

Business Divorce – Dealing With Ownership Conflicts

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Today's Presenter



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The Importance of a Business Pre-Nup

“From a relational standpoint, people enter closely-held businesses in the same manner as they enter marriage: optimistically and ill-prepared.”

~ Charles W. Murdock,

The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares, 65 NOTRE DAME L.REV. 425, 425 (1990)



Business Divorce Overview

- Buy-Sell Agreements
- Valuation Process
- Fiduciary Obligations
- Derivative Litigation
- Protecting Beneficiaries



Limiting Potential For Business Divorce: Due Diligence in Selecting Business Partners

Roughly 50% of companies go out of business in less than 5 years.

U.S. Department of Labor

Approximately 70% of family businesses will fail by the second generation. Harvard Business Review

“The number of businesses that fold due to bad partnerships is staggering. In some cases, they are charlatans, in others inept businesspeople, and others find themselves unable to scale with any growth.”

Michael E. Gerber, Inc. Magazine.



The Potential Partner Checklist

- Track Record (check references, what do former partners say)
- Current Capital Strength (shared balance sheets)
- MBTI Test Result (Myers-Briggs)
- 5 Year Plan Goals – where do you see yourself and see business
- Exit Plan for yourself & business



Business Pre-Nup Planning – Governance Terms To Implement To Avoid Future Partnership Conflicts

- Distribution Plan
- Permitted Dilution
- Management Fees
- Partner Exit = Buy/Sell
- Amendment Provision
- Dispute Resolution
- Non-Comp and Non-Solicit



Mamas Don't Let Your Babies...



Grow Up to be Minority Business Owners
Without a Well-Crafted Buy/Sell Agreement

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Partner Exit Planning = Buy-Sell Agreements: When The Time Arrives for Partners to **Unwind**

Call Right: Benefits majority owners, secures redemption

Put Right: Protects minority owners, secures buyout



Critical Components of Buy-Sell Agreements

- **Trigger**: When can right be triggered
- **Value**: How is the interest valued
- **Payment**: What is structure to pay
- **Dispute Resolution**: Choose process



Triggering the Buy-Sell: When Permitted



Redemption by Majority Owner

- Resignation of minority owner
- Termination with/without cause
- Divorce, disability, death or dysfunction

Redemption by Minority Partner

- When to exercise
- How much stock to include
- Company has right of first refusal

Structuring Buyout Terms

Cash Up Front

Ongoing
Ownership Rights

Notes & Security

Price Adjustments,
Earnouts,
Lookbacks



What's It Worth – Ask a Financial Expert* (?)



*ABV/APA/ASA/BV/CBA/CFA/CFF/CGMA/CMA/
CPA/CVA/FMVA

Determining Company Value

Valuation Formula

- Book value of assets (NAV)
- Discounted Cash Flows
- Market Approach—Comparables

Additional Terms

- Non-compete/Non-solicit
- Normalization adjustments
 - Compensation (disguised dividends)
 - Nonrecurring items
 - Owner perquisites

Valuation Process

- Defined process – formula selected or Business Valuation Experts
- Dispute Resolution



Personal Goodwill – Does It Apply?

Key Questions:

1. Does exiting partner have skills, reputation, or relationships not easily replaced?
2. Is the departing partner willing to sign a non-compete and assist in transition to others?
3. The role of personal goodwill in marital disputes

If the answer to #1 is yes and #2 is no, business value will likely be impaired.

Any process that fails to account for the above by mandating a non-compete and “good faith” transition or accounting for the loss in valuation, will likely misstate value.

Personal goodwill can also be lost through death or disability but can be protected against through-key person insurance policies.

Business Succession Planning

Non-Equity Ownership v. Equity Transfer

Equity – Stock Options/Grants

- Profits paid on liquidity event
- Owed fiduciary duties
- Right to review books/records
- Can vote and call meetings
- No right to interim distributions

Contract SARs and Phantom Stocks

- Payment tied to formula
- No fiduciary duties owed
- No right to books/records
- No voting rights



Fiduciary Duty Issues – Look at All the Branches

- To whom are duties owed?
- What specific fiduciary duties apply to controlling parties?
- Are there contractual limits on the duties?
- What defenses exist?



Fiduciary Duties Imposed on Governance Persons Under Texas Common Law: Case Authorities

- Corporate fiduciaries owe high duties
 - “obligation not to usurp corporate opportunities for personal gain”
 - “extreme measure of candor, unselfishness, and good faith”
 - “dedication of his uncorrupted business judgment for the sole benefit of the corporation” *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963):
- Self-interested transactions by fiduciaries may be protected by a safe harbor provision if approved by disinterested persons. TBOC § 101.255
- LLC managers owe fiduciary duties to LLC



“Fiduciary” Duties of General Partners

- The words “fiduciary duties” are not used in TBOC, but GPs owe duties of loyalty and care to: (1) the partnership, (2) **other partners**, and (3) certain transferees after death of partner. TBOC § 152.204(a).
- GP’s duty of loyalty includes (1) accounting for partnership property and profit, (2) refraining from dealing with partnership on behalf of person who has interest adverse to partnership, and (3) refraining from competing or dealing with partnership in manner adverse to partnership. TBOC § 152.205
- GP must discharge duties (1) in good faith and (2) in manner partner reasonably believes to be in best interest of partnership. TBOC § 152.204(b)
- Partners do not violate duties if conduct merely furthers their interests. TBOC § 152.204(c)

