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INSIGHT: A Litigator's Guide to Avoiding Lawsuits Between Owners of Closely-Held Companies

BY ERIC FISHMAN AND MATTHEW BARKAN

We are litigators. If you own a closely-held company—perhaps as a shareholder of a start-up corporation, or a member of a limited liability company or a partner in a limited partnership—you hope never to require our services, because that would mean you are in a dispute, and likely a dispute with the other owners of your company. These internal disputes are among the most difficult, in large part because they are personal. Your childhood friend, your longtime business partner, or your relative instantly becomes your adversary. These entrenched, often emotional, disagreements frequently lead to lawsuits, financial hardship, and fractured relationships. As litigators, we see this story play out all too often.

The good news is that with proper planning, a great majority of these disputes need not progress to the point of litigation. We have drawn from our experience litigating a wide variety of shareholder actions to identify common issues that typically lead to clashes, as well as to identify actions that every owner should take at the outset of the business venture (or even later) to avoid a lawsuit.

Anticipation of Disagreements Before Launching the Venture is Crucial Most lawsuits between business owners arise from a common set of issues. Most often, disputes arise from disagreements surrounding an owner's ability to take a particular corporate action. In other instances, an owner determined to protect its investment may challenge the distribution of dividends, the dilution of his or her interest by other owners, or the incurrence of corporate debt. Disputes may also arise from a perceived lack of transparency, and a feeling that one partner is hiding key information from the others.

The first—and best—time to head off these disputes is prior to formation of the company.

Soon-to-be partners should engage in detailed planning not only for obvious big-ticket items such as their vision for the venture, initial capitalization, and amount of ownership percentage among the members, but they should also broach the fundamental issue of day-to-day management of the company. For example, will any single partner have managerial control, or will management be by majority of the partners? Some decisions, such as whether to borrow funds, sell assets, or change fundamental aspects of the business, may be too intrinsically important to be left to a simple majority. Partners should identify such decisions early and consider whether a supermajority—or even unanimous approval—should be required to enact them.

Another contingency for which co-owners should plan is a deadlock in voting on any managerial decision. A deadlock invariably leads to disagreement and, often times, the only way to break a deadlock is by court-ordered dissolution of the company. Thus, giving due consideration to the possibility of a deadlock before it arises will pay dividends later. There are several potential solutions. In one example, partners could first be required to attempt in good faith to work out an agreement over a specified minimum period of time. In another example, the shareholder with the largest ownership percentage could be empowered to break the deadlock. Some companies choose yet another option and empower a neutral third party to break a stalemate. Of course, these solutions may not be practical for every type of business, but the overarching point is to anticipate deadlocks and plan for resolution at the time of formation.

Aside from management decisions, it is imperative that prospective owners consider other formative issues, such as admittance of new owners at a later time, the removal of owners, whether owners may transfer or sell their interests to third parties, what happens upon the death of a shareholder, and scenarios when dissolution of the company may be in the best interests of all. Discussing these very basic aspects of a company at the outset of the venture puts you in a position to avoid the

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disputes that we, as litigators, see imperil a company's success all too often.

If you did not have these discussions prior to the formation of your company, do not despair. A company is a living organism, and owners can agree to change the governance at any time.

Draft the Shareholder Agreement to Incorporate the Management Plan Once prospective co-owners have considered and discussed the fundamental issues, their conclusions should be clearly incorporated into a governing document, such as an operating agreement, shareholder agreement, or partnership agreement. You may be surprised to learn that a good number of businesses operate without a governing agreement, or otherwise have a one-page document merely setting forth the company's name, entity type, and principal place of business.

This is a recipe for disaster.

While partners may believe they have an initial understanding as to fundamental management issues, these understandings may diverge during acrimonious times. It is therefore in the best interests of the owners and the company for a written and executed operating agreement to be in effect when the company is formed, or as soon as possible thereafter.

Case law is rife with examples illustrating the problems that can arise in the absence of a valid operating agreement. For example, in a recent case, at the outset of forming a limited liability company, three owners negotiated and exchanged drafts of an operating agreement, but never signed it. Years later, two of the owners adopted and signed a different operating agreement, under which they gave themselves the right to make a capital call, all without the consent of the third owner. The third owner sued, and after a lengthy litigation, the court rejected his claim, ruling that the written operating agreement was validly adopted by the two owners, who together held a majority of the ownership interests, and was therefore binding on all three owners. *See Shapiro v. Ettenson*, 2015 N.Y. Slip Op. 31670(U) (Sup. Ct. N.Y. Co. Aug. 16, 2015), *aff'd as modified*, 146 A.D.3d 650 (App. Div. 1st Dep't 2017).

In another recent case, the parties formed a limited liability company to operate a clothing store but did not adopt an operating agreement. Owner One, who alleged that the parties were each 50 percent owners of the business, ran the store while Owner Two provided funding. Disputes began when Owner Two purported to hold a ''members meeting'' where Owner One was purportedly ousted from the company. Owner One sued and the court concluded that Owner Two could not expel Owner One from the company absent an express provision in a valid operating agreement so providing. *See Matter of Goyal v. Vintage India NYC, LLC,* 2018 N.Y. Slip Op. 31926(U) (Sup. Ct. N.Y. Co. Aug. 7, 2018).

For these reasons, it is highly recommended that legal counsel be employed to draft the company's governing document to ensure that the intentions of the would-be partners are effectuated, and ambiguities are eliminated. Once executed and adopted, the agreement will become a legally binding contract that will govern the company until it is either amended or the company dissolves. It will be the operative document when conflicts arise—and they inevitably will.

