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BUSINESS DIVORCE

The Cause and Process©

By Donald W. Hudspeth

A. "Partnership Disputes" and "Business Divorce"

A major type of business dispute is a dispute among the business owners themselves. This kind of dispute is often called a "partnership dispute" or "business divorce." For instance, in a corporate squeeze out a partner[1] or group of partners will attempt to expel the affected partner because, among other reasons: (i) they know the business is becoming valuable and do not want to share the wealth;[2] (ii) the "partner" is not pulling his weight; (iii) they just do not like the partner and want to be rid of him; or (iv) the business just cannot support all of its owners.[3]

B. The "Money In, Money Out Fallacy"

But the reasons for the "business divorce" are not always malicious. Sometimes they are just practical. A common mistake by business start-up owners is what I call the "Money In, Money Out Fallacy."[4] Often, there is so much uncertainty about, and focus on, getting the business started that the owners will (wrongly) assume that if they can get the funds to get started, then the business will generate the income to support them. This may be true in the long run, but as the economist John Maynard Keynes said "In the long run we're all dead." The working assumption of "money in implies money out" ignores or does not account for the fact that startup companies tend to consume mass amounts of capital, and do not typically throw off cash for a period of years. As a result, we have the common result in start-ups of "somebody stays and somebody goes." It is just the reality of the situation.

C. "Acting Out"

Often, a business divorce is a hostile takeover. A partner or group of partners will, among other things, seize control of the website, domain name, phones or bank account. I call these hostile acts "Acting Out." As a result of this Acting Out, the affected party could lose not only the future value of his investment and investment of time and money, but also dividends or distributions,

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[1] "Partner "in this case and in the trade includes corporate shareholders and LLC members.

[2] This is surprisingly common, even with long-time friends. Greed and human nature come to the forefront.

[3] The case may also be driven by an innate moral sensibility, sense of justice, and the belief that those who violate basic ethical principles should get their "just deserts." Adam Smith, who wrote the book, The Wealth of Nations, upon which in part our capitalist system is based, espoused this principle.

[4] $30,000 in does not mean $30,000 out.

salary and means of livelihood. This loss of the partner's reasons for and expectations of being in the business is called a "squeeze-out" or "freezeout." The question then becomes "How should the affected party respond in this type of situation?" Does he sue or walk away?

D. The "Process"

A key factor in partnership disputes and business divorce, and any dispute for that matter, is what I call the "Process." Typically, the parties begin with directly opposing views of how the case should turn out. (I call this the "Paradigm" of each party). Proceeding from countervailing Paradigms, to work up the case, exchange demand and response letters, argue back and forth, perhaps to file initial and subsequent pleadings, and engage in the legal process until the parties reach the point of settlement or decide to continue with full scale litigation, is what I call the "Process." As used here "Process" does not mean the legal process as a complete series of actions in litigation from beginning to end, but the countervailing and adverse actions of the parties from the beginning of the dispute, which may but does necessarily include litigation, until a point of "Equilibrium" is reached.[5]

As I explain to the client: We could have the best case in the history of law and the best demand letter or response, but virtually never does the other side receive our demand letter or response and say "OK." Even with the hypothetical perfect case where money or property is involved the expected reaction is disagreement, argument, negotiation and perhaps litigation. This is the Process.

E. The Cost-Benefit Analysis

Explained another way: Every dispute proceeds along the parallel tracks of the merits and the money. The attorney's job is to maximize the return on investment. For example, if my client is being sued for, say, $250,000, my job is to reduce this amount by an amount greater than the attorneys' fees to do so. A settlement of $150,000 with $50,000 in attorneys' fees might be a good outcome.

F. The Decision Rules for Litigation

We ask our client to consider three questions based on decision rules.

Decision Rule #1 is that the client must have or be able to get the funds for litigation. The first question, then, is: Does the client have the money to fund the litigation? If the case is going to cost, say, $25,000 and the client does not have and cannot get that amount over time, then the issue is settled.

[5] Here, "Equilibrium" means that point where the costs, including downside risk, start to outweigh the benefits of further argument.

