Business Divorce Mediation

By Richard Lutringer

Lawyers often use the term "business divorce" to describe a contentious split-up of the ownership of a business. Smoldering resentments can further complicate the process in the case of family-held enterprises, particularly if a second generation is at the helm. The founders themselves can also drift apart—experienced corporate lawyers have no lack of examples from their practice of a profitable small business on a downhill trajectory as the owners struggle with each other over the allocation of assets, customer relationships and liabilities. Lawyers themselves, of course, are not immune. Many old-line New York City law firms have ended up in litigation or arbitration when partners with major clients were enticed to join other firms.

This article addresses how mediators can assist ordinary business owners and their counsel to resolve split-up issues more efficiently and fairly than litigation or arbitration.

In a seminal article, Professor Lawrence Riskin described the core concept of mediation as "a process in which an impartial third party, who lacks authority to impose a solution, helps others resolve a dispute or plan a transaction."[1] This definition, which includes the concept of transaction planning, is particularly apt in the context of many business divorces where a mediator may not only need to deal with emotional hurts and to foster an understanding of each other's interests, but also to creatively structure a business transaction to help the parties split up the business and move on.[2]

The Legal Background to Business Divorce Disputes

Litigation strategies of the parties engaged in a business divorce proceeding, whether as equal owners involved in a deadlock or a minority owner pitted against the majority, are fundamentally shaped by the underlying statutory and common law remedies. Because of their commercial importance and unique problems, this article concentrates on business divorce issues involving corporations and limited liability companies (LLCs) formed under New York law.

Shareholders of closely held corporations or LLC members are generally unable to sell their holdings because, unlike public corporations, there is effectively no third-party market and, absent agreement, there is no obligation imposed on the corporation or other shareholder to purchase their interests. To avoid uncertainty, many closely held company owners have buy-sell agreements regulating when, how and at what price their interest may be sold to the business, to another owner or a third party. Although the implementation of such agreements can also lead to litigation, this article discusses the resolution of disputes when there is no prior buy-sell agreement, so that the parties are relying solely on statutory or common law/equitable remedies.

Corporate Shareholder Disputes

Disputes between equal shareholders of a corporation can lead to deadlocks in the election of directors or in the decision-making power of the board itself. Although deadlocks provide a director, and in some cases an equal shareholder a right to request judicial dissolution of the company, courts are loathe to order dissolution if the business continues to be profitable and management isn't paralyzed in essential matters.[3]

Another type of business divorce dispute involves minority shareholders squaring off against the majority. Because shareholders don't have an automatic right to sell back shares to the corporation, the route to cashing out as a minority shareholder can only be reached under BCL § 1104-a in the form of a petition by a 20% shareholder for dissolution of the corporation based on specific misconduct of the controlling shareholders, i.e., "illegal, fraudulent or oppressive actions" or looting, wasting or diverting corporate assets.[4]

In judicial dissolution cases the court often has to weigh in on such difficult issues as the reasonableness of salaries paid and perks given to the manager/shareholders, the adequacy of consideration received or given for assets transferred to or from insiders, usurping of corporate opportunities by the majority, and similar business decisions. New York courts use a "reasonable expectations" test in determining whether the petitioner may have been oppressed. Oppression means unreasonable conduct by the majority which defeats the minority owner's expectations that "were both reasonable under the circumstances and were central to the . . . [minority shareholder's] decision to join the venture."[5]

In cases brought under BCL § 1104-a, where the petitioning minority shareholder has more than a slight chance of success, the negotiating leverage of the minority shareholder can be considerable, due to the unusual provision in the BCL entitling the corporation or another shareholder to completely eliminate the risk of dissolution by the exercise of a statutory election to purchase the dissident's shares at "fair value."[6] The election effectively converts the case into an appraisal proceeding, but the election to purchase must be made within 90 days of the date of the petition filing.[7] Such a result is usually far preferable for the majority to the downside risk of dissolution, with the likelihood of automatic defaults under lease, license, lending or other commercial agreements, as well as adverse business and tax consequences. To up the ante

even more for the majority, if they do not act within the statutory 90 days, they have to obtain court approval to make the election, which, under the statute, can be tied to the payment of the minority shareholder's legal fees.[8]

