



DISPUTE RESOLUTION SECTION

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“Disputes arise across a broad spectrum of relationships and substantive areas of the law. Alternatives to litigation may best serve client needs for resolving many of these disputes. The NYSBA Dispute Resolution Section has prepared a series of White Papers to set forth some of the special advantages of mediation and arbitration in the various contexts in which disputes commonly arise.”

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RESOLVING DISPUTES AMONG SMALL BUSINESS OWNERS : ASSESSING THE BENEFITS OF MEDIATION AND ARBITRATION AS OPPOSED TO LITIGATION

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“For some disputes trials will be the only means, but for many claims trial by adversarial contest must in time go the way of the ancient trial by battle... Our system is too costly, too painful, too destructive, too inefficient for really civilized people.” Chief Justice Warren E. Burger of the U.S. Supreme Court

Any litigator will attest that litigation among business owners can become lengthy and overly expensive, as well as destructive to long-standing relationships and even the business itself. As such disputes will inevitably arise, lawyers seeking to best serve their clients must consider whether forms of dispute resolution other than traditional litigation may in certain cases not only minimize the delay, expense and business disruption inherent in traditional litigation, but also result in a far more satisfactory outcome. Mediation and arbitration, both of which are often responsive to party needs in a way that is not possible in a court proceeding, are two of the most frequently utilized forms of dispute resolution. They have particular applicability where disputes arise among owners of small businesses as these cases raise unique legal and emotional issues, which, if not addressed and resolved promptly, may have a devastating impact on both the owners and the business.

Under current law, a court has relatively few options available to it to resolve disputes between partners, shareholders or managing members of business entities. Those options are often limited to a determination as to whether dissolution is appropriate, as that may be the only remedy that a court can provide. Derivative actions, too, are complex and uncertain in the closely-held entity context. Mediation and arbitration, on the other hand, are flexible procedures which can be focused on the issues and interests that are key to the parties, offer a whole range of remedial options and do so in an expeditious and cost effective manner. In fact, for just these reasons, judges often refer disputes between business owners to mediation at the outset of a litigation.

Mediation and arbitration are no longer *alternate* dispute resolution mechanisms, but rather are now common methods of resolving commercial and non-commercial disputes between and among business entities and/or individuals. Mediation and arbitration are routinely incorporated into contracts as the method of choice for resolving disputes that may arise in the future. They are also routinely used after problems arise and the parties are seeking an appropriate means to resolve their disputes. In the determination of whether litigation is the right method of resolution for a particular dispute between small business owners, lawyers advising small businesses owners have to be both wise architects at the time of formation in the drafting of appropriate dispute resolution clauses and cautious advisors when issues subsequently arise, often years later, among the principals. This white paper is intended to give guidance to the practitioner as to the differences between litigation, arbitration and mediation and the impact the choice of each may have both on the process, the parties and the result.

To illustrate, let's look at three fact patterns that typify small business disputes arising in the partnership, corporate and limited liability company context.

- **Partnership Dispute:** Peter and Arthur have been partners in an unincorporated television and electronic retail business doing business under the name "TV World" for the past 12 years. They never entered into a formal partnership agreement, but both signed a letter agreement in 1998 which provides simply that they will be 50/50 partners in the business. Recently, however, Peter decided he wanted to work fewer hours. He has begun taking Fridays off and is no longer coming in during the three evenings a week when TV World is open till 9 pm. To cover Peter's absence, they have had to hire an extra employee. Arthur, who did not agree to Peter's reduced schedule and believes he is carrying an unfair share of the burden, has instructed their bookkeeper to deduct the extra amounts from Peter's drawing account. About the same time Peter received his first reduced pay check, he learned that Arthur had hired Arthur's 22 year old son, Adam, as a 20 hour/week consultant to the business for video game research and testing and has been paying Adam \$250/hour for two months without Peter's knowledge or agreement. In response to Arthur's unilateral actions, Peter closed the partnership bank account at X Bank, and opened a new partnership bank account at the Y Bank with Peter as sole signatory. How can this escalating situation best be resolved?

