreement. The two formed a new company and closed one of the LLC's prior opportunities. On his later discovery of this event, the ousted manager claimed breach of contract, breach of fiduciary duty, misappropriation of corporate opportunity, conversion, unfair competition and other claims, and sought a receivership.

(d) *Outdated Buyout Provisions*: An individual started and operated a successful commercial wholesale food business, initially as a sole proprietor. He later formed an LLC and brought his three married sons into the business with equal membership upon his death. The LLC agreement, prepared decades earlier, required buyout of the interest of a deceased member's spouse at book value over a lengthy time period and at a below market interest rate. At the time of the first son's death, the company had substantially expanded and diversified into new markets and its fair market value far exceeded its book value. The widow refused to accept book value under the agreements, challenging the enforceability of the buyout provisions and also asserting mismanagement and breach of fiduciary duty claims against the other two sons.

(e) *Challenging Management Decisions and Transactions*: Two individuals formed a partnership to exploit oil and gas development opportunities. Their partnership agreement provided that they were co-managers and all decisions had to be jointly made. One partner, a petroleum engineer, was successful in developing and selling sites. The other partner had little background in the field, but provided almost all of the capital and personal guaranties. As the business grew the latter complained that the engineer had effectively frozen him out by making deals without consultation, that the deals were disadvantageous to the partnership, and that the engineer violated the co-management clause. He asserted breach of contract and breach of fiduciary duty claims while seeking to wind up the company.

(f) *Valuation Disputes*: Founders of an emerging technology company included a put provision for buyout of a founder after a fixed number of years if the company had not been sold or gone public by then. When one founder exercised the put, disputes arose about interpretation of the appraisal process and formula in the governing documents, with widely divergent valuations by the parties' competing appraisers. Claims to enforce the buyout provisions were met with counterclaims for theft of trade secrets, unfair competition and other business torts.

(g) *Manager Removal*: A real estate development partnership agreement was entered into between two partners (one an LLC and the capital partner, and the other a husband and wife). It provided for the husband, an experienced developer, to be the initial manager, responsible for developing the property and serving without compensation. It also required cause for his removal. The husband died before the project was completed, and the wife became the successor manager. The capital partner later removed her as manager without cause, which precipitated an arbitration claim for alleged wrongful removal and for interpretation of the agreement as to the cause requirement, as well as counterclaims to dissolve the partnership.

4. *Legal Issues In Dispute In A Business Divorce*

As the above scenarios illustrate, many disputes are triggered by events that involve different values and expectations in a business in which the partners have invested heavily, not only financially but through work, commitment to the business, emotional bonds, and often family ties. A business divorce that ensues in arbitration is driven by the determination of one or more of the partners to terminate the relationship as a result of a precipitating event or the erosion over time of the relationship.

The scenarios above also illustrate recurring themes in the claims asserted in a business divorce arbitration. Because partners, LLC managers, and majority shareholders owe a fiduciary duty to the other owners, breach of fiduciary duty claims are common. Such claims also often involve torts such as negligence in management; fraud or negligent misrepresentation; conversion of the business' property; self-dealing; misappropriation of an opportunity, a trade secret, or confidential information belonging to the business; or unfair competition based on the same set of facts. Claims concerning interpretation of the governing documents and the parties' rights, usually seeking declaratory relief, and/or claims for breaches of contractual terms also are prevalent in the business divorce.

Claims in the business divorce where the harm is to the company (as in misappropriation of its property or corporate opportunity, or damages alleged as a result of a disfavored transaction) are derivative and need to be brought in the name of and for the benefit of the company. Depending on applicable law, such derivative claims may require pre-claim demand on the respondent parties or demonstration that such demand would be futile. Other claims may be direct claims where the alleged harm is to the partner, such as a dispute over the buyout price or whether contractual conditions have been met to allow a purchase.

5. *Advantages Of And Issues In Arbitrating The Business Divorce*

Once the business divorce has commenced, how and in what forum it gets resolved is usually controlled by the entity's governing documents and/or pertinent statutes. Many closely held businesses include arbitration clauses in their governing documents (sometimes also preceded by required negotiation or mediation steps). Even without such a clause, the parties may agree to arbitrate their claims after a dispute arises rather than proceed with traditional court litigation. Arbitration provides a uniquely advantageous forum to resolve a business divorce among owners for several reasons, including the ability to select an arbitrator with expertise, privacy and confidentiality, streamlined discovery, and an expeditious process to address whether all necessary parties are included in order to afford the relief sought.

(a) Arbitrator Expertise

As noted above, closely held companies may be in any industry or field of endeavor. Where the products or services offered are technical, or accounting or valuation issues dominate the resolution of the dispute, trying the case before an arbitrator or panel with expertise in those areas may be highly advantageous over having a judge or jury decide such issues. Arbitrators may offer the parties a flexible, phased, or streamlined adjudicatory process suitable to efficient resolution because the process lends itself to adaptation more readily than court litigation. The learning curve for selected arbitrators with subject expertise also generally is far less steep than that typically needed to educate a judge or jury, leading to time-saving efficiencies in case presentation.

