

PROTORÆ LAW<sub>PLLC</sub>

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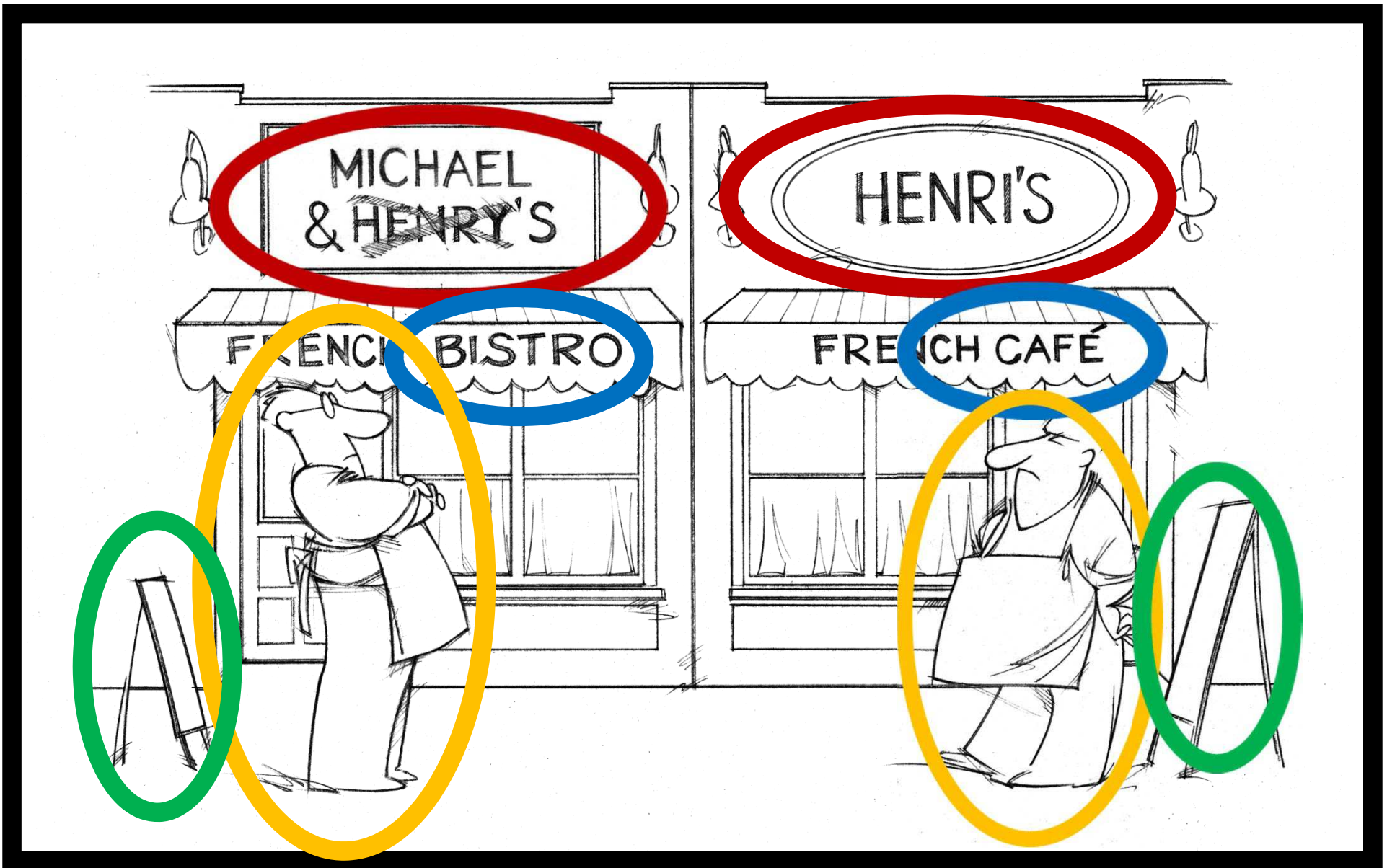
# Business Breakups

*Breaking Up is Hard to Do*

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- This presentation is a summary of the law and should not be viewed as a comprehensive description of the law.



