

Can I Fire My Business Partner?

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The decision to form a business with a partner or permit another person to obtain an equity interest in one's existing business is a significant decision that undoubtedly will have a meaningful impact on the future of the business. Joining forces in a new venture or admitting a new equity owner into the business requires one to investigate the capabilities, relationships, finances and the work ethic of that individual. When, after serious deliberation, the decision is made to launch a new venture with a partner or permit another to obtain an equity interest, a business owner is best served by engaging an attorney to document the relationship between the now business partners. This documentation should, among other things, address the terms upon which the equity will be split, the rights and responsibilities of all of the parties and the circumstances and terms pursuant to which the parties can sever ties. While best practices dictate the need for proper documentation, the reality of almost all multi-owner businesses is that no such documentation exists. Or if some documents do exist, they almost always fail to address most of the situations that create strife among co-owners and/or fail to provide an equitable and structured manner for ending the business relationship.

The inadequacies of the documentation governing the relationships among co-owners of a business are often highlighted when a majority owner is looking to terminate the employment of a minority owner and purchase the terminated owner's equity. Unfortunately, absent the existence of an agreement between the co-owners providing majority owners with such a right, the majority owner will not be able to effectuate a split from his business partner absent a costly litigation or a negotiated buy-out. Although majority owners are quick to realize the limitations of their remedies vis-à-vis acquiring the equity of a co-owner, they are often surprised to learn that they cannot terminate the employment of their minority equity holding partner without concern - even though the minority shareholder had no employment agreement with the company.

Minority Shareholder's Reasonable Expectation of Continued Employment

Courts from New York,¹ Pennsylvania,² New Jersey,³ Texas,⁴ Utah⁵ and North Dakota⁶ have recognized that a minority owner, under certain circumstances, has a reasonable expectation of continued employment.⁷ These courts have relied on state shareholder protection laws and fiduciary duties to protect minority equity owners from the "oppressive conduct" of majority owners.⁸ Without either the existence of an employment agreement or untoward conduct by the minority owner, very often, merely terminating the employment of an equity holder is considered oppressive. Courts have responded to this type of oppressive conduct by reinstating the employment of owners, requiring the company to make significant severance payments to the terminated owner and even requiring that the company be dissolved.

For example, in *In re Imperatore*, John Imperatore was employed by Forest Transmissions, of which he was one of three co-owners.⁹ John initially invested in the company based upon an understanding that he would be a salaried employee.¹⁰ However, when the company fell into poor financial condition and was not making a profit, largely due to John's "ineffective performance" as a "technical man," John's business partners decided to discontinue salary payments for both John and Charles Fox, the manager.¹¹

Being unable to support himself without a salary, John resigned and petitioned the court to dissolve Forest Transmissions, Inc. The court held that the decision to stop paying John's salary was "oppressive," and that the lower court should have dissolved the corporation.¹² Specifically, the court held that "if the corporation had fallen into such poor financial condition that it could not afford to pay him [John] any salary," John reasonably could have expected his partners to agree to the dissolution of the business.¹³ The court was unmoved by the fact that Charles Fox, also a co-owner, discontinued his own salary to save the business. The court also did not consider the effect paying salaries would have on the ability of the business to continue as a going concern.

In another case, *Bonavita v. Corbo*, Julia Bonavita inherited 50 percent of the outstanding stock of Corbo Jewelers, Inc. from her late husband.¹⁴ For almost 50 years, Gerald Bonavita and Alan Corbo had shared equal ownership and management of Corbo Jewelers. Before Gerald's death, the business partners and their families enjoyed an amicable and casual business relationship. For example, after Gerald retired, he continued receiving a salary. However, after Gerald's death, the relationship between Julia and the Corbo family deteriorated. It began when Alan advised Julia that he was going to discontinue Gerald's salary (retirement) payments. With her late husband's salary discontinued and being retired herself, Julia needed a source of income.

In response, Julia requested Gerald's salary payments be reinstated. When Alan refused, she requested that Corbo Jewelers pay a dividend. This Alan also refused, so Julia petitioned the court to order a dividend. The petition was denied. Being wholly unsuccessful at deriving any profit from her 50 percent interest in Corbo Jewelers, Julia petitioned the court as an oppressed minority shareholder to order a mandatory stock buy-back of her stock by either Alan or the corporation. The court granted this petition, and in doing so, the court held that Alan had an obligation to at least try to provide some alternative benefit to Julia when he discontinued making Gerald's salary payments after Gerald's death.

*Wilkes v. Springside Nursing Home, Inc.*¹⁵ demonstrates just how difficult it can be for business partners to go their separate ways when relationships sour. In *Wilkes*, Stanley Wilkes and three associates built a nursing home. The parties agreed that each party would receive equal payments from the business as long as the business could afford the distributions. It was further understood that each man would be a director and serve in a management capacity. For nearly 10 years, the business operated successfully.