- **Shareholder Dispute:** Alice, Bob, and Charlie are the sole shareholders and directors of ABC Stationery Corp., a New York corporation which has been operating a stationery store in New York City for the last 8 years. Alice and Bob each own 20% and

Charlie owns 60% of the outstanding shares. Because they wanted to save on legal fees when they formed the business, they only drew up a very simple shareholders agreement providing only a restriction on the sale of shares to third parties. Six months ago, Bob was injured in a skiing accident and has been unable to work, but he believes he is still entitled to receive his regular ABC salary each week, as well as the automobile and other perks that the company provides. Alice and Charlie disagree. Just about the time Bob was injured, Charlie, without telling the other shareholders, incorporated another stationery business in Westchester near his home where he spends three afternoons a week. Now that Alice and Bob have learned about Charlie's Westchester store, they insist it should be part of ABC. All parties agree that the New York City store is a profitable enterprise that they would all like to continue to operate if they can work through these two issues. How can that best be achieved?

- **LLC Member Dispute:** Assume the same facts as above, except ABC Stationery was originally organized as an LLC instead of a corporation and Alice, Bob and Charlie each have full managerial authority in a one-page operating agreement. Does this make a difference?

In the following sections we examine how a choice of litigation, arbitration or mediation could impact the resolution of each of these disputes.

I. Litigation

Litigation claims addressing these types of ownership and management disputes must conform to established and limited statutory and common law rights, procedures, causes of action and remedies. Substantial lawyer time is required just to get the process moving: analyzing the facts and applicable causes of action and commencing an adversarial and public proceeding, often seeking immediate injunctive relief. Litigation requires the preparation of adversarial documents that often must contain strong allegations of wrongdoing to meet statutory requirements, having the effect of infuriating the other party and further exacerbating the dispute. It generally involves an expensive and time-consuming discovery process, which is subject to numerous avenues of delay, before a hearing or trial is held. During this lengthy process, the public and adversarial nature of the dispute may itself have a serious impact on the business, as the stress in the parties' relationship seeps into the workplace and employees feel caught in the middle, customers start to look elsewhere, accounts receivables go unpaid, the owners focus on their dispute instead of the business and legal costs spiral upward. When the process finally concludes, the facts are determined and a remedy is imposed by a third party – judge or jury – who may be constrained by law to only take into account limited options. All too often, the end result is that neither party is satisfied and the business itself may not have survived.

The ability to deal effectively with the real world disputes set out in the above hypotheticals through litigation is severely limited. Certainly, in the partnership scenario, a court might provide an avenue for Arthur to seek protective equitable relief against Peter's actions in usurping sole possession over the partnership bank accounts. However, because courts do not traditionally entertain issues among partners of an ongoing partnership, apart from

preserving the assets for both parties, the resolution of the many additional underlying business related issues would not be possible in a court outside of breach of fiduciary duty, breach of other contract or other common law or statutory theories. Moreover, given the nature of an at will partnership, it is likely that the only legal remedy the party seeking redress would have is to seek dissolution of the partnership and an accounting.

Similarly, in the shareholder dispute described above, Alice and Bob, owning more than 20% of the shares, may be able to commence a proceeding under BCL Sec. 1104-a and seek to hold Charlie, the majority owner, accountable for misconduct. That statutory remedy, however, generally requires dissolution, followed by winding up and splitting the remaining assets less liabilities among the shareholders pro rata. Alice and Bob's stated goal of compelling Charlie to transfer the Westchester store may simply be beyond the power of the court. Even a derivative action would add complexity and expense. Moreover, for Alice and Bob to prove their case, they may have to demonstrate that Charlie's conduct was "illegal, fraudulent or oppressive" and whether he stole a corporate opportunity or diverted corporate assets -- allegations that are likely to deter business and inflame Charlie and which they ultimately may fail to prove. The adversary process will likely irrevocably damage any trust between Charlie, Alice and Bob and make it impossible for them to achieve the uniformly desired objective of continuing to work together if the two discrete issues in dispute can be resolved. That result may also be difficult to reach under the law and remedies available to a court. If Alice and Bob "win," one likely scenario is that they will sell their shares to Charlie at "fair value" (the determination of which may itself extend the litigation process considerably), lose their jobs and will no longer be associated with ABC. If they lose, they may have their shares, but will most likely be replaced on the board and may also lose their salaries and perks. They will also have a large legal bill to pay.

