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Civil LITIGATION

Law and the art of automobile maintenance

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Readers of a certain vintage may recall this TV commercial from back in the day: An auto mechanic who has clearly seen it all gives advice from under the hood about the need to replace your oil filter on a regular basis.

His point is that if you spend $4 on an oil filter to keep your engine clean, you could avoid spending $200 (OMG!) on an engine job later. He rolls out from under the car to deliver the punch line: "The choice is yours. You can pay me now, or you can pay me later." Check it out on YouTube.

I think of that commercial when consulting with a client involved in a dispute over control of a closely-held business - whether a corporation, LLC or partnership. As a business litigator, I usually get involved long after the time when the legal equivalent of an oil filter replacement should have happened. Of course, it's not a perfect analogy, because the lawyer who gets paid later – the litigator – is often not the same lawyer who could have done the proper maintenance in the first place. But the economic effect on the client is proportionate.

When people get together to start a business, or inherit or buy an ownership interest in a business, optimism and excitement often overpower pragmatism. After all, why bring what might be perceived as negativity or adversity into the mix when the future looks so bright? The answer is: because people and circumstances change; both success and struggle affect the owners' views of their respective contributions and entitlements; owners may have legitimate but conflicting opinions on strategy or day-to-day business decisions; and, sometimes, people get greedy or turn into crooks.

Particularly in negative control situations (where the adverse parties each have 50% of the ownership), opportunities for nightmare scenarios abound. Deadlock, freeze outs, oppression, waste and misappropriation can lead to litigation involving, depending upon the type of entity, requests for dissolution or expulsion, or the assertion of derivative claims in the name of the entity against the alleged offender, often accompanied by a request for the appointment of a receiver to protect the entity's assets.

This type of litigation tends to be costly and is not quickly resolved. The client involved in a "business divorce" case must also endure disruption to the business, including impacts on operations, employees, customers and vendors, as well as the stress and intense emotions almost inevitable when a long-term, and at least cordial, relationship sours and accusations of misconduct or dishonesty start to fly.

There is no preventative maintenance that will guarantee that business owners who are "equal partners" will not have problems down the road. However, there are numerous things that owners can do at the formation stage to reduce the likelihood of litigation, and its attendant high cost, in the event of a future conflict that could lead to the termination of their relationship. While not an exhaustive list, experience teaches that the following precautions are critical.

First, each owner should have her own lawyer. People often think this is a waste of money, but remember the mechanic's advice. An experienced lawyer will give sound advice, and knows how to negotiate necessary terms without making things personal.

Second, the owners should have a written agreement. A writing spells out the rules of the road and greatly reduces the likelihood of conflicting understandings and recollections that might destroy a handshake agreement. In the absence of a written agreement, the owners' relationship will be governed by case law or by default to statute (particularly if an LLC is involved), and they may find that their rights and remedies are much different than they thought they were.

Third, keep in mind that negative control means that when the owners are not in agreement, no action can be taken. Some people might prefer this outcome, but such deadlocks often impair productivity. Therefore, the written agreement should address decision-making processes. Who has final say? In a corporation, who is the president and what is her authority? In an LLC, who is the manager and what decisions can he make without the consent of the other member? Is there a tiebreaker mechanism to prevent management paralysis? These are not easy questions, but it is better to ask them at the outset than to deal with the ramifications later.

Fourth, the agreement should reflect an exit strategy. Terms for the buyout of an owner wishing to leave the business (or sell to a third party) should be included, keeping in mind that the business would not likely be in a financial position to make a lump sum cash payment to the departing owner for her 50% ownership interest. Price and payment terms should also be negotiated.

In addition, while New York statutes address the non-judicial and judicial

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dissolution of corporations, LLCs and partnerships, business owners have some room to establish grounds and voting procedures for dissolution, thereby taking as much control as possible over the process. This is an especially important issue for LLCs, because the New York LLC statute sets a high and narrow bar for judicial dissolution.

Last, consider that in many closely held entities, the owners also work for the business and it is their primary source of income. The written agreement should accordingly address: the owners' salaries and other compensation (and who decides what that compensation will be); whether an owner can have her employment terminated, and if so, by whom and on what grounds; and, in the event an owner has her employment terminated, and that termination does not trigger an owner's obligation to sell her interest in the entity, how that owner will receive compensation for her ownership interest in the future.

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