The Legal Intelligencer

3 Common Mistakes Litigators Make When Handling a Business Divorce

Curtis L. Golkow

03-30-2009

When business owners decide to split up, they turn to their company's buy-sell agreement — if there is one — and almost invariably find that its terms for separation are unhelpful. The typical buy-sell agreement has no provision to compel another owner to sell, and leaving the company may require the departing owner to sell out at a discounted price. Frustrated, the business owner then hires the most rabid litigator he can find, to make or threaten claims against the partner as a means to create leverage to force a buyout or sale on favorable terms — the ultimate goal in business divorce. However, without depth of knowledge in transactional business law, even the most talented litigator is likely to make one or more of the following three mistakes:

Mistake 1: Failing to Consider the Full Menu of Options

Litigators, by training, typically start by figuring out what claims, if any, each business owner could assert against the other. Litigation is expensive and potentially damaging to the business, so while it may be an effective strategy in some cases, in many cases it should be a last resort. And after exercising inspection rights and digging for information in every conceivable way, what advice does the litigator offer the business owner in the absence of a good faith basis for a lawsuit against the partner?

In most cases, the menu of options for initiating a business divorce and for creating negotiating leverage extends beyond litigation. For example, the business owner with voting control generally has the power to compel a transaction resulting in a buyout of the undesired business partner, such as a merger, share exchange, reverse stock split or stock redemption to name the most common "squeeze-out" transactions. Each type of transaction has certain advantages, disadvantages and potential risks, including risks that the transaction will result in litigation (e.g., a dissenter's rights action or breach of fiduciary duty claim). Options for the business owner with control abound and typically include a variety of other "freeze-out" techniques.

Representing the business owner with a minority interest usually presents a greater challenge, but discovering leverage points is possible with some creativity. A business owner who lacks voting control nonetheless may have some other type of control, whether over an aspect of business operations or key customer relationships or by virtue of owning intellectual property rights that were never assigned to the company.

While analysis of potential claims is an important part of assessing the facts and developing an overall strategy, it is only one part. Choosing the best strategy for a business divorce matter requires consideration of both the litigation and non-litigation options.

Mistake 2: Failing to Identify Business Law Issues

A strong case in litigation starts by building a record, and, in the business divorce context, knowledge of corporate, LLC or partnership law is essential. Consider a typical scenario, when one business owner calls a meeting for purposes of gathering information and eliciting admissions from the other owner. Will each business owner be entitled to have his lawyer present at the meeting? What issues belong on the meeting agenda? Can the meeting can be recorded or transcribed?

Answers to these questions are not found in the corporate or LLC statutes or annotations, nor are these issues typically addressed in corporate bylaws or LLC operating agreements. The answers also may vary from state to state, and the entire issue of which state's law applies has nuances. When a litigator shows up at a board of directors meeting thinking he will turn the meeting into the other director's deposition, the litigator may be caught off guard when corporate counsel precludes him from attending. Even worse, the litigator may have led his own client to slaughter by failing to prepare the client to participate at the board meeting without assistance of counsel. A litigator should obtain the advice of an expert in corporate, LLC or partnership law in maneuvering through the pre-litigation, record-building phase of the business divorce.

Furthermore, outside of commerce court, judges do not always have the knowledge of business law or the experience in business matters to understand and apply the corporate, LLC or partnership law properly or to fashion practical remedies. To make the best arguments to the court, to convince the judge as to the appropriate course of action and to identify a judge's errors and preserve grounds for appeal, the

most successful business divorce litigators generally bring a business lawyer to court with them.

Mistake 3: Failing to Treat the Settlement as an M&A Deal

After successfully creating leverage to negotiate a favorable buy-out, a litigator will come up short in settling the business divorce if he fails to recognize that the settlement, in essence, is an M&A transaction between the business owners.

Settlement of the business divorce typically involves a buyout of an owner's equity interests and an exchange of mutual releases, but structuring the deal should include analysis of all business, tax and other issues that apply to any other M&A deal. Will any portion of the consideration be treated (including for income tax purposes) as payment for services, a lease, an intellectual property license or restrictive covenants? Are there loans to be repaid between the seller and the company, or any personal guarantees by the seller to be released? Will the transaction include rights of indemnification or contribution relating to third-party claims against the company or the company's claims against third parties? Will the buyout constitute a default under any "change of control" provision in any lease or other contract or result in a financial covenant default under any bank loan? Will there be acquisition financing from an institutional lender, or will payments to the seller be made over time (i.e., seller financing) secured by collateral, guarantees or post-sale covenants? The settlement of a business divorce is no ordinary litigation settlement, nor is it a typical M&A deal either.

Achieving the best results in a business divorce case requires consideration of a broad range of complex business, finance, securities, tax, employment, intellectual property and other legal issues. From the initial phase of gathering information and developing the strategy, to posturing and record-building in the pre-litigation phase and the actual litigation if it ensues, to the negotiation and consummation of the buy-out transaction, the business divorce case is best handled with a multi-disciplinary approach. Litigators handling such cases would be well advised to team with a transactional business lawyer who is experienced in business divorce.

Curtis L. Golkow, *a partner at Fox Rothschild, has been practicing corporate, securities and finance law for more than 20 years, concentrating heavily on M&A, joint ventures and strategic alliances, capital-raising transactions and a wide array of other commercial matters, including transactions involving distressed companies. Golkow devotes a substantial portion of his practice to business divorces.*