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Business Divorce Could Be Better Balanced In Texas

Law360, New York (October 29, 2013, 8:19 PM ET) -- Business divorces can be exhausting, complex and emotional. When business partners lose trust and confidence in one another, and set out to disentangle themselves and their finances, the process is oftentimes lengthy and expensive. Common allegations found in business divorce lawsuits run the gamut from more mild cases involving the mismanagement of company affairs or nondisclosure of company information, to more extreme cases involving disloyalty, usurpation of company opportunities, or even outright misappropriation of company funds.

While the discovery that one's business partner has mismanaged the company or siphoned off company funds for personal gain is devastating, when the plaintiff in a business divorce suit discovers that his soon to be ex-partner has tapped into the company coffers to fund the litigation — frustration turns to outrage. After all, the funds belong to the company, and each owner is entitled to their proportionate share. Moreover, access to a deep source of funding with which to vigorously defend against the lawsuit presents significant leverage for the defendant. Generally, the plaintiff must bear the cost of his own legal expenses, but at the same time, the plaintiff is now forced to effectively fund some portion of his estranged business partner's defense. Indeed, from the plaintiff's perspective, this conduct simply constitutes another misapplication of company funds.

This scenario presents significant fairness issues, and the courts and the legislature should explore ways to level the playing field. This article examines the applicable law in Texas and other jurisdictions, and provides some considerations for the courts, the legislature and litigants to bear in mind.

Typical Fact Pattern

When litigation erupts between business partners, it is common for governing persons, such as the general partner of a partnership or the managing member of an LLC, to retain counsel on behalf of himself, individually, and the company, and utilize the company's bank account to fund the litigation. The following is a typical scenario.

An investor, such as a limited partner of a partnership, or a member of an LLC, files a lawsuit against the governing person, such as the general partner of a partnership or the managing member of an LLC, alleging that the defendant has mismanaged the company, withheld information, usurped corporate opportunities and misappropriated company funds. The defendant, pointing to an indemnity provision in the organizational documents, or the fact that the entity itself was named in the lawsuit, will then make the unilateral determination that the company will provide indemnification to defend against the lawsuit. The defendant then simply pays his attorneys' fees from the company's bank account.

Not only is the plaintiff now confronted with a well funded opponent, but the defendant's actions also have the effect of further deteriorating the value of the plaintiff's asset. As a practical matter, there is very little the plaintiff can do to remedy this situation.

Applicable Law

The Texas Business Organizations Code (BOC) sets forth an extensive statutory scheme related to indemnification. The same provisions govern indemnification in relation to both corporations and limited partnerships. Tex. Bus. Org. Code §§ 8.001-8.152. Under the BOC, a corporation or limited partnership is required to indemnify a governing person who is "wholly successful, on the merits or otherwise, in the defense of the proceeding" unless indemnification is limited or prohibited by the organizational documents. Id. §§ 8.003(b), 8.051. In contrast, indemnification is prohibited in a proceeding in which the person has been found liable for: (a) wilful or intentional misconduct in the performance of the person's duty to the enterprise; (b) breach of the person's duty of loyalty owed to the enterprise; or (c) an act or omission not committed in good faith that constitutes a breach of a duty owed by the person to the enterprise. Id. § 8.102(b)(3).

"Permissive indemnification" applies when a governing person is determined to have met certain standards, including that the person acted in good faith, reasonably believed that the conduct was in the best interest of the enterprise if the conduct was in an official capacity, or in any other case, that the person's conduct was not opposed to the enterprise's best interests; and, in the case of a criminal proceeding, that the person did not have reasonable cause to believe the person's conduct was unlawful. Id. § 8.101(a).

The BOC also addresses the issue of "advancement" of expenses. Id. §§ 8.004, 8.104, 8.105. The advancement of expenses is only authorized upon a written affirmation by the person of the person's good faith belief that the person has met the standard of conduct necessary for indemnification and a written undertaking by or on behalf of the person to repay the amount paid or reimbursed if the final determination is that the person has not met the standard for indemnification. Id. § 8.104(a).

Nationwide, courts in many jurisdictions have addressed the distinction between attorneys' fees incurred in defending against third-party claims, and those expended in "first-party" or "inter se" litigation. Most courts interpret indemnity provisions to apply exclusively to third-party actions, unless the provision expressly permits the recovery of fees in connection with claims between parties to the contract. See e.g., NevadaCare Inc. v. Department of Human Services, 783 N.W.2d 459, 470–71 (Iowa 2010) (holding that "an indemnification clause that uses the terms 'indemnify' and 'hold harmless' indicates an intent by the parties to protect a party from claims made by third parties rather than those brought by a party to the contract"); Nova Research Inc. v. Penske Truck Leasing Co., 952 A.2d 275, 285 (Md. 2008) ("Where the contract provides no express provision for recovering attorney's fees in a first party action establishing the right to indemnity, however, we decline to extend this exception to the American rule, which generally does not allow for prevailing parties to recover attorney's fees."); see also, Philip L. Bruner & Patrick J. O'Connor Jr., 3 Construction Law § 10:51 (2007) ("Most courts distinguish between the recovery of attorney's fees incurred in defending against the third-party claim and those expended in prosecuting a claim against the indemnitor. Unless the indemnity provision expressly permits the recovery of fees incurred in prosecuting claims against the indemnitor, such fees are not recoverable.")

Notwithstanding these principles, as a practical matter, the rules do not provide the noncontrolling plaintiff, mired deep in the struggles of litigation, with any effective relief against the governing defendant tactically using company funds to defend against the lawsuit. There is nothing to prevent the control person from providing the required written affirmations regarding the necessary standard for indemnification, and proceeding to advance defense funds from the company's account. Accordingly, it is imperative for business people to conscientiously negotiate indemnity provisions when forming companies. In addition, courts and legislators should explore possible solutions to the imbalance created by this scenario.

The Pre-Nup

Similar to most issues that arise in business divorce cases, indemnification should be addressed when the parties first get married. The parties should thoughtfully consider the wording of any indemnification provision included in the organizational documents. The governing party will always want to include a broad indemnification provision, and in the context of claims brought by third parties, governing persons usually should receive such protection from the company. However, the indemnity provision should clearly express whether the parties intend for the provision to apply even in lawsuits between the parties themselves. If the governing person is adamant that indemnification should apply in relation to “first-party” actions, the other parties may consider demanding that the entity pay litigation costs for both sides in the event of a business divorce.

Policy Proposal

Neither the Texas statutory scheme, nor the common law, addresses the practical realities facing business divorce claimants. Namely, notwithstanding the applicable statutory provisions or doctrinal analyses, in business divorces, the governing party typically has access to the company’s funds, while the other parties do not. Even assuming a plaintiff can assert a successful argument to prevent the governing party from utilizing company funds for legal fees, it would most likely take years to reach such a final determination. In the interim, the defendant is continuing to write checks from the company’s bank account to pay legal bills.

Accordingly, in lawsuits between the owners of the same company, where one owner taps the company coffers to pay legal fees, the courts and the legislature should consider permitting the plaintiff to utilize company funds for litigation costs as well. This would create a system similar to those set forth in family and probate law, where, under certain circumstances, the parties’ legal bills are all paid from the estate. In addition, requiring the entity to fund both parties’ attorneys’ fees will not only level the playing field in terms of costs, but may also encourage the parties to approach the negotiating table. Indeed, rational business people may prefer to settle their differences, and go their separate ways, than watch the company’s capital drained away to pay legal fees. In any event, these policy issues must be addressed with the goal of maintaining a safe and encouraging business environment in Texas.

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