For the minority shareholder, however, even if the majority elects to purchase the minority's shares at fair value, the war is far from over, since, if the parties can't agree on a price and terms among themselves, a contested appraisal proceeding can take additional months or years of wrangling, with valuation experts hired by both sides to determine "fair value," depending as it does on the nature of the business and its prospects.[9] Thus, either of the available judicial roads for a minority shareholder—a purchase after the appraisal proceeding has determined "fair value" or an order of judicial dissolution and liquidation—may leave payment for their shares, whether for retirement or, possibly, a new business venture, far on the horizon.

Limited Liability Company (LLC) Membership Disputes

As under the BCL, discussed above, a minority member of an LLC does not have the right to withdraw and demand an in kind distribution of specific assets or a *pro rata* share of the net assets of the business. On petition, the court may dissolve the LLC if it is not "reasonably practical to carry on the business in conformity with the articles of organization or operating agreement."[10] In other words, a judge has to be convinced either that the business is no longer viable or that the controlling members have breached fiduciary duties to the minority, but without the statutory guidance provided by the BCL. A few of the reported New York cases in this area dealing with judicial dissolution of LLCs have used the BCL remedies by analogy, but, except in egregious circumstances, provide limited guidance as to the parameters of the "reasonably practical" standard.[11]

The Mediation Alternative

Given the myriad of fact patterns with respect to the management of a closely held business and the lack of easily applicable black letter law when it comes to the grounds for dissolution of either a corporation or an LLC, business divorce disputes among the owners present a compelling case for an alternative means of resolution. With the exception of the fast track of BCL § 1104-a, discussed above, providing for a statutory 90-day automatic election period, litigation involving the claims necessary to force a dissolution and liquidation is particularly prone to the uncertainties and expense of protracted litigation. Mediation, as an alternative, or even on a parallel track, can free the parties to deal confidentially and without the judicial strictures of who's "right" and who's "wrong." In mediation the parties are able to craft whatever solution makes sense to them, which may include not only such relatively simple solutions like a high-interest installment promissory note, but also more complex possibilities, such as a special class of redeemable preferred stock, personal guaranties and other security arrangements, transfer with or without separate consideration of specific assets important to the exiting owner, assumption of certain liabilities, non-compete covenants, consulting arrangements, license agreements, pension and health care benefits, and even temporary or long-term office space, among the universe of other arrangements of importance to one party or the other that allow a bargain to be made.

Guidelines for a Successful Business Divorce Mediation

1. Choice of Mediation Style for Business Divorce

Given the many possible dynamics of a relationship among co-owners of a closely held business, there is no one style of mediation that will fit each dispute or stage of dispute resolution. Professor Riskin, in his seminal 1966 article, classified mediator styles from "narrow evaluative" to "broad facilitative."[12] More recently he has modified his grid to reflect the range of mediator behavior from "elicitive" to "directive," describing typical mediator conduct during a mediation as a process of shifting from one style to another depending on the desires of the parties and the needs at the stage of the mediation.[13]

A complex business divorce involving a family business is a prime example of the necessity of mediator flexibility as it may require a mediator to use an elicitive, if not transformative, approach through much of the initial mediation sessions and caucuses in order to deal with underlying family dynamics.[14] A dispute between a minority shareholder/former employee seeking only to redeem his or her shares at fair value at an appraisal, on the other hand, may be more efficiently handled by an approach shifting between facilitative and evaluative.

2. Mediate Early

Litigators often have tactical reasons for the early commencement of a lawsuit, including statutes of limitation, forum choice or even valuation concerns in the case of a petition for dissolution under BCL § 1104-a which, when converted to an appraisal proceeding under BCL § 1118 (b), measures the value of the corporation as of the day prior to the filing of the petition. When such concerns are not primary, it should be remembered by counsel that laymen are not used to the harsh conclusory language of complaints and petitions for judicial relief. If the end goal is in fact settlement, service of process, in itself, may so polarize the parties that mediation of the dispute becomes more difficult.

