

Am I Handcuffed to My Business Partner?

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The scenario is a familiar one to just about every lawyer who represents owners of closely-held businesses: disquieted client calls and expresses his or her disappointment and frustration with the internal operations of the business and/or sees little hope for profitability and success. Perhaps there are personality differences among the owners. The co-owners might struggle with one another about the need for certain expenditures or capital calls. Perhaps there may be persistent differences regarding the most recent hiring (or termination) decision. Such an escalation of bickering takes a toll on the owners' peace of mind, and one or more of the owners may begin looking into new opportunities. A real challenge emerges for the counselor when this hypothetical frustrated client pushes the envelope a bit further, and announces, "I'm looking into starting a business of my own." And although the client did not state it, you know the client is contemplating competing with his current business and for one reason or another the prospect of negotiating a buy-out of your client's equity interest is not in the cards.

The prospect of one owner in a closely-held entity going into competition with his fellow owners begs the question of the legal rights and obligations of the competing owner. This article first seeks to define the precise nature of the duty such an owner owes to his fellow owners, as well as the origins of this duty. After addressing the duty, the focus will shift to the judiciary: by discussing several case studies, we will examine the factors that the courts consider in assessing the conduct of competing co-owners and when courts have found the duty to be extinguished.

The Duty of Loyalty Among Owners of a Closely-Held Entity: Its Origins and Its Obligations

About half a century ago, the courts began to recognize that shareholders in close corporations occupied a radically different position than their counterparts in public corporations.¹ In form, close corporations and public corporations are identical statutory creatures; both enjoy the same benefits of limited liability. Yet, as a functional matter, the shareholders of a closely-held corporation think and act as partners.² Far from being 'mere' owners, close corporation shareholders typically participate together as partners in the day-to-day operations of the business: they make investment decisions together, and they rely on each other to be fair and open in discussing the affairs of the business. Close corporation shareholders often pay taxes as though they were partners.³ In business and legal parlance, close corporations have earned the moniker "incorporated partnership."

Because as a functional matter closely-held entities operate as partnerships, the courts will hold the owners of such entities to the stringent fiduciary duties imposed under partnership law. One court summarized the duty thus: "there exists between partners the highest degree of fidelity, loyalty, trust, faith and confidence. . . . [W]hen these characteristics cease between owners of . . . shares in a close corporation, the close corporation ceases to be beneficial to the . . . shareholders."⁴ The duty of loyalty imposed upon owners of small businesses imposes a high burden: the shareholders must act with the "utmost good faith and loyalty," a more rigorous standard than mere "good faith and inherent fairness."⁵ Given the nature of the relationship among the owners in a close corporation, the law assumes that unless the owners are held to the fiduciary standards of partners, the entity will not function to the benefit of the owners.⁶

It is important to note that the duties discussed in this article arise as a consequence of sharing an ownership stake. If two businesspeople, each owning his own separate business, become involved together in a single project, the duty would be evaluated differently than if the undertaking were their sole business. Though the two are participating on a joint venture, there is no question that the two established businesses would have expansive, perhaps unfettered latitude to pursue new projects in direct competition. Naturally, the extent of the duty inquiry is

different here: the one-shot cooperation between the venturers is necessarily colored by an understanding that the venturers are full-time owners of competing businesses.

A Competing Co-Owner is Taken to Court: The Nature of the Judicial Inquiry

At the most basic level, the cases reveal that the duty of loyalty imposed on owners of closely-held businesses is breached where one co-owner competes with his fellow owners. Absent a contrary agreement, the duty of loyalty will generally be relieved only upon complete divestment of the equity stake in the business.⁷

In the key New York case on this point, the two principals, Fender and Prescott, each owned a fifty percent stake in a close corporation.⁸ As their relationship deteriorated, the principals entered into a buy-sell agreement whereby “either party could offer to buy out the other, and, thereupon, the offeree had the option to elect to be the purchaser or the seller” under the terms of the offer.⁹ Prescott offered to purchase Fender’s interest, and Fender then elected to buy out Prescott’s interest at Prescott’s proffered price.¹⁰ However, Prescott had “great misgivings” about selling, and refused to consummate the closing.¹¹ Believing that the buy-sell arrangement had effectively relieved him of any duties to the corporation, Prescott then proceeded to compete with the corporation by offering to purchase warehouse properties on his own account.¹² The court held that Prescott breached his fiduciary duty as a shareholder by seizing a corporate opportunity while he continued as a shareholder.¹³ The court noted that the duty of loyalty applied to Prescott as long as he held an equity stake: mere execution of a buy-sell agreement will not terminate the duty; Prescott would be free to compete only upon an actual sale of the shares and withdrawal from the business.¹⁴