# Types of Business Relationships

- **Corporations**
- **Limited Liability Companies**
  - *Professional Limited Liability Companies*
- **Partnerships**
- **Joint Ventures**
- **Contractual**
- **Favors**



# Sources of Governing Law

- Businesses are “***Creatures of State Statutes***”
- Virginia Statutes
  - *Title 13.1 Corporate Code*
- Common Law
  - *Governs internal and external conduct*
    - e.g., fiduciary duty, piercing corporate veil
- Federal Laws
  - *SDVOSB*
- Contractual
- Morals

# Typical Scenarios

- ***Business Owners in Conflict***
  - *Majority vs. Minority*
  - *Deadlocks*
- ***Disputes Over Ownership***
- ***Minority Squeeze Outs***
- ***Improper Spin-Off Businesses***

# Common Traits in Business Breakups

- ***High stakes and emotional***
  - *Survival of existing company*
  - *Former owners' right to compete in chosen field*
- ***Greed*** often a factor



# Shaky Foundations

- **“Back of the Envelope”** Agreements
- Overly **complicated** agreements
  - *No one understands it and/or contrary to “actual” deal*
- **No** written agreement
- **Verbal Promises** by Owner to provide employee ownership interest



# “Back of the Envelope”

- Usually **Not** drafted by an Attorney
  - *Often downloaded from the Internet*
- Minimal terms
- Often 50/50 or other equal ownership split
- Most terms need to be filled-in
  - *Conduct*
  - *Other writings, e.g. emails, memos*
- Often messy and disparate finances

# Overly Complex Agreements

- Drafted by or adopted **from an Attorney**
- **Little understood** by Owners
- Often **mismatch** between terms and conduct
- More likely to have blend of monetary and sweat equity
- Broad contractual overlay of rights and obligations
  - *Dissolution and Wind-Up terms usually included*

# No Written Contract

- Hodge-podge of Terms
  - *Pre- and Post-agreement conduct and writings must be interpreted*
  - *Straight lines are hard to find*
    - Inconsistencies abound
    - Different historic narratives and “facts”
- Statutes Dominant

# Ownership Promises

- **Verbal promises** by owner to provide employee ownership interest
  - *Offered to existing employee in exchange for:*
    - Working for less or free, investing money, staying on rather than starting own company
- Promises to Friend, Neighbor, or Relative
  - *To begin working at company because can't afford to pay that person*

# Ownership Promises

- Raw emotions are a given
  - *Both parties feel betrayed*
- Money usually follows paper
- Self-Help prevalent
  - *Bank accounts manipulated*
  - *Client contact*
  - *Employee contacts*
  - *Access to office*



# Virginia Statutes

- **Different** for Corporations, Partnerships and LLCs
- **Differences Matter** in Corporate Disputes and Breakups



# Federal Laws

- *Special Set-Asides*
- *Minority Owned*
- *Woman Owned*
- *Service Disabled Veteran Owned (SDVOs)*
- *Require “Management Control”*



# Dissolution of Corporation - Voluntary

- Corporation's Board may propose dissolution to shareholders
- For proposal to be adopted:
  - *Board recommends dissolution to shareholders unless Board is conflicted*
  - *Shareholders entitled to vote to approve the proposal*
    - 2/3's vote unless Articles of Corporation state otherwise



# Corporate Judicial Dissolution- Process

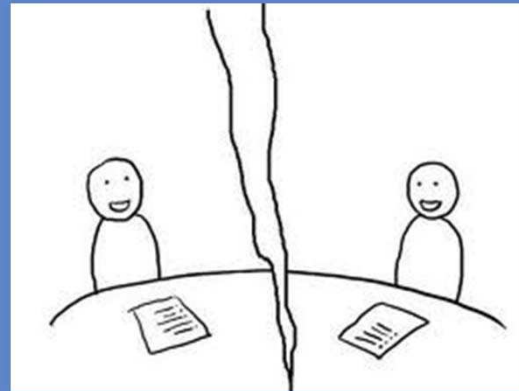
- How the Process Happens
  - *Suit filed by shareholder in state circuit court*
  - *The court may appoint a receiver or custodian pendente lite to take control of and protect corporate assets*
  - *It is not necessary to make the directors or shareholders parties to the case unless there are claims against the directors*

