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Till Dissolution Do Us Part

Law360, New York (September 29, 2011, 1:16 PM ET) -- Involuntary dissolution and liquidation caused by a dispute or deadlock among the managing board or owners of a closely held business enterprise is the sad ending to many otherwise promising business stories. It's an ending that could be avoided in almost all cases with proper advance planning. Like a couple considering marriage, many business partners at the outset of a company's formation do not envision, and therefore do not plan for, the very real possibility of a bitter ending to the relationship.

Business relationships change and evolve over time. Issues such as perceived unfairness in distribution of profits, inadequate or inappropriate allocation of duties and responsibilities, unclear channels of control and decision making, and squabbles caused by jealousy or envy can fester and lead to conflicts among business partners. All too often, those conflicts paralyze a business, preventing the owners from being able to agree upon important decisions to move a company forward. Unresolved issues can lead to deadlock, and deadlock often leads to the court-ordered dissolution and liquidation of the business enterprise.

Disputes among owners or managers of a closely held business are like a pebble in the shoe. They are ignored until they become a problem, and once the problem is noticed it is often too late to avoid lasting damage. Disagreements have a tendency to become more, not less, difficult to resolve with time. Although it is best to properly plan for such disagreements well in advance, that's not always possible. In those cases, it is vital to keep communication channels open and to take immediate and decisive steps to prevent the dispute from festering. An experienced business attorney or a trusted adviser can often quickly and effectively mediate such disagreements before they get out of hand.

If a disagreement between the owners of a business is allowed to deteriorate, the only options available may be unpalatable, expensive and disruptive, if not destructive, to the business. These options often include mediation, arbitration or litigation. If the dispute cannot be solved, virtually every state statute regulating corporations or limited-liability companies calls for the ultimate court ordered dissolution of the company. A dissolution will result in a judge or receiver winding up the business and presiding over the fire sale of the company's assets.

In a recent case, a successful and growing 15-year business partnership among two longtime friends started to unravel when one of the partners saw what he perceived as an inequity in the workload responsibilities between himself and his partner. As is very common in closely held businesses, he thought he was pulling more weight than his partner, yet their compensation and ownership remained equal. Rather than bring these concerns to the attention of his partner, he stewed on them until he was convinced that his longtime friend and partner simply had to go. It was only at this point that he approached his partner with his concerns.

Unfortunately, the company had never seen a need to document the various duties and responsibilities of the partners, nor had it adopted any written policies or procedures to handle

disputes among the partners. What started out as a minor irritation had grown into a full-blown dispute. After months of expensive litigation and threats of a court-ordered receivership to run the business until it could be dissolved and liquidated by the court, the partners bitterly agree to split the company in two. The friends and partners have become competitors in a competitive business. The success they enjoyed together had been squandered on poor communication and lack of planning.

The vast majority of cases involving disputes among the owners of a closely held business enterprise could be avoided with a little planning. It's much easier to agree on how to deal with hypothetical or potential disputes than it is to find your way out of an actual dispute that typically involves mistrust and feelings of resent or betrayal. The best time to adopt a dispute resolution mechanism is before the dispute occurs, when each partner is level-headed and focused on the success of the business, rather than obsessed with the relative success of his or her partners.

As the business is being organized, the partners should map out expectations, define responsibilities and workload, clarify how the money will flow, and determine how decisions will be made and how disputes will be resolved at an early stage. By discussing and documenting these basic matters, the partners avoid countless problems and are provided with something concrete to point to if disagreements arise in the future. This will usually keep such disagreements from spiraling out of control.

Although these issues are best dealt with in a business' infancy, it is never too late to implement and document effective dispute resolution procedures.

An experienced business attorney can help the founders of a new business or the managers or partners of a mature closely held company negotiate and draft a shareholders agreement or operating agreement that will address the most common sources of disagreement among business partners. Some of the sources of friction that should be covered by an agreement between the partners include:

Distribution of Profits

How will profits be divided, and when will they be distributed?

Control, Decision Making and Resolution of Disputes

How will decisions be made? How will the business get around a disagreement or deadlock among the managers or owners? Sometimes the solution is as simple as having an odd number of decision makers to allow a tie-breaking vote among the managers. Disagreements that can't be decided at the manager or partner level may need to be resolved through mediation, arbitration or some other process, the mechanics of which should be spelled out in the agreement. It's important to balance the ability to work through disagreements with the assurance that each partner will feel like he or she has an effective voice in the affairs of the business.

Duties and Responsibilities

What are the duties and responsibilities of each owner? The owners of a closely held business should document what responsibilities they will each have, and how much time and effort each owner will be expected to devote to the business. The parties should also consider what the consequences should be if a partner doesn't pull his or her own weight or carry out his or her assigned duties and responsibilities.

Capital Contributions

How will the business be financed? Will the owners be expected or required to make capital contributions when the company needs capital? This is a common source of friction in closely held businesses. An agreement between the owners should also document the consequences of one owner being unable or unwilling to match the financial contributions of the other owners.

Exiting the Business

How and when can a partner exit the business? An agreement should address the conditions under which an owner can sell all or part of his or her ownership in the business to someone else. In a closely held business, the owners typically want the company and/or each owner to have a right of first refusal in the event one owner desires to sell his or her interest in the company. Involuntary exits such as death, disability, divorce or bankruptcy should also be addressed. Sometimes, a partner no longer wants to actively work in the business, and some consideration should be given as to whether the partner in such a situation will be allowed to keep his or her ownership interest.

Resolution of issues such as those outlined above requires compromise and a common purpose — two qualities in rare supply once a serious dispute arises. However, those qualities are typically abundant when the business is initially being organized or when things are running smoothly. Addressing these issues at the outset can save business relationships and friendships, and can often save the very business.

--By Randy K. Johnson, Kirton & McConkie PC

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