

Civil Litigation: LLCs: Breaking up is hard to do



**By THOMAS
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A lawsuit among owners of a closely-held business like a limited liability company — sometimes referred to as a “business divorce” action — often involves issues for both transactional lawyers and litigators. Your authors, a transactional lawyer and a litigator, have worked together to help our clients get through the business

divorce process on many occasions.

A transactional lawyer’s role is, of course, much different than that of a litigator. Transactional lawyers are involved at the outset of the relationship and work with their business-owner clients to create companies and agreements and conduct transactions intended to help the clients accomplish their business objectives. They try to anticipate and address areas of potential conflict and design processes to resolve those conflicts and, failing that, include written provisions to manage the separation of the owners or the dissolution of the business. When a transactional lawyer represents one out of two or more potential owners of the business, they have to negotiate with the other side’s lawyers over the terms that will govern the contemplated relationship.

Litigators usually do not get involved at the formation stage. However, when conflicts among owners arise, they often work closely with their firm’s transactional lawyers to try to resolve those conflicts in a way that will allow the business to continue, or to negotiate terms to sever the now-adverse parties’ relationship. Lawsuits get filed when the parties are incapable of compromise on the business or financial issues or when one owner accuses another owner of conflicts of interests, self-dealing or other breaches of fiduciary duty.

These types of lawsuits tend to be costly and are not quickly resolved. A client involved in a business divorce case must also endure the disruption to the business, including impacts on operations, employees, customers and vendors, as well as the stress and intense emotions almost inevitable when a long-term, and at least cordial, relationship sours and accusations of misconduct or dishonesty start to fly.



**By STEVEN R.
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Business divorces involving LLCs present their own particular problems. However, there are a number of things that owners can do at the formation stage to reduce the likelihood of litigation in the event of a future conflict that could lead to the termination of their relationship.

The owners should have in place a signed, written LLC operating agreement. An operating agreement sets out the rules of the road and greatly reduces the likelihood of conflicting understandings and recollections that might destroy a business founded on an oral agreement. Although the New York LLC Law requires a written operating agreement, we often see disputes in which the parties used an “off-the-shelf” agreement with boilerplate provisions that were not tailored to the owners’ specific needs, or in which there is no written agreement of any kind. Where the LLC has no written operating agreement, the owners’ relationship will generally be governed by the default provisions in the LLC Law and judicial decisions interpreting that law. In those circumstances the owners may find that their rights and remedies are much different than they thought they were.

In our experience, the best way to avoid, or reduce the negative impact of, conflicts between owners over critical aspects of their business is to plan for those conflicts in the operating agreement. The agreement should address decision-making processes. Who governs the LLC and what decisions can be made without the consent of the other member or members? Who decides when additional capital is needed, or profits are distributed? What happens if an owner can no longer actively participate in the day-to-day operation of the business? The operating agreement should include a mechanism to avoid deadlock over decisions that have to be made in the ordinary course of business, as well as major decisions.

The operating agreement should also address compensation. In many closely held businesses, the owners also work for the business and it is their primary source of income. How will the

owners’ salaries and other benefits be set and paid? Can an owner have her services terminated, and if so, by whom and on what grounds?

An LLC should also contemplate (and perhaps restrict) transfers of a member’s interest and anticipate the need to purchase a member’s interest and, if necessary, dissolve. A good buy-sell clause will cover the purchase of a member’s interest by describing the circumstances under which that interest may or must be sold, the method to be used to value the member’s interest, and the payment terms.

Concerning dissolution, most boilerplate operating agreements allow for the dissolution of the LLC only under very limited circumstances. Moreover, if there is no written operating agreement, the default to the statutory dissolution provisions of the LLC Law makes the dissolution of an LLC more difficult than the dissolution of a corporation. For example, the courts have consistently held that allegations that the majority members engaged in unlawful or oppressive conduct against the minority members were insufficient to plead the statutory grounds for the dissolution of an LLC, even though the oppression of minority shareholders would support a corporate dissolution action. In fact, the courts hold that a deadlock among the members will not support a request for dissolution unless the aggrieved party shows that LLC management is unable or unwilling to reasonably pursue the stated purpose of the LLC, or that continuing the business is financially unfeasible. A well-constructed operating agreement can include provisions to ensure that when dissolution of the entity is warranted, it can be obtained on the terms agreed before the dispute arose.

There is an old saying that if you don’t care where you are going any road will take you there. If you want to stay on the road of business success, then it is important that you have appropriate written governance documents as your roadmap to get there. Those documents need the expertise of a seasoned transactional lawyer. If you don’t pick that path, let me introduce you to my law partner, the litigator...

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