# Grounds For Judicial Dissolution of Corp.

- Directors deadlocked and irreparable injury
- Directors actions “illegal, oppressive, or fraudulent.”
  - *Shareholders are deadlocked, fail to elect successor board, or*
  - *Corporate assets misapplied or wasted.*

# Dissolution Causes of Action

- Breach of Fiduciary Duty
- Misappropriation of Trade Secrets
- Tortious Interference with Contract or Business Expectancy
- Business Conspiracy
- Fraud



# Contract vs. Tort

- **Contract**: *Enforceable Agreement*
  - *Contract remedy is exclusive if only duty is contractual*
  - *Damages: benefits reasonably foreseeable at time contract was made*
- **Tort**: *Extra Contractual Duties*
  - *Violation of common law and statutory duties imposed to protect society*
  - *Damages: all losses suffered*

# Good Faith/Fair Dealing in Contracts

- **Virginia and Maryland**
  - *Not a Separate Cause of Action*
- **District of Columbia**
  - *Separate Cause of Action*
  - *Right of parties to receive the fruits of the contract*
  - *Underlying Contract Required*
    - But written contract not required



# Election to Purchase Shareholders' Shares

- During dissolution, the corporation, or the shareholders, may elect to purchase shares at “fair value”
- “Fair Value” calculation is from the day before which the petition filed
  - *Court has the power to change that date*
- Election is irrevocable

# “Fair Value” of Shares

- Agree on “Fair Value”
- If no agreement, the court may select appraiser
- The court may allocate cost of appraiser
- Court may hold a hearing on the value

# Valuation Standards

- Fair Market Value
  - *Discounts can be taken for lack of marketability and minority interests (lack of control)*
- Fair Value
  - *No discounts*
- Discounts can be significant





# How the Purchase of Shares Occurs

- After “***Fair Value***” determined the court directs the purchase on “appropriate” terms
  - *Installment sale*
  - *Interest included “if equitable”*

# Dissolution of Limited Liability Companies

- LLC is dissolved when:
  - *Any event triggering a dissolution under the LLC operating agreement occurs;*
  - *Upon unanimous members consent*
- Court entry of a decree of dissolution;
- Automatic cancellation of the LLC existence by SCC (for failure to maintain a registered agent, office, etc.)

# Judicial Dissolution of LLC

- Upon a Member's application, the court may decree dissolution "if it is not reasonably practicable to carry on the business in conformity with the articles of organization and any operating agreement."
- After LLC winds up, the court will advise the SCC, which enters an order of cancellation.

# Winding up an LLC

- “All debts, liabilities, and obligations” need to be paid and discharged an “reasonably adequate provision” has been made, and all remaining property and assets of the LLC have been distributed to its members.
- The members are responsible for winding up the LLC, but, upon the application of any member the court may appoint a “liquidating trustee” to handle the wind up
- A “liquidating trustee” may:
  - *Prosecute any suits on behalf of the LLC*
  - *Wind up the LLC’s business*
  - *Dispose of and convey LLC property*
  - *Discharge or make reasonable provision for LLC’s liabilities*
  - *Wind up known claims against LLC*
  - *Distribute to the members of any remaining assets*

# Priority of Payment of Dissolved LLC's Assets

- **First**, to all creditors of the LLC, including all members who are creditors
- **Second**, to any members in satisfaction of liabilities for distributions
- **Lastly**, to members in return for their contributions and second in respect to their interests in the LLC



# Unanimous Consent Clauses

- Unanimous consent agreements can cause problems
- If one member breaches fiduciary duty, LLC may be unable to agree to sue offending member
- Previously no Virginia law on point
- Recent Virginia case redefined a LLC's unanimous consent requirement to permit the LLC to sue one of its members. *Infinite Design Electric Assoc. LLC, et al. v. Donald R. Hague*, 2010 Va. Cir. LEXIS 27 (Fairfax Cir. Ct. 2010).

