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Averting a Business Divorce - Lessons from the Pandemic

Best Practices for Navigating Owner Disputes

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The Covid-19 pandemic impacted many private companies so severely that their owners had no choice but to part ways. They were forced to do so, due to legitimate, intractable disputes over how to respond to the issues buffeting their companies.

This article discusses the Covid-19 pandemic's effects on private companies and the inescapable owner conflicts that resulted. Certainly, the pandemic made clear that business "divorce" is sometimes the only option. Yet perhaps this terrible event may provide us lessons to help owners avoid ending the business they nurtured together for so long.

Impacts from the Pandemic

Regardless of their form, nearly all privately-owned companies faced many of the same severe market conditions.

Decreased Demand

Demand for their goods or services may have fallen drastically, due to curtailed spending or state-mandated health and safety measures. Regardless of the cause, consumers were not buying what the company was selling. Owners had to decide how their company should adjust both in the short and long term. Should it lower its prices? Should it change its business model? Could it?

Disruptions in the Supply Chain

Supply delays, disruptions and shortages became rampant, resulting in higher costs and even scarcity. Owners had to decide how to respond. Should they pass the increased costs on to their customers or absorb those costs in the hope of retaining goodwill? Could they even afford to absorb those costs?

Employment Issues

Employment issues have abounded. Lower revenues and fixed labor costs was one. Owners had to decide whether to institute across-the-board salary reductions or make selective layoffs. Company owners may have disagreed about these cost-cutting moves, which employees were not critical, and which salaries were no longer affordable. Moreover, while some businesses were able to pivot to remote work, others, by their nature, were much more tied to a brick-and-mortar location. How to respond?

Contractual Nonperformance

Many company were unable to perform their contracts or faced counterparties that were unable to perform. Critical decisions had to be made and many involved potential liability. Cancel outstanding purchase orders? Renegotiate or default – when is nonperformance the best option?

Fixed Costs

Each had certain costs that remained (mortgages, rent, utilities, and insurance premiums, etc.) despite economic conditions. Companies had to decide which they should continue to pay. Perhaps for some, defaulting was the better, or only, alternative. Deciding which was paramount.

Liquidity and Financing

Owners likewise faced fundamental decisions over cash and financing. Events may have triggered a default or material adverse change in a financing agreement. Was restructuring debt possible, and if so, were the owners able to agree to new obligations?

Increased Potential for Owner Disputes

Business owners had to make difficult, and even critical decisions to respond to each of these challenges. Each owner may have weighed legal, operational, and practical considerations differently. The potential for legitimate, good faith disagreements was unavoidable.

For example, while one owner may have sought to preserve sales, another may have focused on cost. While some owners may have favored targeted layoffs, others wanted uniform salary cuts across the labor force.

A company's shareholder, operating, or partnership agreement may have required certain decisions to be made by unanimous owner agreement. Certainly, unanimous or supermajority clauses are quite common; they are included in owner agreement for "major decisions" outside the ordinary course of business. But how did these provisions provision play out now? Did they result in deadlock?

Each owner's particular life circumstances and personal financial condition may have also resulted in disputes. This is understandable. Owners with sizable nest eggs may have asked all to refrain from taking distributions, while those lacking such resources may have demanded their distributions and favored other cost-cutting measures.

Perceived or actual differences in owner performance or contributions to the business enterprise may have caused still other disputes. Personal matters (marital discord, family obligations, and medical issues) may have affected the owners differently and even caused underperformance.

If the company ownership agreement did not adequately address how to respond to underperformance or inequities, resentment and discord among the owners may have built up, and even burst open into full disputes, and even parting of ways.

Resolving Disputes

Direct Discussions

Ideally, if all owners had desired to continue their business, they should have attempted to resolve their disagreements among themselves. This is undoubtedly the least costly route. Trust, open-mindedness, and compromise are critical, however.

Renegotiations

If the owner agreement did not sufficiently address the issues that arose, renegotiations among the owners may have been necessary.

Mediator-Facilitated Discussions

A mediator or other designated professional may have been helpful, if direct negotiations were not fruitful or even possible. As noted below, in the dispute resolution provisions of an owner agreement, it may be beneficial to provide for a fixed period of mediator-facilitated discussions.

Best Practices when Drafting Owners' Agreements

Regardless of the nature of the form of the private company (e.g., corporation, partnership, or limited liability company),the best practice would be to have a well-drafted, clear, and comprehensive written agreement that sets forth the rights and responsibilities of the owners.

The agreement should address, among other things:

- How company decisions are to be made (e.g., for what types of issues are majority, supermajority and unanimous consent appropriate);
- Officer, partner and manager responsibilities and roles (not only the scope of work for each, but also the standards by which decisions may be made);
- When and how shares or member interests may be sold or transferred (e.g. voluntary dispositions, first-refusal rights, and transfers in the event of incapacity or death of an owner)
- Involuntary automatic sell-back provisions given certain triggering events (such as an owner breach of a fiduciary duty or contractual obligation or other "bad act");
- Valuation procedures for shares or interests (including, for example, whether an independent valuation firm will be engaged);
- When and how profit and other distributions are made;
- Restrictive covenants (including confidentiality agreements, non solicitation clauses and non-compete clauses); and
- Dispute resolution provisions (these often include arbitration, even may specify a particular arbitral forum and incorporate that forum's procedures).

As noted, the agreement should address how company decisions are made. For, example, it may allow for decisions "in the ordinary course" by a majority vote or vest officers or LLC managers with discretionary authority over such matters.

Conversely, it should require certain "major decisions" to be decided by supermajority, or even unanimous consent. Best practice is to define such significant decisions in the agreement. Examples are:

- Hiring or terminating key officers and employees;
- Executing contracts of a specific type or above a dollar amount;
- Taking actions that are not in the ordinary course of business; and
- Any other matter sufficiently important to require more than a mere majority vote.

Dispute Resolution

Without question, the Covid-19 pandemic and accompanying financial turmoil required significant decisions by companies and their owners that were not in the ordinary course of business. If the owner agreement included a unanimous consent rule, the owners were able to act if all agreed. However, the possibility of deadlock loomed.

If deadlock did occur, hopefully, the owners' agreement's dispute resolution provisions were helpful.

Owners should consider including a non-binding negotiation and/or mediation clause in their owner agreement. This provision requires a fixed period of negotiation or mediation with the assistance of a professional facilitator before any owner may invoke arbitration. Good faith, meaningful attempts should be made to reach agreement, before resorting to arbitration or other adjudication procedures.

Negotiated resolutions are almost always better and are certainly less costly than zero-sum-game processes.

Conclusion

When responding during the pandemic and financial turmoil, companies needed to make critical decisions. While some owners felt no choice but to call it quits and end their businesses, others who sought to weather the storm may have seen their businesses survive and thrive. The lessons learned from the Covid-19 pandemic provide good guidelines for private businesses to follow in order to weather any future pandemics or any other major business disruption.

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