If ABC were a limited liability company, Alice and Bob would be unable to seek a court order transferring the Westchester Company's shares and, like a shareholder of a corporation, would not have the right to withdraw from ABC at will. Under NY LLC Law Sec. 702, the court may dissolve an LLC if it is not "reasonably practical to carry on the business in conformity with the articles of organization or operating agreement." This remedy, however, is rarely granted unless the business is no longer viable or the majority has egregiously breached fiduciary duties to the minority. Whether it is "reasonably practical" for ABC to continue in business if it has been and continues to be profitable and whether Charlie has violated his fiduciary duties would be the subject of discovery and legal arguments. Even though the NY courts have created a derivative-type remedy for minority owners of an LLC, it is time consuming, complex and legally uncertain. At the end, just as the shareholder dispute described above, the litigation track may result in a no win situation for Alice and Bob.

Whether "winning" or "losing", and whether the client is in the majority or the minority, the litigation outcome of all of these scenarios is not likely to result in any satisfied clients.

In the following two sections the arbitration process and the mediation process are compared and contrasted with the litigation alternative.

III. Arbitration

Arbitration is a process in which parties engage a neutral arbitrator or panel of three arbitrators to conduct an evidentiary hearing and render an award in connection with a dispute that has arisen between them. As arbitration is a matter of agreement between the parties, either pre-dispute in a contract as is generally the case, or post-dispute when a difference arises, the process can be tailored to meet the needs of the parties. With the ability to design the process and the best practices that have developed, arbitration is worth considering either in a pre-dispute agreement or even an agreement after a dispute has arisen. In many situations, arbitration can offer significant advantages.

Agreement of all Parties Required to Arbitrate. Arbitration is strictly a creature of contract—if the parties have not already committed to the process, such as in the shareholder, partnership or LLC agreement or after the dispute has arisen, a party cannot be required to arbitrate the dispute. On the other hand, before a dispute has arisen at the commencement of a business relationship, it is relatively easy for parties to structure almost any reasonable format, procedure and time limits which the parties feel would make the arbitration process an efficient proceeding.

Speed and Efficiency. In an appropriate case, arbitration can be a more expedited process than court litigation, particularly if certain modifications are made to the standard arbitration clause. As discussed above, arbitrations can be contractually structured so that they can be concluded in less than a year. Leading dispute resolution providers report that the median time from the filing of the demand to the award was 8 months. It should be pointed out, however, that once an arbitration hearing has been convened it may in some cases take longer than comparable litigation, either because (i) in litigation the case can be more easily disposed of on motion, or settled (sometimes through mediation), or (ii) because arbitrators, unlike judges, do not generally try to settle cases prior to award (and the rules of dispute resolution providers rules generally prohibit the arbitrators from mediating a case they are arbitrating).

Expense. The arbitration process can result in a substantial savings of attorney's fees, court costs and related expense because arbitration generally does not include the same amount of time consuming and expensive discovery that is common in courts in the United States (such as taking multiple depositions and very extensive e-discovery). Time consuming and expensive motion practice is also much less common. While litigation may strategically be more advantageous to a party who has a strong motion to dismiss or summary judgment motion, business disputes between owners do not generally fall into that category. Moreover, even successful summary judgment motions can be subject to multiple appeals and possible remands. Of course, private arbitration tribunals charge fees depending on the amount in dispute and arbitrators are paid hourly or daily rates, whereas court filing fees are relatively low and parties do not pay for a judge's time.

More Control and Flexibility. In cases where arbitration is required by contract, the parties can prescribe various preferences to suit their needs, such as the number of arbitrators hearing the case, the location of the arbitration, the scope of discovery and time limits. Once the arbitration is commenced, a party seeking a more streamlined and less expensive process will be better

able to achieve that goal than in court where the applicable procedural and evidentiary rules govern. The parties will also have input in scheduling the hearing at a time that is convenient.

Quality of Decision Makers. The parties can select arbitrators with expertise and experience in the relevant subject matter or that meet other criteria that they desire. Arbitration avoids a trial where the subject matter may not be within the knowledge or experience of the judge or jury. The selection of experienced and respected arbitrators can minimize the risk of an arbitrary and legally incorrect award.