# Infinite Design Case

- LLC member formed a competing company and solicited existing LLC's clients using its information
- Court asked: "Should a manager of an LLC be able to hold the entity hostage when it is the bad acts of that manager that the LLC seeks to redress?"
- But, no prior Virginia law on point with this situation
  - Looked at "analogous authority from Virginia and other states:" "Pennsylvania does not allow interested managers to vote to sue if that manager has 'an interest in the outcome of the suit that is adverse to the interest of the company.' 15 Pa.C.S. § 8992(2) (2009).
  - New York's LLC act precludes managers of LLCs from transacting with the LLC when that manager has a 'substantial financial interest' in the transaction. NY CLS LLC § 411 (2010)."
  - 1937 Virginia Supreme Court case that "suggests that the vote of a director of a corporation who has a personal interest in a matter is not to be counted in relation to that matter," citing *Crump v. Bronson*, 168 Va. 527, 537, 191 S.E. 663 (1937).

# Infinite Design Case (Continued)

- Operating Agreement included Virginia Code §13.1-1024.1: requiring “good faith business judgment” in “best interest” of the LLC.
- Court said clear reflection of the LLC’s “intention to hold managers' actions to a certain standard.”
- Court held LLC did not need unanimous approval of the managers to bring suit against one of its managers as it would amount to a “suicide by operating agreement,” and paralyze the LLC.



# Other Issues

- The court did not address countervailing legal principles, such as
  - “Operating agreement” is “an agreement of the members as to the affairs of a limited liability company and the conduct of its business . . . .” Va. Code § 13.1-1002.
  - Virginia Code sections governing LLCs “shall be construed in furtherance of the policies of *giving maximum effect to the principle of freedom of contract and of enforcing operating agreements.*” Va. Code § 13.1-1001.1.C.
  - LLC is bound by its operating agreement whether or not the LLC executes it, and it may contain any provisions regarding the affairs of the LLC as long as not inconsistent with the laws of the Commonwealth or the articles of organization. Va. Code § 13.1021.A.1.
  - Case law – court can’t rewrite contracts between two parties, *Coker v. State Farm Fire & Cas. Co.*, 45 Va. Cir. 510 (Fairfax Cir. Ct. 1998).
- Economic consequences: member being sued has to pay his *pro rata* share for both the LLC’s lawyer and his own lawyer, even if the member prevails at trial.

# Judicial Dissolution of Limited Partnership

- Similar to LLC: “if it is not reasonably practicable to carry on the business in conformity with the partnership agreement.”
- After winding up, the court advises the SCC which enters a cancellation order

# Process of Dissolution for Limited Partnerships

- Similar to LLCs, but the winding up is by the general partner who has not “wrongfully dissolved a limited partnership.”
- If no general partner, then the limited partners, or a person approved by the limited partners
- Court may appoint a “liquidating trustee”



# A Partnership is Dissolved When

- Upon notice of partner's intent to withdraw as a partner;
- Dissolution event occurs under the partnership agreement;
- Partner's expulsion pursuant to the partnership agreement;
- Partner's expulsion by the unanimous vote of the other partners if:
  - *It is unlawful to carry on the partnership business with that partner; or*
  - *There has been a transfer of all or substantially all of that partner's transferable interest in the partnership which has not been foreclosed*
- On application by the partnership or another partner, the partner's expulsion because:
  - *Wrongful conduct that adversely affected the partnership business;*
  - *Material breach of the partnership agreement or a duty owed to the partnership or breached the statutory standards of partnership conduct; or*
  - *Conduct that makes it not reasonably practicable to carry on the business in partnership with the partner*
- Certain events relating to a partner becoming a debtor in bankruptcy;
- Death, guardianship, or incapacity

# The Power of Partners to Dissociate

- Partner can dissociate at any time, rightfully or wrongfully, by “express will”
- Dissociation is **only** wrongful if:
  - *The dissociation breaches the partnership agreement; or*
  - *Expiration of the defined partnership term or completion of the defined undertaking*

