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How LLCs Can Prevent Deadlocks From Leading To Business Divorce

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Many limited liability companies (LLCs) consist of two members with equal decision making and voting power. This leaves the business vulnerable to potential management deadlocks, which may put the members on a path to business divorce litigation. By thinking ahead and putting deadlock-breaking provisions into their LLC operating agreements, business owners can prevent differences in opinion from evolving into irreconcilable differences.

Plan Ahead Today for What Could Go Wrong Tomorrow

About 25 percent of all LLCs have two members, and in many of these companies, the members have equal power, which means they each have one vote on decisions concerning the company. When the equal members disagree on an important matter impacting the business, it could create a deadlock, which can lead to wasted opportunities, increased expenses, hard feelings and, eventually, business divorce.

LLCs are often formed by two colleagues or friends, who are looking forward to collaborating amicably to ensure that their shared vision for the business prospers. Much like a couple entering into marriage, they are full of hopes and dreams and may not be able to imagine a day when their disagreements may threaten the future of the business. But disagreements in business, as in marriage, are inevitable. It’s human nature that the two members’ opinions may diverge on important matters, such as who to hire for an executive role, whether to take on more debt or which product to launch next. The members must have a plan in place to resolve deadlocks.

Include Dispute Resolution Provisions in Your Operating Agreement

When drafting your LLC operating agreement, consider a broad array of potential issues upfront and decide in advance how you will resolve disputes over those issues. This agreement will provide you with a framework of steps to take in the event of a deadlock.

The agreement can state that when a deadlock arises, the members will use their best efforts to negotiate a voluntary resolution. If this fails, there will be a predetermined mandatory resolution process. LLCs can use a variety of mechanisms to address deadlocks. Below are some common ones.

Tie-Breaking Vote

The parties may decide that, in the event of a deadlock, that a tie-breaking vote will be cast by a certain informed third party. The party can be internal, such as a trusted controller, or external, such as a business advisor or the board of an affiliated entity. However, some company owners do not like the idea of giving decision-making authority to someone other than themselves. An alternative option is to allow the two members to cast the tie-breaking vote on an alternating basis when deadlocks arise.

Alternative Dispute Resolution

The operating agreement may specify that if the parties cannot resolve the deadlock on their own, that they will proceed first to mediation, and if that proves unsuccessful, binding arbitration with a single arbitrator.

Mediation is a negotiation presided over by a neutral party, who helps the parties overcome their disagreement through negotiation. Mediation can be particularly successful when the mediator is skilled and the parties are motivated to compromise.

Arbitration also involves a neutral party, but this individual functions like a judge at a trial and enters a decision, to which the parties agree they will abide. Relative to litigation, arbitration is private, which limits the potential that the company’s dirty laundry will be aired publicly and cause damage to the brand. However, it is costly and often leads to bitter feelings for parties who do not get their way.

Buy-Sell Agreements

If the partners are deadlocked on a key issue, they may agree that one party will buy the other party out. They may agree that the price and terms will be determined by the appraisal of a qualified independent expert. Or they may opt for the popular “Texas shoot-out” or “shotgun” model. With this model, one party may offer to buy out the other for a specified price and terms, and the other must either sell based on those terms or use the same terms to purchase the interests of the other member. In the end, only one member will remain, hence the nickname.

This model may incentivize some disputing members to reach a compromise in order to prevent the other party from "pulling the trigger." However, it is not recommended for companies in which there are inherent imbalances between the two members. For instance, if one partner is the face of the business, with responsibility for developing all the client relationships, and the other focuses on back-office functions, the partner who controls the customers can walk off with the good will of the company. Similarly, if one member has significantly more economic resources outside the LLC, this type of agreement may not impact them equally.

Mandatory Sale to a Third Party

Another potential provision requires that if the parties decide they cannot go forward working together, that they will both agree to make every reasonable effort to sell the LLC. This solution allows both parties to cash out and alleviates the potential issue that one party may lack the funds to buy the other out. Similar to the Texas shoot-out provision, a mandatory sale provision may have the effect of encouraging the parties to endeavor to find a voluntary way to resolve their dispute.

Just as every company is different, deadlock-breaking provisions can be custom-tailored based on the needs and wishes of the company owners. It is important to work with a business lawyer with expertise in LLC operating agreements. Once your business lawyer has helped you draft an agreement, consider running it by a business litigator, who can examine the agreement with a critical eye toward limiting your risks in case of future litigation.

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