Internal Struggles — Know How Best to Divorce Your Business Partner

BY JOHN M. RICCIONE

This article is designed to provide some basic and little-known information on how certain business corporation laws prescribe how to separate from, buy out, and deal with a business partner with whom you no longer wish to work.

Like any contracting, it is always best to draft the initial agreements with your business partners carefully after studying and considering all potential issues, good or bad, that may arise during your relationship. Also, plan for your separation in the beginning. This up-front work and expense will always be worth it. Litigation over a separation and doing so with a not-so-well-thought-out shareholder agreement will always be much more expensive and time-consuming than working with a good company and business lawyer to draft a solid agreement up-front.

Some Basics

The document or contract that governs your relationship with your partner(s) is called something different depending upon the type of entity that you use to operate your business. In a corporation, the operative agreement is generally referred to as a Shareholders' Agreement. In a limited liability company, the similar agreement is called an Operating Agreement. And in a partnership, the agreement is called — you guessed it — a Partnership Agreement.

Although most states have laws that govern, and fill in the blanks in, a company's operative agreement, it is best to draft one that is comprehensive and provides for all facets of the start-up, operation, and ending or dissolution of the company. While it is impossible to provide in 1,000 words or fewer all of the rules relating to what you should and should not do in connection with forming, operating and dissolving a company, I can share a real-time war story with you to illustrate why it is critically important to think about these agreements when

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choosing a business partner and entering into such business agreements.

Real-Life Example

There were once two best friends (John and Jane) who from the time they were in high school worked together as reps in the construction industry. John even eventually married Jane's sister. And when the time and opportunity came to purchase and begin their own company from Jane's father, they sat down with a Google-form shareholders' agreement and started inserting terms to which they agreed — or didn't care too much about. One provision that they discussed and which they believed was an integral part of the company's success was to dis-incentivize each other from walking away from the business. So, they agreed in writing that if either chose to sell their interest in the company or get out of the business, they could sell their interest to a third party, giving a right of first refusal to the other, or take only $40,000 as full and final payment for their interest, notwithstanding the then-value of the company. (At the time of entering

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into this agreement, a professional valuation pegged the value of the company at $3MM.)

The two ran the company amicably and almost flawlessly through prosperous and difficult times for about six years. Then one began working less — according to the perception of the other; discretionary bonuses were handed out to some key employees in amounts that differed according to their respective value — as perceived by the president of the company (John); and other irritants followed. One accused the other of "expensing" on company personal expenses. These feelings festered and grew to accusations, then to resentment, then to dislike, then ultimately to litigation.

Know the Applicable Law

Here is where it got interesting. Jane filed suit accusing John of essentially taking or stealing from the company and she requested in her suit several remedies, including an audit or accounting for all expenses; a court-appointed receiver to run the company; *and a valuation and buy-out of her shares at fair market value*. The request for this last remedy, in most states, triggers a series of options for the non-suing shareholder. In Illinois, for example, under Subsection 12.56(a) of the Business Corporation Act, a shareholder of a nonpublic corporation may petition the court to order the corporation or its shareholders to purchase his or her shares for their fair value. 805 ILCS 5/12.56(a), (b)(11). In that event, the corporation or its shareholders may elect to purchase the shares "for their fair value." 805 ILCS 5/12.56(f). If the parties cannot agree on the shares' fair value within 30 days, then on application of any party, the court must stay the court proceedings and determine the fair value of the shares and other purchase terms. 805 ILCS 5/12.56(f)(6).

I No Longer Like the Terms of the SH Agreement

Now recall that in their Shareholders' Agreement, they agreed that their shares were worth only $40,000 if they chose to sell out and walk away. However, the company was once worth $3MM, so Jane really wanted the court to take a fresh look at the value and order payment of 50 percent for her ownership interest. She no longer agreed with John that her shares were worth $40,000. The law allows the other shareholder to make an offer to purchase — which John did — for $40,000 as provided in the Shareholders' Agreement. Under the law, Jane is entitled only to the fair value of those shares and the parties left it up to a court to decide what that fair value was. Was it the value the parties had agreed to previously in the SH Agreement or was it something else? They could not now agree.

Litigation Is Expensive

Realizing her mistake in requesting a buy-out in her initial complaint after John had formally elected to purchase Jane's shares for $40,000, Jane quickly asked the court to amend her lawsuit to drop her requested buy-out. Although the law seems to suggest that the court cannot allow the amendment under the circumstances, the court erroneously did grant her request and allowed her to amend her complaint.

Notwithstanding her amended claims do not include a buy-out, she still really wants to be bought out. She cannot actually request that relief in her lawsuit because the applicable law would force her to be bought out for only $40,000. So, instead, she is using the lawsuit to harass and cause great expense for John with the hope that he will eventually capitulate and agree to pay more for her shares than the $40,000 price, just to be finally rid of her. The fees in this ongoing lawsuit have already surpassed $100,000 for each party, and there will be no quick end to it.

The lesson to be learned is to choose your business partners wisely and draft your operative agreements carefully with experienced counsel for each to guide you. Most importantly, plan and write your organizational documents as if you were going to file for divorce from your partner the next day.

MANA welcomes your comments on this article. Write to us at mana@manaonline.org.

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