The essence of the *Fender* holding is that selling your interest and resigning from the company will generally relieve you from the duty of loyalty. A duty is generally not discharged before actual sale of shares, but the duty is almost always discharged after selling off an interest. Interestingly, a federal court applying New York law has applied this rule in favor of a competing co-owner who committed fraudulent acts against the company.¹⁵ More specifically, the defendant was a twenty percent shareholder/director/employee who was fired for fraudulent acts, including forging signatures and diverting funds.¹⁶ Upon his termination, the employee’s shares were repurchased pursuant to the shareholder’s agreement.¹⁷ The employee subsequently became involved in a competing venture.¹⁸ Though the shareholder/employee engaged in affirmative bad acts against the company, he was absolved of any breach of the duties attaching to a shareholder: because he was no longer a shareholder, the duty of loyalty was severed.¹⁹

Under certain factual scenarios, an owner may be relieved of his or her duties to co-owners before an actual divestment of the equity interest. For example, an owner who is made to suffer oppressive conduct at the hands of his co-owners will often be found free to compete.²⁰ Generally, the conduct must be egregious. In a leading case considered by the Wyoming Supreme Court, the business owner held a 50 percent stake in a game processing business.²¹ She was also an officer and director.²² Her co-owner squeezed her out of the business by excluding her from day-to-day operations and changing the locks.²³ After the squeeze out, she formed a competing company and actively solicited customers.²⁴ Despite the fact that she was still a shareholder, she was found to owe no duty.²⁵ As the court held, “*the fiduciary duty not to compete depends on the ability to exercise the status which creates it.*”²⁶ In other words, a shareholder owes a duty because he is a participant in the affairs of the business. Where the shareholder is wrongfully forced out of the business, he can no longer rightfully be required to behave as a fiduciary.

While some cases in other jurisdictions have taken the same course as the Wyoming court,²⁷ other jurisdictions have taken the minority position that a mere freeze out, without divestment of ownership interest, is not enough to relieve the duty.²⁸

In addition to its pronouncement on the effects of a squeeze-out, the *J Bar H* case is also helpful in considering the relative difference between active and passive ownership interests. While co-owners in a close entity generally owe one another a duty, the Wyoming court reminds us that the very existence of the duty will depend on the functional reality that creates the need for the duty.²⁹ Under this functionalist paradigm, the case in favor of imposing a duty grows stronger as the shareholder's role in the day-to-day operations of the business increases. An active owner has more access than his passive counterpart: the active owner uses the company's bank account; he communicates with the business's customers; and he contributes more to the entity's decision-making process. In exercising these functions, a self-dealing active owner would have the means at his disposal to take advantage of the ignorance of the passive owners, should he be so inclined. Naturally, then, a vigilant court might protect the rights of passive owners by applying the duty more vigorously against an active owner.

As seen from the case law, once a claim for breach of fiduciary duty is brought against a co-owner for competing with the original venture, there is no certainty in predicting the outcome of the litigation. The inquiry is inherently fact-sensitive. The court may compare the proportions of the interests owned by the various members of the company. A judge may consider whether the alleged offending member played an active role in management of the company, or whether he was a mere investor. Some courts may weigh issues of commercial morality underlying the case, and note whether any of the parties committed any acts of fraud or oppression. The difficult question, then, is deciding when the duty of loyalty ends. While it is true that the courts have said that oppressive conduct will relieve an owner of the duty of loyalty, the problem is assessing when oppressive conduct becomes so oppressive that a court would hold the duty extinguished. It is a risky move indeed to begin to compete in advance of a final buy-out or dissolution order. Therefore, advance planning offers the best preparation.