Duties of Corporate Governing Persons

Section 7.001(b),(c)—entities other than partnership or LLC—certificate of form. may restrict governing person’s liability “for an act or omission by the person,” except that it may not restrict or eliminate liability for:

- 1) a ***breach of the person’s duty of loyalty***, if any, to entity or to its owners or members;
- 2) an ***act or omission not in good faith*** that:
 - a) constitutes breach of duty to entity; or
 - b) involves intentional misconduct or a knowing violation of law;
- 3) a ***transaction from which the person received an improper benefit***, regardless of whether the benefit resulted from action within scope of the person's duties; or
- 4) an act or omission for which the liability of a governing person is expressly provided by ***an applicable statute***

Fiduciary Duties of LLC Participants

TBOC § 101.401

- TBOC does not list any fiduciary duties, so duties must exist at common law.
- “[W]e presume, based on the assumption inherent in section 101.401 of the Business Organizations Code” that a corporate executive or partner “would owe the same fiduciary duties that a corporate executive or partner would owe a corporation or partnership, unless the LLC agreement shows otherwise.” *Straehla v. AL Global Servs., LLC*, 619 S.W.3d 795 (Tex. App.—San Antonio 2020, pet. denied)
- TBOC: LLC agreement “may expand or restrict any duties, ***including fiduciary duties***, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.”

Fiduciary Duty Runs to the Company, Not to Any Individual or Any Group of Shareholders

Estate of Poe, 648 S.W.3d 277 (Tex. 2022)

- Directors owe fiduciary duties to their corporations.
- “Fiduciary duties run to the corporation, not to individual shareholders or even a majority of shareholders.”
- “We conclude...as a matter of law, a corporation’s director cannot owe an informal duty to operate or manage the corporation in the best interest of or for the benefit of an individual shareholder.”



Texas Business Judgment Rule



“ . . . the **business judgment** rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are **negligent, unwise, inexpedient, or imprudent** if the actions were within the exercise of their discretion and judgment in development or prosecution of the enterprise in which their interests are involved.”

Sneed v. Webre, 465 S.W.3d 169, 178 (Tex. 2015) (emphasis added)

Safe Harbor Provisions: The Interested Director Rule

Interested Director Rule provides “safe harbor” immunity from interested party deals when:

1. Majority of disinterested directors approve with full knowledge of facts;
2. Shareholders approve with knowledge of the facts; or
3. Transaction was objectively fair to the company.TBOC 21.418 and 101.255



Texas Shareholder Derivative Litigation: Standard Cases

- Claims v. Governing Persons
- Recovery - Injury to Company
- Procedural Rules - Demand Required on the Company
- Recovery Goes to Company



Shareholder Derivative Claims for Closely Held Texas Companies (TBOC § 21.563)

- ✓ Less than 35 shareholders
- ✓ Stock not traded on national market
- ✓ Exempt from derivative suit hurdles

Benefits to Shareholders

Procedural rules waived (TBOC § 21.563)

Minority shareholder may obtain direct recovery – where justice requires

Recovery of Legal fees if benefit shown

Also applies to LLCs (TBOC § 101.463)
but not limited partnerships (TBOC § 153.401-404)



Legal Strategies Fiduciary Cases

For Plaintiff/Owners

- Plead BOTH direct action and derivative claims for injury to the stakeholder and to the company
- Present evidence of reduced value of ownership in company
- Demonstrate that irreparable harm has been sustained

For Defendant Companies and Majority Owners

- Plead lack of capacity in verified pleading
- Contest evidence of separate harm to individual
- Return assets subject to dispute – remedy any harm

Texas Case Law Regarding Standing, Capacity and Duties of Minority Owners

- The *Wingate* Prohibition: “A corporate stockholder cannot recover damages personally for a wrong done solely to the corporation, even though he may be injured by that wrong.” *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990)
- *Pike v. Texas EMC Mgmt., LLC*, 610 S.W.3d 763, 778 (Tex. 2020): “a partner or other stakeholder in a business organization has constitutional standing to sue for **an alleged loss in the value of its interest in the organization**. In so holding, we are mindful of the statutory provisions that define and limit a stakeholder's ability to recover certain measures of damages, which protect the organization's status as a separate and independent entity.”
- *Benge v. Thomas*, No. 13-18-00619-CV, 2020 WL [5054800](#), at *9 (Tex. App.—Corpus Christi—Edinburg Aug. 27, 2020, no pet.)(trustee did not owe fiduciary duty as a limited partner)

Trustee Checklist Evaluating Private Company Ownership

- Determine nature of ownership
- Evaluate beneficiary conflicts
- Review company cap table
- Determine company value
- Secure dividend history
- Confer w/company management
- Analyze buy-sell agreements
- Confirm limits on transfer
- Assess dispute resolution terms



Thank You!



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