Confidentiality of Process. Arbitrations are conducted in private. Only the arbitrators, the parties, counsel and witnesses attend the arbitration. Confidentiality of the arbitration proceedings, including sensitive testimony and documents, can be agreed to by the parties. In contrast, court proceedings are generally open to the public. In the generally less adversarial context of a private arbitration, ongoing relationships may suffer less damage than in litigation.

Finality. In court proceedings, parties have the right to appeal the decision. In 2008, the civil case reversal/modification rate of the NY Court of Appeals was 52% and in the Appellate Division, First Department, 38%. In contrast, the grounds for court review of an arbitration award are very limited. The award of an arbitrator is final and binding on the parties. The other side of the coin, of course, is that there is no right of appeal if the arbitrator makes an incorrect legal interpretation or other error which could be reviewed in a court proceeding.

How could this process impact the resolution of the disputes raised in the fact patterns set forth above? In the partnership context, arbitration could be limited to the issue of the value of the service contributions of the partners and their reasonable expectations of each other could be framed for an arbitral tribunal. Or, the parties could ask the arbitrators to decide between proffered resolutions short of dissolution, such as determining the appropriate amounts to be paid to Peter and Adam in the partnership scenario or directing Charlie to transfer the Westchester store to ABC Stationery Corp. Also, the time and expense of extensive discovery could be minimized by agreement or arbitration forum rule.

Moreover, where parties do seek a comprehensive shareholder, partnership or LLC agreement, spending time crafting the details of the format, procedures, and time limits of a dispute resolution procedure at a time when the parties are commencing the relationship can turn the uncertainties of a future dispute into a far less expensive and controlled process.

IV. Mediation

“Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser -- in fees, and expenses, and waste of time.” Abraham Lincoln

Mediation is the process in which parties engage a neutral third person to work with them to facilitate the resolution of a dispute. The growth of mediation over the past fifteen years has been exponential, a tribute to the success of the process. User satisfaction is high as parties retain control and tailor their own solution in a less confrontational setting that preserves

relationships and results in a win/win instead of a win/lose. While not every case can be settled, an effort to mediate is appropriate in virtually any subject matter and any area of the law. The advantages of mediation include the following:

Mediation Works. Statistics have shown that mediation is a highly effective mechanism for resolving disputes. The rate of success through mediation is very high. For example, the mediation office of the U.S. District Court for the Southern District of New York reports that over 90% of its cases settle in mediation. Most cases in mediation settle long before the traditional “courthouse steps” at a significant saving of cost and time for the parties. Since over 98% of all cases in the Southern District eventually settle, it is more a question of “when” rather than “whether” and mediation can accelerate the settlement process. Moreover, as noted below, the process of settling through mediation can also have significant benefits to the parties over one that is reached under pressure on the courthouse steps.

Control by the Parties. Each dispute is unique, and the parties have the opportunity to design their own unique approach and structure for each mediation. They can select a mediator of their choice who has the experience and knowledge they require, and, with the help of the experienced mediator, plan how the mediation should proceed and decide what approaches make sense during the mediation itself.

The Mediator Plays a Crucial Role. The mediator’s goal is to help the parties settle their differences in a manner that meets their needs, and is usually preferable to the litigation alternative. An experienced mediator can serve as a sounding board, help identify and frame the relevant interests and issues of the parties, help the parties test their case and quantify the risk/reward of pursuing the matter, if in her field of expertise and if asked by a party provide a helpful and objective analysis of the merits to each of the parties, foster and even suggest creative solutions, and identify and assist in removing impediments to settlement. This is often accomplished by meeting with parties separately so that participants can speak with total candor during the mediation process. Alternatively, the mediator has the flexibility to address issues with all the participants together thereby also assisting the parties in developing the skills to have difficult conversations with each other in the future. The mediator can also provide the persistence which is often necessary to help parties reach a resolution.

Opportunity to Listen and be Heard. Parties to a mediation have the opportunity to air their views and positions directly, in the presence of their adversaries. The process can thus provide a catharsis for the parties that can engender a willingness to resolve differences between them. Moreover, since they are heard in the presence of someone whom they may view as a neutral authority figure, the parties often feel that they have had “their day in court.” Litigators sometimes express a disinclination to participate in mediation on the ground that they do not want to give the other side “free discovery”. Such concerns are generally unwarranted. Typically, where parties voluntarily choose to mediate, it is because they have a genuine desire to resolve the case. That can often best be accomplished by exchanging information that can help clarify the issues and the strengths and weaknesses of the case. Going into a mediation fearful of showing one’s cards – at least to the mediator – could effectively doom the process to failure. Moreover, the process itself provides each party ample protection from having to reveal anything to the other side they choose not to, simply by so advising the mediator.