Advice for Owners of Closely-Held Entities in Search of an Exit Strategy

Given that the judicial inquiry is intensely fact-sensitive, it is impossible to say with any certainty whether a given factual scenario will result in a finding of liability on the part of the competing co-owner. Indeed, the case law suggests that the only way for a former owner to compete safely is to be just that: an ex-owner. Until complete and formal divestment of the equity interest in the entity, the duty of loyalty will continue to haunt the co-owner. And even after selling one's interest, a claim may still lie for misappropriation of confidential information or theft of trade secrets.

Given the plethora of uncertainties associated with competition, one clear observation presents itself: no advantage can ever come from waiting for a litigation-based resolution. By the time a court battle is decided or settled, the parties will have expended a great deal in the way of resources and time, perhaps without any satisfactory resolution vis-à-vis the rights of the original and competing businesses.

It is therefore to the advantage of all stakeholders to reap the benefits of counseling. If a conflict over competition arises when an alleged competing entity is already in existence, it would be advisable to work at negotiating a buy-out. As the cases illustrate, total divestment of the equity interest, together with resignation from any corporate offices, should relieve the competing owner from the duty of loyalty.

Further, the benefits of pre-formation counseling cannot be overstated. From the very beginning of entity formation, it is advantageous to consult an experienced corporate attorney regarding the possibility of future competition. Indeed, some clients may be interested in specifically reserving the right to compete in the entity's organizational documents.

Prospective owners of closely-held entities are advised to be cognizant that the judicial response to any limitation of fiduciary duties not to compete may vary, depending on the type of entity involved and the factual background of the particular business. For example, courts have been tremendously permissive when members of limited liability companies endeavor to limit the

applicability of certain common law duties. Though LLC members must ordinarily act towards one another with the “utmost trust and loyalty,” an Ohio court has noted that such duties may be limited by the operating agreement, even to the point of permitting a current LLC member to actively compete with his LLC.³⁰

While the potential for private modification of corporate duties is not entirely foreclosed, prospective shareholders in a close corporation desirous of contracting around the duty of loyalty may have a more difficult path to tread. The state legislatures are a bit hesitant to allow for certain limitations of corporate fiduciary duty.³¹ Similarly, the courts may look askance on efforts to narrow the duty of loyalty applicable to shareholders in close corporations. *Neubauer v. Goldfarb*,³² a case considered by the California Court of Appeal, provides an example for consideration. Neubauer and his family trust owned 40 percent of a close corporation.³³ Neubauer agreed to sell his stock to the company for \$70 per share, for a total purchase price of \$14.4 million.³⁴ Less than three months later, the corporate defendants sold 65 percent of the corporation at \$347 per share.³⁵ When Neubauer alleged that the defendants breached their fiduciary duty in negotiating the price of the shares, the defendants cited a provision in the parties’ agreement that provided, “Seller acknowledges that neither [the corporation] nor its officers, directors or controlling shareholders have any fiduciary duty to seller or [to the corporation] in connection with the execution of this agreement or a sale including, but not limited to, the fairness of the overall consideration or the allocation thereof.”³⁶

The court held that this exculpatory provision was unenforceable as against public policy.³⁷ According to the Court of Appeal, the public interest weighed in favor of not enforcing the privately-negotiated waiver of fiduciary duty.³⁸ Though the sweeping *Neubauer* holding represents a general reluctance to cut back on the duty of loyalty in the close corporation context, it is important to remember that the Court of Appeal was reacting to a very specific set of facts, and as such, it is possible that the application of *Neubauer* is limited to these facts. That is, the majority shareholder buyers in *Neubauer* breached their duty to the seller in representing that a grossly inadequate price was fair. Then, *after* the fraud was achieved, the buyers attempted to insulate themselves from liability through the exculpatory clause in the buy-sell agreement. Therefore, it would seem that the *Neubauer* holding may be limited to just such a case, where an overreaching majority with superior bargaining leverage effects an unjust transaction and then negotiates a pardon for *his own* prior bad acts.³⁹ The exculpatory clause in *Neubauer* was a one-way street: the majority shareholders with superior bargaining power were guaranteeing a free pass for their own prior bad acts. In contrast, a provision negotiated in good faith in an arms-length transaction, with prospective application that offered benefits to both sides, may elicit a different response from the courts.⁴⁰