Thereafter, one of the owners retired and, later, after some in-fighting, Wilkes sought to have his interest bought out. But before a buy-out could be arranged, a director's meeting was held where salaries were approved for all of the owners except Wilkes. Then, at the next shareholders meeting, Wilkes was not re-elected as a director or officer, and he was told that his services would no longer be needed.

Wilkes sued his business partners for breaching the fiduciary duties owed to him as a minority stockholder. Ultimately, the court held that Wilkes' business partners acted in concert to freeze Wilkes out of the management of the nursing home and cut off his salary payments in an effort to force the sale of Wilkes' stock at prices his co-owners would not have accepted themselves. All the while, Wilkes was ready, willing and able to continue working in exchange for regular salary payments.¹⁶ In the end, Wilkes was entitled to damages equal to the salary he would have received if he had remained employed. Although this case relied on an early standard for determining shareholder oppression¹⁷ that has since changed,¹⁸ faced with the same facts today, the court would likely have ruled the same way.

Factors Influencing Existence of Right to Continued Employment

As indicated in the cases discussed above, courts protect the right to continued employment and recognize it as a "privilege and power" of having an ownership interest in a corporation.¹⁹ The right, however, isn't available to every shareholder of a company. Courts

have typically only recognized a reasonable expectation of continued employment where the minority shareholder commits resources under the impression that he or she will be permitted to work for the corporation²⁰ and when employment only begins near the date of investment.²¹

Generally, when deciding whether the termination of a minority owner's employment is permissive, courts consider the firing from the complaining minority owner's perspective and decide if his or her reasonable expectations have been frustrated and whether he or she is thereby oppressed.²² Courts also look at the effect the controlling party's conduct has on the complaining party, only passively considering the majority owner's and the business' interests.²³

Terminating Minority Shareholder's Employment Requires Patience, Planning and Documentation

To be clear, the right is not absolute. It is possible to lose the right to continued employment. An employee's own misconduct or incompetence may nullify the reasonableness of expecting continued employment.²⁴ Failing to get along with other employees, causing key employees to quit and quitting several times without notice have been deemed sufficient grounds for termination.²⁵ However, in the majority of instances where firing an underperforming business partner has been permitted, it has been a result of careful planning and proper documentation.

For example, in 1986, Jerome Moore founded Maine Industrial Services, Inc. (MIS), a heavy industrial cleaning company.²⁶ Moore and six outside investors capitalized MIS. The company's management was best described as casual, and there were few restrictions on Moore's authority to run the business. Within its first two years, the company was a success. At the end of 1988, the stockholders decided to become more involved in the corporation. The first formal shareholder meeting was held in November of 1988.

At the first shareholder meeting the shareholders discovered that Moore, acting on behalf of MIS, had entered into a very expensive contract with Gary Wheelock, Inc. to provide vacuum trucks essential to the business. The shareholders viewed the contract as one-sided and imposed a spending cap on Moore so that all future contracts valued over the cap required shareholder approval. The shareholders began meeting regularly and soon found additional contracts that they viewed as disadvantageous to MIS.

Relations between Moore and the other shareholders became strained. At a shareholders meeting that Moore did not attend, the other shareholders replaced Moore as President. The shareholders offered Moore a position as sales representative and overseer of large projects subject to a spending cap. Moore did not have an employment agreement with MIS, but when his position was reclassified, he consulted an attorney, had an employment agreement drafted and presented his draft employment agreement to the shareholders. At the next shareholder meeting when Moore's employment agreement was considered, the shareholders voted to terminate Moore's employment rather than agree to his terms. In response, Moore filed a lawsuit against the majority shareholders alleging a breach of fiduciary duty and the frustration of his reasonable expectation of continued employment.

Unfortunately for Moore, the court found that his reasonable expectation of continued employment was not frustrated. In reaching its conclusion, the court pointed to the following facts: (i) Moore agreed to several over-priced contracts that were not in the best interests of MIS; (ii) Moore experienced difficulty managing anything beyond individual projects; (iii) Moore permitted his wife - who had no accounting experience - to manage the corporate books; and (iv) the majority shareholders made reasonable efforts to work with Moore, but he was uncommunicative and lacked financial acumen, making him unfit to continue as president of a multi-million dollar corporation.²⁷ The court also highlighted the shareholders' offer to continue Moore's employment in a new position better tailored to his abilities, and Moore's subsequent stubbornness and refusal.

Being patient, however, isn't the only way to "properly" fire a business partner. Being prepared goes a long way, too. The right to continued employment can be contracted around. Courts encourage parties to reduce their expectations to writing, and an employment agreement is an excellent way to avoid putting the success of a business in the hands of a court.