# What if the Dissociation is “Wrongful”?

- **Partner is liable** to the partnership and to the other partners for:
  - *Damages caused by the dissociation*
  - *Partner’s other obligations*



# Effect of the Partner's Dissociation

- Terminates right to participate in the management and conduct of the partnership except right to wind up
- Duty of loyalty terminates;
- Duty of care continues only with regard to events occurring before the partner's dissociation, unless winding up

# Purchase of Dissociated Partner's Interest

- Partnership **can purchase** the interest of dissociated partner
- Buyout price is based on the amount that would have been distributable if, on the date of dissociation the assets of the partnership were sold at a price equal to the greater of either:
  - *Liquidation value of the partnership or;*
  - *The value of the partnership based on a sale of the entire business as a going concern without the dissociated partner*



# Purchase of Dissociated Partner's Interest

- If the Dissociation was “Wrongful”
  - *Damages for wrongful dissociation and other amounts owing are offset from buyout price*
- If the Dissociation Occurs Prior to the expiration of a definite term or occurrence?
- No payment of any portion of the buyout until the expiration of the term or completion of the undertaking.

# Indemnity Provisions

- Upon the buyout, the partnership indemnifies against all partnership liabilities
- Except liabilities caused by an act of the dissociated partner

# Right to Review Records-Stock Corporation Act

- Limited right of shareholders to review records:
  - *Articles of incorporation and any amendments*
  - *Bylaws or restated bylaws and all amendments*
  - *Resolutions creating classes of shares or fixing the relative rights and preferences of the various classes.*
  - *Minutes of all shareholders meetings and all records of all action taken by shareholders without a meeting, for the past 3 years.*
  - *Written communications to shareholders within the past 3 years*
  - *List of names and business addresses of current directors and officers*
  - *Most recent annual report delivered to the SCC*

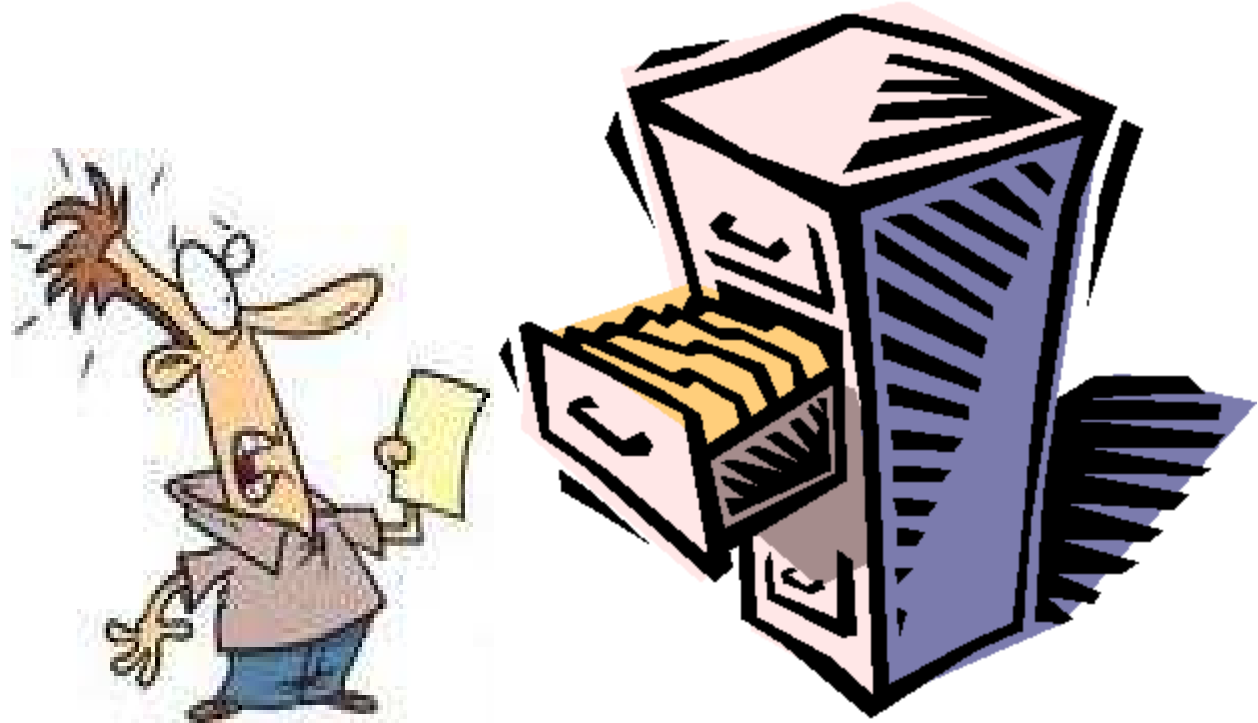
# Rights to Review Records-Stock Corp. Act