(b) Privacy And Confidentiality

Just as the nature of the partnership is private, the dispute may revolve around sensitive interpersonal issues as well as confidential business matters. A principal advantage of arbitrating a business divorce, rather than suing in court, is keeping the dispute out of the public domain. This may be especially important to the owners when the dispute concerns transactions with third parties (*e.g.*, suppliers, licensees), management issues, misappropriation claims, and other issues demonstrating internal or external weaknesses. In such instances, the privacy of arbitration may protect the business and its owners from harm by exposing such issues to competitors or other third parties who potentially could take advantage of matters disclosed in public pleadings.

(c) Discovery in the Arbitrated Business Divorce

One of the frequently cited benefits of arbitration is the ability to limit and control pre-hearing discovery costs, as compared with traditional court litigation. Because owners of a closely held business often already have had access to books and records, and generally have statutory rights to review them on reasonable notice, financial discovery of the company's condition or particular transactions may often be streamlined. Information critical to resolution, such as the financial records, projections and business plans, typically is already accessible to the partners. Their information exchange, therefore, often starts from a common base and may be expedited in arbitration, compared to discovery in litigation. From the outset, an arbitrator can work with counsel to limit other document requests and e-discovery to issues that are material, rather than the traditional discovery approach in court that often casts an overly wide net at greater expense with less return of material information.

(d) The Right Parties

Arbitration of disputes among owners of closely held companies often raises the issue of whether the right parties are joined. For example, questions arise when non-signatories to the arbitration agreement are named as respondents or seek to join as claimants. Questions also arise about whether the company itself is either properly or necessarily a party to the arbitration. Arbitrators can address and manage those issues efficiently without the lengthy motion practice required in court proceedings, to ensure that the parties are proceeding in a manner that allows adjudication with the right participants, or, if some non-parties cannot be joined, to proceed with full understanding of the corresponding limitations as to the relief sought.

6. *Drafting Arbitration Clauses For Closely Held Companies*

Drafting an arbitration agreement for a closely held business requires consideration of parameters suitable to the business and its partners. A preliminary consideration is whether a step clause would be appropriate, to require mediation first (possibly preceded by required direct party negotiation). Given that such businesses often are owned by people who know each other well, and may be family members, a structured opportunity for consensual resolution of disputes may preserve the parties' relationship and obviate the need for a formal assertion of claims.

The drafter should be aware of and consider any related or ancillary agreements affecting the business that might be involved in a future dispute, and seek consistency among them as to arbitration issues. For example, partners may lease real property, make loans, or grant intellectual property licenses to the business, all either individually or through other businesses they also own. The business may also enter into consulting or employment agreements with partners. If agreements memorializing such arrangements are made contemporaneously, or even later, and lack an arbitration clause or have one with materially different terms, disputes about the scope of any arbitration may ensue. While it is a fact-driven determination, drafters should be aware that the courts have sometimes found that significant disparities among arbitration clauses in related agreements result in there being no meeting of the minds and therefore no enforceable arbitration agreement – a result a drafter can avoid by paying close attention to these matters.

The drafter must also consider the parties to be bound by the arbitration agreement. Most commonly the signatories are binding themselves to arbitrate. Inclusion of their successors and assigns should be explicit, and provision should be made for binding partners who subsequently join the company. An important issue that is often overlooked is binding the entity itself to the arbitration. If the claims to be arbitrated could include derivative claims on the company's behalf or require relief that the company must give, the company is a necessary party. To avoid disputes over such issues, an arbitration clause should express the signatories' intent that the company is also bound to arbitrate. Because arbitration is a matter of contract, the drafter needs to be precise in describing the scope of the matters to be arbitrated. Typical formulations involve language such as any claim or dispute "arising out of" or "relating to" the agreement, including matters concerning breach, enforcement, interpretation, and validity. A clause for a particular closely held business may adopt other specific inclusive language for types of matters that are anticipated to arise, or exceptions may be sought to be carved out.

The drafter should be specific as to what substantive law applies, which in most instances will be the state in which the business was formed. If, however, the business has most of its operations in another state, consideration should be given to selecting that forum's laws to govern. The drafter also should specify the place the arbitration should be conducted, considering the location of most of the parties and other people essential to the business (*e.g.*, the company's accountants) in a likely intra-company dispute.

The drafter should also consider whether it is desirable to specify the credentials or experience that an arbitrator should have. For example, in a real estate partnership, where disputes concerning valuation of properties may be at issue, the drafter may want to specify that the arbitrator should be an appraiser or an attorney with a specified number of years practicing real property law. If the business has intellectual property as its main asset, then specifying an arbitrator with expertise in the particular type of such property may be desirable.

7. *Conclusion*

A business divorce is usually a highly contentious dispute fraught with complex factual and legal issues, often with an overlay of high emotional content. Arbitration is well-suited as a means of adjudication to get the parties' dispute resolved in a comparatively private, flexible, cost-effective and efficient process compared to court litigation. Drafters of agreements between closely held business owners and counsel advising disputants in such businesses should consider the advantageous aspects of resolving disputes through arbitration in counseling their clients.

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