The next story is a familiar one – a child returns home to take over the family business, expectations are not met, and the relationship among the co-owners/family members erodes. In *Bolander v. Bolander*, Bruce Bolander was a partner with a major East coast law firm before he left to work for his parents' construction company, Carl Bolander & Sons Co (CB&S). His goal was to assume control when his parents retired.²⁸ To accomplish this, Bruce and his parents consulted an attorney, who drafted a succession plan whereby Bruce's parents would slowly retire from CB&S, and Bruce would slowly assume control.

Bruce and CB&S entered into an employment agreement for a term of seven years, such that, unless Bruce was fired for "due cause," he would receive his full salary, bonus and

benefits, for the remainder of the term of the employment agreement. Bruce and his parents also entered into a shareholders agreement and trust agreement. Under the trust agreement, Bruce's parents would transfer a portion of their stock to a trust that Bruce would serve as trustee of, so long as he was continuously employed by CB&S, and under the shareholders agreement, the stock of Bruce's parents would eventually be repurchased by CB&S.

During much of Bruce's tenure at CB&S the company operated at a loss. Since Bruce's compensation was tied to CB&S's performance, Bruce found himself in need of money. To maintain personal solvency, between September 1994 and March 2000 Bruce borrowed approximately \$200,000 from CB&S. Bruce continued making cash withdrawals from CB&S for the next five months, totaling an additional \$153,000. When his parents learned of the loans they informed Bruce of their intent to terminate his employment. The CB&S Board instructed Bruce to immediately repay the "borrowed" \$353,000, and when he did not, they terminated his employment.

Bruce sued CB&S for, among other things, shareholder oppression, including frustrating his reasonable expectation of continued employment. The court dismissed Bruce's claim against his parents for shareholder oppression. The court held that mere existence of an at-will employment relationship embodied in Bruce's employment agreement was sufficient to vitiate any reasonable expectation of continued employment someone in Bruce's position may otherwise have had.

In *McLaughlin v. Schenk*, the court was confronted with a different situation, one where a significant period of time elapsed between the initial date of employment and the equity investment by Sam McLaughlin in Cookietree, Inc., a privately held Utah corporation that produced and sold baked goods.²⁹ Ten years after Cookietree, Inc. was founded, McLaughlin was hired as its operations leader. After being employed for a period of time, McLaughlin was promoted to Chief Operating Officer and Vice President of Operations. McLaughlin signed an employment agreement with Cookietree that provided an option to purchase stock in the company, but it also made clear that McLaughlin was an at-will employee.

During the course of his employment, McLaughlin exercised some of his options to acquire equity in Cookietree. In connection with his exercise of the option, McLaughlin became a party to a shareholders' agreement. Among other terms, this agreement granted the company and existing shareholders a right of first refusal before the sale of any company stock held by McLaughlin. In 2003, after McLaughlin had been working at Cookietree for over 10 years, Greg Schenck, the majority owner and son of the founder, decided to sell the

company. McLaughlin expressed interest in buying the company but experienced difficulty in raising the requisite capital. Otis Spunkmeyer, a major competitor, also expressed interest in acquiring Cookietree. In order to prevent the sale to a rival purchaser, McLaughlin engaged in a course of action designed to stall negotiations.

Ultimately, as a result of his actions to upset the sale to Otis Spunkmeyer, McLaughlin was fired, and although under the terms of his employment agreement McLaughlin's termination wasn't effective for six months, he was immediately relieved of all duties, blocked from the company e-mail and excluded from company premises.

After being forced out of the company, McLaughlin sued Cookietree and Schenck under several causes of action, including frustrating his reasonable expectation of continued employment. The court ruled that neither Cookietree nor Schenck frustrated McLaughlin's reasonable expectation of continued employment. In so ruling, the court based its decision on the following important facts: (i) McLaughlin was not a founder of the company; his primary reason for joining the company was employment; (ii) he was compensated at market rates for his work as an employee; (iii) as an employee he was permitted to purchase stock but not required to do so; and (iv) McLaughlin's stock purchases in the company were not made concomitantly with his hire and therefore should be viewed as a separate investment distinct from his employment.³⁰

Conclusion

It is important to document the relationship between business partners. This includes the terms of any equity investment, formalizing terms of employment and developing an exit strategy should business partners decide to go their separate ways. Employment agreements and buy/sell agreements go a long way in both preventing and resolving disputes. They also keep courts from guessing what the business partners may have been thinking when they initially decided to join forces.