- Shareholders who meet **6-month or 5% test** and makes a “good faith” demand with “proper purpose” may review:
  - *Excerpts from minutes of any meeting of the board of directors*
  - *Accounting records of the corporation*
  - *Record the shareholders of record*



# Right to Review Records-Partnership

- Must “provide partners and their agents and attorneys access to its books and records.”



# Right to Review Records – LLC Act

- Each member has the right to inspect and copy all records which the LLC must legally maintain
  - *operating agreements, tax returns, articles of organization, a current list of all members and their business addresses*
- A member may also inspect and copy all
  - *“true and full information regarding the state of the business and financial condition of the LLC;”*
  - *And all other information regarding the affairs of the LLC*
- But may be restricted by the LLC’s operating agreement

# Fiduciary Duties

## What Fiduciary Duties Are Owed?

- No Self-Dealing
- No Misuse of Proprietary Data
- No Misappropriation of Trade Secrets
- No Solicitation of Customers Prior to Termination of Employment

# Intra-Corporate Disputes

## What Fiduciary Duties Are Owed?

- **Employee Related Duties**

- Limited Solicitation of Employees Prior to Termination of Employment?

- Contours Not Well Defined

- No Planning for Mass Resignation



# Intra-Corporate Disputes

- **Who Owes Fiduciary Duties to Whom?**
  - Officers, directors
    - Duty to shareholders as a class
    - Duty of loyalty to corporation
  - Employees
    - Duty of loyalty to corporation
  - LLC Members
    - Owe duties to LLC
    - No duty to one another
  - Shareholders
    - No duty to one another
    - Majority no duty to minority
    - Generally no fiduciary obligations of minority shareholders toward the corporation, absent officer or director status

# Intra-Corporate Disputes

- **Defenses**

- Business Judgment Rule

- Presumption that directors acted on informed basis in the company's best interest
    - **Exception:** fraud, bad faith or self-dealing
      - burden shifts to show transaction was fair
    - If majority shareholder(s) act within their rights, then motives or ill will are of no consequence



# Hypothetical Fact Patterns



# Hypothetical

- Minority and majority shareholders disagree
- Minority locks out majority shareholder from office based upon an “investigation”
- Transfers money to new account
- Management team forms new company to create “safe haven” for company’s clients

# Hypothetical

- Company out of money
- Company verbally promises employee 50-50 share in exchange for \$350,000 loan from employee
- No written agreement
- Company subsequently refers to employee as “partner” and “president,” give signing and negotiating authority
- Corporate books and records are not updated to reflect the change
- Approx. 6 years later, company terminates the employee

# Electronic Discovery



- Damaging E-Mails **almost always exist**
- Less formal dialogue
- Patterns usually emerge
- **Numerous Sources:**
  - E-mails
  - Text Messages
  - Phone Records
  - Calendars

# Electronic Discovery

- Destruction of Electronic Docs
  - *Preservation obligations*
  - *Timing of destruction important*
  - *Sanctions Available*
    - Adverse Inference
    - Evidence Preclusion
    - Default Judgment
    - Monetary Sanctions



# Introduction to Team

- Cross-Disciplinarian
  - *Employment*
  - *Corporate*
  - *Intellectual Property*
  - *Government Contracts*
  - *Commercial Litigation*
- Attorneys Experienced in Business Breakups





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