By the time mediation is suggested by the court or one of the parties who has just received the first legal bill for the litigation, papers will have been exchanged, discovery may have begun and characterizations of nefarious conduct by the controlling shareholder or incompetency of

the minority shareholder/employee have all but buried a once-collegial relationship. Weeks or months have been spent preparing for document delivery, depositions and conferring with their respective litigating attorneys about strategy to "destroy" the other side's case. In many instances, formerly cordial social life has been affected as spouses are drawn in and the relationship withers. Mediators have sometimes been described as magicians in their ability to resolve difficult disputes, but the skill of resurrection is more difficult.

A pre-litigation meeting with counsel and parties on both sides, facilitated by a mediator, may pay huge dividends in the saving of time and legal expenses.

3. Build Rapport and Set Expectations

It's not unusual to talk separately with each counsel prior to the first mediation session to find out the positions of each party. If possible, after the customary conference call with the lawyers, the mediator should meet privately with each party and their counsel prior to the first session. Particularly if the mediation is court-ordered, it's possible that counsel, if not the party, may see the mediation process as merely one step in the litigation. An early meeting will give the mediator an opportunity to explain the potential benefits of mediation and respond to (and learn about) any reservations the lawyer has about the process or the other side. It will also give the mediator an opportunity to hear from the client his or her version of the facts, without the first mediation day pressure, and, incidentally, shortening the time spent in the first day's initial caucuses, when the non-caucusing party is left waiting, often for what seems like hours. By being sincerely interested and listening to the client in a more relaxed environment, the mediator will often be able to get beyond the legal rhetoric and find out what the underlying issues may be.

4. Make Sure the Necessary Parties Are at the Table

One of the primary reasons for impasse is that the right people aren't at the table.[15] In one business divorce case I mediated, three factions of shareholders of a family corporation were at the table, each represented by counsel. The matriarch of the family, still very much interested and involved in the business and who had originally doled out the shares to her children, wasn't present, but her "intentions" were regularly referred to by each of the factions. After several hours of caucuses, the mediation ended without visible progress. If I had ascertained beforehand the importance of the matriarch, even though she held no shares herself, I would have discussed with the parties the possibility of her participation at the mediation.

5. Listen for Unexpressed Needs and Interests

Business divorce disputes often are between partners who have worked together for years and who know each other's families and family problems. In one family business mediation of a litigation brought by a nephew against the family corporation, then controlled by his Uncle Joe, forcing the nephew's father Al (also in the business) into the uncomfortable position of having to take sides against his brother or his son, I was told by Al in caucus, "Joe's wife will kill him if he gives something to my son while his own kids didn't get anything." As it was, the case settled before the next session, but in the event there had been a second session, I would have asked questions of all parties in the interim period exploring tactfully with Joe and Al separately whether they thought it might be necessary to reach agreement on a family-wide basis.

6. Explore Unique Settlement Options and Tools

Sometimes a solution that had not been contemplated at the time of the initial discussions becomes obvious once tempers have calmed and options can be freely explored. It is Mediation 101 that an orange has both juice and a peel, and what may be very valuable to one party may be less valuable to the other.[16] Perhaps a consulting or carefully honed non-compete agreement can close a gap that seems unbridgeable. The parties themselves, with their deep knowledge of their own interests and the intricacies and sensitivities of the business, can come up with solutions that would not occur to third-party neutrals.

In one settlement negotiation I was involved in years ago, involving the split-up of a syndicate owning a thoroughbred stallion, the parties after many hours of negotiating agreed on a cash payment to the departing partner, but only when a certain number of annual "nominations to the stallion" (a term of art for insemination, which, under thoroughbred rules, cannot be done artificially), was at the last minute added to the mix. This is a good example of the importance of letting the parties find their own best solutions, since their proposal was not something in my toolbox.