Two aspects of the governing document require special consideration. First, owners should specify in the agreement the process for amending it. Despite best efforts at undertaking the process described above, partners must also recognize that they are not clairvoyant, and may encounter unforeseen circumstances or a practical change over time in the day-to-day functioning of the company, requiring a restructuring of relations among the parties. Of course, owners may have differing views on an amendment; majority owners may want to have unfettered power to amend, while minority owners may want to add certain safeguards in order to protect themselves from an amendment that will dilute or otherwise harm their ownership interest. Whatever the parties decide, the operating agreement should set forth clearly the process for amending it, and whether it is appropriate under the circumstances to require a supermajority of owners to effect such changes.

It is also important for owners to consider and decide on a dispute resolution mechanism. Many operating agreements include provisions requiring adverse partners to pursue good faith efforts to resolve their disputes, or even mediation, as a precondition to commencing litigation. Many operating agreements also provide for arbitration—which is typically faster than proceeding in a court of law—as the sole dispute resolution mechanism. If the owners agree that disputes should be arbitrated rather than brought to the courtroom, they should take care to craft an arbitration clause specifying whether all disputes, or only a certain subset, are arbitrable.

The Importance of Transparency and Communications It goes without saying that trust in fellow owners is essential for effective business operations. But owners unfortunately cannot simply trust their partners to be honest and forthright. Protections must be put in place to ensure transparency.

State statutes often mandate that co-owners have rights to inspect the company's books and records, whether upon reasonable notice or at predetermined times. These statutes attempt to balance a shareholder's need for information to determine how to vote their shares with the burden on the company that may be posed by extensive information requests. For example, Section 220 of the Delaware General Corporate Law provides that a shareholder ''shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from . . . the corporation's stock ledger, a list of its stockholders, and its other books and records.'' But Delaware law also provides that the shareholder making the request must identify the information sought with ''rifled precision'' and state a proper purpose for the request, i.e., the statute cannot be deployed by a shareholder in support of a ''fishing expedition'' to identify alleged mismanagement.

Partners should discuss whether to provide even more transparency into the operational and financial aspects of the company than is required by statute. Such an approach could make sense where one partner manages the day-to-day affairs of the company and is given the right to make decisions on behalf of the company. In this situation, it may be especially important that key company information be provided to non-managing partners on an equal basis with managing partners. A non-managing partner faced with a capital call to pay for the launch of a new product, who was

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given no prior warning that a call was necessary, is likely to be both angry and uncooperative. By contrast, partners who are regularly provided information about the company's performance are much more likely to perceive their own interests as being aligned with those of the company and other partners.

As books and records statutes recognize, there may be downsides to providing more transparency. Managing partners should be encouraged to focus their efforts on running the company, instead of having to answer non-stop requests for information from passive owners. Thus, a middle ground of providing reasonable transparency is often the best approach.

Planning For Shareholder Transitions It should be expected that the ownership makeup of a company will change significantly over time. While you may expect that you and, for example, your brother-in-law will always be co-equal owners, that may not always be the case. Your brother-in-law may encounter financial distress causing him to sell his interests. The company may need to raise capital, which could also lead to the issuance of new equity interests. Or, your brother-in-law may want to retire, or worse, may become incapacitated, which would lead to a change in ownership structure. You have devoted your entire life to your business, do you really want a complete stranger to become your partner and potentially upend your business?

Unsurprisingly, issues surrounding ownership makeup and structure often become hotly contested disputes. In one notable case, three owners held 50 percent, 30 percent and 20 percent of a limited liability company. When the 50 percent owner attempted to assert sole control of the company over the objections of the two other owners, the 30 percent owner became discontented with the dispute and purported to assign its entire 30 percent interest to the 20 percent member, which would then leave the company deadlocked with two 50 percent members. The 50 percent member argued that the 20 percent member would essentially have to be ''readmitted'' as a member to receive the additional 30 percent interest. The Court disagreed, holding that the operating agreement, read as a whole, permitted members to freely transfer their interest to other members. *See Achaian, Inc. v. Leemon Family LLC*, 25 A.3d 800 (Del. Ch. 2011).

In a more recent dispute involving expulsion, the former member of a limited liability company was forced out by vote of the other members, who paid him the value of his capital account only, not the fair value of his member interest as he demanded. Because the operating agreement was silent as to compensation for members who are forced out, the court applied the default provisions of Delaware's limited liability company law, and found for the former member. *See Domain Assoc., L.L.C. v. Shah*, C.A. No. 12921-VCL (Del. Ch. Aug. 13, 2018).

Thus, it is important for co-owners to determine the manner in which owners may leave or otherwise dispose of their interests. There are fundamental questions to broach: If an owner wishes to part ways, can she freely sell her interest to any third party? Does the company have a right of first refusal to purchase these shares? If a majority of the owners wish to sell the company, can they force the minority members to sell their shares (often called a ''drag along right'')?

There are other considerations, depending on the nature of the business and the makeup of the partnership. For example, a company started by family members may wish to restrict future ownership to the family. In another example, the original owners may want to protect their ownership interests and voting rights from being diluted. It is imperative that owners consider such issues at the outset of the venture.

Conclusion With proper planning, a comprehensive operating agreement, transparency and communication, you should be able to engender trust and stave off disputes in your company. This will allow you to focus on your business and avoid that dreaded phone call to a litigator.

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