If, for whatever reason, documenting the terms and conditions of the business relationship is not an option, consideration should be given to employing a new business partner before permitting the business partner to obtain an equity interest. This will help demonstrate that there is no connection between the two. In addition, the time period between commencement of employment and equity acquisition will provide a proving ground for partners to determine whether they work well together. Finally, if it becomes necessary to terminate the employment of a business partner, document the reasons, and if possible, be

able to demonstrate that the decision to terminate was made only after one or more attempts to find an objectively reasonable alternative.

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¹ *E.g., In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1179 (N.Y. 1984).

² *E.g., Del Borro v. Del Borro*, 62 Pa. D. & C.4th 417, 426 (Ct. Com. Pl. Pa. 2001).

³ *E.g., Brenner v. Berkowitz*, 634 A.2d 1019, 1028 (N.J. 1993).

⁴ *E.g., Willis v. Bydalek*, 997 S.W.2d 798, 802-03 (Tex. App. 1999).

⁵ *McLaughlin v. Schenk [sic]*, 2009 UT 64, ¶ 1 (Utah 2009).

⁶ *E.g., Balvik v. Sykvester*, 411 N.W.2d 383, 388 (N.D. 1987).

⁷ A minority of states, including Delaware, have held otherwise. *See Riblet Products Corp. v. Nagy*, 683 A.2d 37, 39 (Del. 1996) (refusing to recognize a shareholder right to employment qua shareholder).

⁸ *E.g., John Henegan, Oppression of Minority Shareholders: A Proposed Model and Suggested Remedies*, 47 Miss. L.J. 476, n2 (1976); *In re Topper*, 433 N.Y.S.2d 359, 364 (Sup. Ct. 1980) (explaining that at least 12 other states and the District of Columbia have statutes similar to § 97 of the ABA-ALI Model Business Corporation Act (1972 ed.)).

⁹ *In re Imperatore*, 128 A.D.2d 707, 707 (N.Y. App. Div. 1987).

¹⁰ *Id.* at 708.

¹¹ *Id.*

¹² *Id.* at 709.

¹³ *Id.*

¹⁴ *Bonavita v. Corbo*, 692 A.2d 119, 120, 128 (N.J. Super. Ct. Ch. Div. 1996).

¹⁵ *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E.2d 657, 660-61 (Mass. 1976).

¹⁶ *Id.* at 663-64.

¹⁷ *Id.* at 661-62 (relying on *Donahue v. Rodd Electrottype Co. of New England, Inc.*, 367 Mass. 578, 585-86 (1975) and *Cardullo v. Landau*, 329 Mass. 5, 8 (1952) for the proposition that "the standard duty owed by partners to one another is one of 'utmost good faith and loyalty'").

¹⁸ *Pointer v. Castellani*, 918 N.E.2d 805, 817 (Mass. 2009) (explaining that a "breach of a fiduciary duty through a freeze out occurs when the reasonable expectations of a shareholder are frustrated").

¹⁹ *See, e.g., In re Kemp & Beatley, Inc.*, 473 N.E.2d at 1178 (quoting O'Neal, Close

Corporations (2d ed.), § 1.07, at 21–22); *Balvik*, 411 N.W.2d at 386.

²⁰ *E.g.*, *Gunderson v. Alliance Computer Prof'ls, Inc.*, 628 N.W.2d 173, 190–92 (Minn. Ct. App. 2001); *In re Kemp & Beatley, Inc.*, 473 N.E.2d at 1179.

²¹ *E.g.*, *Brenner v. Berkowitz*, 634 A.2d at 1033.

²² *E.g.*, *Bonavita*, 692 A.2d at 127 (defining "oppression" in terms of the minority shareholder's viewpoint).

²³ *E.g.*, *Exadaktilos v. Cinnaminson Realty Co.*, 400 A.2d 554, 560 (N.J. Super. Ct. Law Div. 1979), *aff'd*, 414 A.2d 994 (N.J. Super. Ct. App. Div. 1980). *See also Brenner*, 634 A.2d at 1029 (discussing and applying *Exadaktilos*).

²⁴ *E.g.*, *Exadaktilos*, 400 A.2d at 561–62; *In re Kemp & Beatley, Inc.*, 473 N.E.2d at 1179.

²⁵ *See Exadaktilos*, 400 A.2d at 561.

²⁶ *Moore v. Maine Industrial Services, Inc.*, Civil Action Docket No. CV-91-856 at 2 (Sup. Ct. Me. 1995).

²⁷ *Moore*, Civil Action Docket No. CV-91-856 at 17–19.

²⁸ *Bolander v. Bolander*, 703 N.W.2d 529, 536 (Minn. Ct. App. 2005).

²⁹ *McLaughlin*, 2009 UT 64 at ¶ 1.

³⁰ *McLaughlin*, 2009 UT 64 at ¶ 28.