It is a fundamental principle of mediation that the parties are in charge of the substance of their dispute, since they are best able to decide what is in their long-term interest. The mediator, however, as the one most experienced in dispute resolution techniques, has the role of guiding the parties along a road on which they may have never traveled. An important aspect of this is the suggestion by the mediator of innovative, efficient, and perhaps less emotionally charged techniques to assist in the resolution of their dispute. For example, where there are a number of definable business assets to be split up between business partners (e.g., sales regions, properties, inventories, offices, etc.), the mediator might suggest using game theory techniques designed to fairly allocate assets among competing interests. One of the most useful is the so-called "adjusted winner" technique which allows each of the competitors to use a form of weighted voting to allocate the rights/items of property in which he or she is interested.[17] Each party typically will allocate its "points" among individual items on a jointly developed list. Although one round is rarely sufficient to allocate all

the items, by repeating and rebalancing, a fair allocation can be achieved, often allowing each party to get its most valued items. These simple, yet highly sophisticated, techniques are designed for efficiency, equity and to result in an allocation that is as "envy-free" as possible. Although clearly useful in matters involving numerous items left to two or more heirs, or when a divorce settlement requires an allocation of everything from child custody to vacation homes, the technique can also be used to assist in finding a rational way to divide a closely held enterprise.

Conclusion

As with marital divorce, an area where mediation has been highly successful, the legal issues involved in business divorce litigation are often inextricably intertwined with emotional ones. The flexibility of mediation presents a unique and adaptable method to address and resolve both parts of a damaged relationship.

Endnotes

1. Lawrence Riskin, *Understanding Mediation Orientation, Strategies and Techniques: A Guide for the Perplexed*, 1 Harv. Neg. L. Rev. 7 (1966).
2. *See* Dan Krieger, *Not Just for Disputes! Mediation Techniques for Negotiation and Deal Making*, 8 JAMS Dispute Resolution Alert, No. 4, 1 (Fall, 2008); James Freund, *Three's a Crowd-How to Resolve a Knotty Multi-Party Dispute Through Mediation*, 64 The Business Lawyer 359 (February, 2009).
3. N.Y. Business Corp. Law (BCL) § 1104(a)(1) and (2); *see* 15A N.Y. Jur. 2d Sec. 1408-1409 (2009).
4. BCL § 1104-a; for holders with less than 20% of the shares, a common law right has been recognized where there has been an "egregious" breach of fiduciary duty, 15A N.Y. Jur. 2d Sec. 1378 (2009).
5. *In re Kemp & Beatley, Inc.* 64 N.Y. 2d 63, discussed in Moar, *Protecting Minority Shareholders in Close Corporation Valuation Proceedings*, 81 NYSBA Journal No. 4, p. 24 (May 2009), 15A N.Y. Jur. 2d 1416–1417 (2009).
6. BCL § 1118 (a).
7. *Id.*
8. BCL § 1118 (c) (1).
9. 15A N.Y. Jur. 2d Sec. 1428–1435 (2009).
10. N.Y. LLC Law § 702.
11. *In re Youngwall*. 2008 N.Y. Slip Op. 30811 (U) Sup. Ct., Nassau Co. 2008); discussed in Mahler and Schoenberg, *The Beat of Business Divorce Litigation Continued*, 2008, N.Y.L.J., Mar. 30, 2009.
12. Riskin, *supra* note 1.
13. Riskin, *Decisionmaking in Mediation: The New Old Grid and the New New Grid System*, 79 Notre Dame L. Rev. 1 (2003).
14. *See* Bush & Folger, The Promise of Mediation (San Francisco, Jossey-Bass 2005).
15. Lee J. Berman, *Impasse is a Fallacy*, www.mediationtools.com.
16. Fisher, Ury & Patton, Getting to Yes (2d ed. 1991) New York: Penguin Books, p. 57.
17. Brams & Taylor, The Win-Win Solution (Norton 1999); for an interesting discussion of the use of these techniques in analyzing the divorce settlement agreements of Prince Charles and Diana and Donald and Ivana Trump, as well as the negotiation of the Camp David Accords, see pp. 89–118.

Richard Lutringer is an independent mediator and serves on the mediation panels of federal, state and bankruptcy courts, as well as Community Mediation Services in New York City. He was formerly a partner of Morgan Lewis LLP and Schiff Hardin LLP. He can be reached at rlutringer@mac.com.