Owners of closely-held entities, regardless of whether they hold majority or minority interests, will generally owe a duty to their fellow owners. The law evolved to recognize the functional realities surrounding small businesses: owners of closely-held entities generally behave like partners, so they should be treated like partners. Yet, what the law gained in realism, it lost in precision and predictability. Absent an actual divestment of the ownership interest, a member of a business who forms a competing entity cannot be sure of the precise moment when the duty is discharged. Counseling offers the best opportunity to inject a bit more certainty into the nature of the relationship among the owners. Agreements, when executed in good faith, can be crafted to implement the parties’ desires regarding competition during and after one’s association with the entity.

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¹ See, e.g., *Application of Pivot Punch & Die Corp.*, 182 N.Y.S.2d 459, 462 (Sup. Ct. 1959); *Weiss v. Gordon*, 301 N.Y.S.2d 839, 842 (App. Div. 1969) (preferring to treat close corporations as the situation “exists in fact rather than in theory,” and recognizing that “the relationship between the stockholders in a close corporation vis-à-vis each other in practice closely approximates the relationship between partners”).

² *Pivot Punch & Die*, 182 N.Y.S.2d at 462.

³ *Id.* at 462-63.

⁴ *Id.* at 464.

⁵ *Medical Air Technology Corp. v. Marwan Investment, Inc.*, 303 F.3d 11, 19-20 (1st Cir. 2002) (citing Massachusetts law).

⁶ Courts will apply the partnership law duty of loyalty to owners of other types of close entities. For example, a limited partner of a limited partnership may be subject to the obligations of a fiduciary. See 6 Del. C. § 17-403 (generally incorporating the fiduciary obligations of the UPA into Delaware’s enactment of the RULPA). In addition, most of the states’ LLC statutes impose a duty of loyalty on LLC members who participate in management. Callison & Sullivan, *Limited Liability Companies: A State-by-State Guide to Law and Practice*, § 8:7. The modification of fiduciary duties in closely-held entities by private agreement will be discussed further *infra*.

⁷ See, e.g., *Fender v. Prescott*, 476 N.Y.S.2d 128, 132 (App. Div. 1984); *Hagshenas v. Gaylord*, 557 N.E.2d 316, 323-24 (Ill. App. Ct. 1990); *Sohon System, Inc. v. Troub*, 300 N.Y.S. 438, 439 (App. Div. 1937).

⁸ *Fender*, 476 N.Y.S.2d at 130.

⁹ *Id.*

¹⁰ *Id.* at 130-31.

¹¹ *Id.* at 131.

¹² See *id.*

¹³ *Fender*, 476 N.Y.S.2d at 132.

¹⁴ *Id.* *Fender* points out that mere execution of contract for a buyout is not enough; an actual closing on the transaction is necessary. *Id.* The corollary to this proposition relates to the petition for dissolution: In *Hagshenas v. Gaylord*, 557 N.E.2d 316 (Ill. App. Ct. 1990), a 50 percent shareholder in a travel agency corporation sued for dissolution. 557 N.E.2d at 317-18. While the court proceeding was pending, the shareholder presumed the petition had relieved him of any responsibility to his co-owner. See *id.* at 318. He therefore resigned as an officer and director, opened a competing agency, hired employees of the original venture, and actively solicited customers. 557 N.E.2d at 318-19. The shareholder was held liable for breach of the duty to loyalty. *Id.* at 323. As the court reasoned, a mere petition for dissolution was not enough; only an actual dissolution order could relieve a shareholder of his fiduciary duties. *Id.* at 324.

¹⁵ *Innovative Networks, Inc. v. Young*, 978 F. Supp. 167 (S.D.N.Y. 1997).

¹⁶ *Id.* at 172.

¹⁷ *Id.* at 183.

¹⁸ *Id.* at 174-75.

¹⁹ *Id.* at 183.

²⁰ See *J Bar H, Inc. v. Johnson*, 822 P.2d 849, 861 (Wyo. 1991).

²¹ *J Bar H*, 822 P.2d at 852.

²² *Id.*

²³ *Id.* at 853.