One side note to this rule is that often the "bad actor" has taken money or something of value from the client. This could be a takeover of the business itself. Thus, it is common that the plaintiff starts the case at a financial disadvantage because the bad actor defendant is using the client's own money against him.

Decision Rule # 2 is that the case should be a reasonable investment. Assuming the client has the money to fund litigation, is the client spending $10,000 to get $10,000 or $10,000 to get $100,000? So, question # 2 is: Does the case make economic sense as a business investment?

Decision Rule # 3 is to consider the long-term effects of inaction. Question # 3 is: How will the client feel five years from now if it takes no action now? Often the answer is not just a matter of money, but how the client has been mistreated. The client wants justice.

G. Not Knowing and Regret versus Quality of Life

Sometimes the client is not sure, or has doubts, about beginning the Process. On the one hand the client may be concerned that if he does nothing, then he will never know what could have been achieved by the Process ("Not Knowing"), and will later and "forever" regret the decision not to have done anything in response to the other party's misconduct ("Regret"). For that reason, we ask the client to consider how he might feel about a decision not to proceed after a period of years, say 5 years or even 10 years. If, in thinking about the future, the client is concerned about Not Knowing or Regret, we might propose that the firm draft a demand letter to the offending party. There is some expense but usually little downside to working up the case and writing this demand letter, and, it has some advantages:

One advantage is that usually the recipient will take the demand letter to an attorney. As discussed above, often the parties Acting Out (in our example the business partners) do so out of "legal ignorance," by which I mean they do not know the legal significance and consequences of their actions. The advantage to us, then, of sending a demand letter is that it may get an attorney involved on the other side. And, as discussed in my article "Now Let Us Praise Opposing Counsel,"[6] while the Defendant may not respect the arguments or heed the warnings posited by Plaintiff or Plaintiff's legal counsel, he will usually listen to his own attorney. Thus, it can be Defendant's own attorney who can stop the Acting Out. At the same time, if the Defendant's attorney knows the area of law well, the attorneys may resolve the issues early. Though perhaps counter-intuitive, sometimes, the better the opposing attorney, the better the chance of early resolution.[7]

[6] Copy available on the firm website Blog at azbuslaw.com or by request to the firm.

[7] This firm represented a CFO squeezed out by a local semi-conductor company. We were able to settle the dispute in about ten days because the parties were motivated and the attorneys knew the area of law so did not waste time on weak arguments.

H. Pre-Litigation "Stage Management"

Litigation is a battle of the stories as they would be presented at trial, where the best and most believable story will win. The objective, then, throughout the case, is to get as many facts as possible in support of one's own story, and to prevent or reduce the number of facts which support the opponent's story. (I used to refer to this battle of fact accumulation as each party's "yellow pad.") By the time the case gets to trial the parties know their lines. In this way a trial is much like a play. The case then is largely a matter of presentation.

A common mistake among litigants is being oblivious to the importance of strategy, pre-litigation planning and "stage management" in support of their story. Once legal counsel is hired, often the attorney will coach the client to engage only in communications designed to elicit certain responses and otherwise not to communicate at all with the other side, witnesses or parties of interest. Attorneys are masters at asking the underinclusive question, the answer to which may be truthful as far as it goes, but does not tell the full story. Also, attorneys ask "box car" questions which assume facts not in evidence, perhaps facts that are not even true, or which add conclusions or interpretations which are not how the client would state, explain and present his case. The firm has had cases where the client has been "staged managed" by selective questioning and communications so effectively by the other side that by the time the client walked in the door the case was almost unwinnable. To prevent this, once we know "the game is afoot,"[8] we will advise our client not to answer, send or engage in any communication with the adverse party, or any knowledgeable or interested party, without prior approval and input from the firm.

I. Last Word

Partnership disputes tend to be long, nasty and expensive. It is an area where not only may money and property be taken, but also one's life can be drastically altered. In such cases it is important to have a *business lawyer* familiar with partnership disputes to represent you. I have seen some very sad outcomes where the attorney was not well versed in the business law practice area.

[8] From Shakespeare's King Henry V. 'Before the game is afoot, thou still let'st slip. Arthur Canon Doyle "The Adventure of the Abbey Grange" when Holmes tells Watson: "Come, Watson, come! The game is afoot."