²⁴ *Id.* at 854.

²⁵ *Id.* at 861.

²⁶ *Id.* (emphasis in original).

²⁷ See, e.g., *MGM Court Reporting Service, Inc. v. Greenberg*, 532 N.Y.S.2d 533 (App. Div. 1988) (where 40 percent owner/employee of court reporting corporation was frozen out by other shareholder, the owner/employee did not violate his duties when he established his own court reporting business and solicited former clients); *O'Donnell v. Marine Repair Services, Inc.*, 530 F. Supp. 1199 (S.D.N.Y. 1982) (35 percent owner who began a competing venture was held not liable where he had been excluded from day-to-day operations and was wrongfully terminated as an officer and director).

²⁸ *Rexford Rand Corp. v. Ancel*, 58 F.3d 1215, 1220-21 (stating that the *J Bar H* court did not reach an “optimal result,” and maintaining that an owner may still be held to the standards of a fiduciary, despite an oppressive campaign waged against him).

²⁹ 822 P.2d at 861.

³⁰ *McConnell v. Hunt Sports Enterprises*, 725 N.E.2d 1193, 1206-07, 1215-16 (Ohio Ct. App. 1999). In *McConnell*, a limited liability company named CHL was established in order to secure a National Hockey League (NHL) franchise for the city of Columbus. *Id.* at 1200. When CHL's members could not agree on whether or not to sign a certain lease agreement for an arena (the lease being a necessary prerequisite to obtaining the franchise), some of CHL's members executed the lease agreement independently of CHL and in the name of a new ownership group. *Id.* at 1202. The NHL then awarded the franchise to the competing ownership group. *Id.* The court rejected CHL's claim that the breakaway ownership group had breached their fiduciary duty. *Id.* at 1206-07, 1215-16. Instead, the court enforced Section 3.3 of the CHL operating agreement, which stated “Members shall not in any way be prohibited from or restricted in engaging or owning an interest in any other business venture of any nature, including any venture which might be competitive with the business of the Company.” *Id.* at 1206. The case is indicative of the trend that limited liability members are free to modify default duties through private agreement. Callison & Sullivan, *supra* n.6 at 123, 123 n.13.

³¹ For example, the corporate statutes of certain jurisdictions now allow for the certificate of incorporation to provide for the limitation or elimination of the personal liability of directors for damages occurring as a result of a breach of the fiduciary duty of care. See, e.g., 8 Del. C. § 102(b)(7). However, these statutes are careful to prohibit any private modification of the duty of loyalty. *Id.*; Minn Stat. § 302A.251. Acts taken in bad faith; instances involving “intentional misconduct or a knowing violation of law”; or transactions resulting in “an improper personal benefit” will not be pardoned by a purported limitation in the certificate. *Id.*

³² 133 Cal. Rptr. 2d 218 (Ct. App. 2003).

³³ *Id.* at 220.

³⁴ *Id.* at 221.

³⁵ *Id.*

³⁶ *Id.* at 223.

³⁷ *Id.* at 224-25.

³⁸ *Id.* at 225 (stating in rather absolute terms, “waiver of corporate directors’ and majority shareholders’ fiduciary duties to minority shareholders in private close corporations is against public policy and a contract provision in a buy-sell agreement purporting to effect such a waiver is void”).

³⁹ In a subsequent unpublished case, the California Court of Appeal noted the limited nature of the *Neubauer* holding. *Geddes v. Campbell*, No. B185506, at 6-7 (Cal. Ct. App. 2006). In *Geddes*, the court noted that the *Neubauer* court was concerned with the application of a California statute that invalidates attempts by private contract to exculpate an individual “from responsibility of his own fraud.” *Id.* at 6 (quoting Cal. Civ. Code § 1668). The *Geddes* decision notes that the principle of seemingly per se invalidity of fiduciary duty exculpatory clauses might not apply in cases of full disclosure, since there is then no “attempt to avoid liability for fraud.” *Id.* at 7. Additionally, the analysis in the partnership context comes out a bit differently since sales of partnership interests do not implicate the public interest in the same manner as sales of stock. *Id.*

⁴⁰ See *Geddes*, No. B185506, at 6-7.