Mediation Helps In Complicated Cases. When the facts and/or legal issues are particularly complicated, it can be difficult to sort them out through direct negotiations, or during trial. In mediation, in contrast, there is an opportunity to break down the facts and issues into smaller components, enabling the parties to separate the matters that they agree upon and those that they do not yet agree upon. The mediator can be indispensable to this process by separating, organizing, simplifying and addressing relevant issues.

Mediation Can Save An Existing Relationship. The litigation process can be very stressful, time consuming, costly and often personally painful. At the end of litigation, the parties are often unable to continue or restart any relationship. In contrast, in mediation disputes -- such as those between partners or shareholders in a business -- can be resolved in manner that saves a business or personal relationship that, ultimately, the parties would prefer to save.

Expeditious Resolution. The mediation can take place at any time. Since mediation can be conducted at the earliest stages of a dispute, the parties avoid the potentially enormous distraction from and disruption of one's business and the upset in one's personal life that commonly results from protracted litigation.

Reduced Cost. By resolving disputes earlier rather than later the parties can save tremendous sums in attorney's fees, court costs, discovery and related expenses.

Lessens the Emotional Burden. Since mediation can be conducted sooner, more quickly, less expensively and in a less adversarial manner, there typically is much less of an emotional burden on the individuals involved than proceeding in a burdensome and stressful trial. Furthermore, proceeding through trial may involve publicly reliving a particularly unpleasant experience or exposing an unfavorable business action which gave rise to the dispute. This is avoided in mediation.

Confidential Process and Result. Mediation is conducted in private -- only the mediator, the parties and their representatives participate. The mediator is generally bound not to divulge any information disclosed in the mediation. Confidentiality agreements are often entered into to reinforce the confidentiality of the mediation. Moreover, the parties may agree to keep their dispute and the nature of the settlement confidential when the matter is resolved.

Avoiding the Uncertainty of a Litigated Outcome. Resolution during mediation avoids the inherently uncertain outcome of litigation and enables the parties to control the result. Recent studies have confirmed the wisdom of mediated solutions as the predictive abilities of parties and their counsel are unclear at best. Attorney advocates may suffer from "advocacy bias" -- they come to believe in and overvalue the strength of their client's case.

In an analysis of 2,054 cases that went to trial from 2002 to 2005, plaintiffs realized smaller recoveries than the settlement offered in 61% of cases. While defendants made the wrong decision by proceeding to trial far less often -- in 24% of cases -- they suffered a greater cost -- an average of \$1.1 million -- when they did make the wrong decision.¹

A mediator without any stake in the outcome or advocacy bias can be an effective "agent of reality" in helping the parties be realistic as to their likely litigation or arbitration alternative."

There are no “winners” or “losers.” In mediation, the mediator has no authority to make or impose any determination on the parties. Any resolution through mediation is solely voluntary and at the discretion of the parties. Sometimes a mediator may be able to help parties explore options that will expand the pie and create a win-win result. At a minimum, each party should walk away satisfied that the agreed upon result was the best option taking into account all of the circumstances.

Parties Retain Their Options. Since resolution during mediation is completely voluntary, the option to proceed thereafter to trial or arbitration is not lost in the event the mediation is not successful in resolving all matters.

Conclusion: How could the choice of mediation impact the resolution of the disputes raised in the fact patterns set forth above?

In all of the above scenarios, the Partnership Dispute, the Shareholder Dispute and the LLC Member Dispute, the use of mediation at an early stage could have kept the parties focused on the actual interests and brought prompt resolution to the issues. Precisely because the remedy obtained through mediation is dependent on the individual needs and interests of the parties, it is impossible to foresee in advance how the parties with the help of a mediator might resolve their issues. One could imagine that in the TV World scenario an agreement could be reached that Peter would take a smaller share and Arthur would charge most of his son's consulting fee to his drawing account, but there could be many other very workable solutions. Similarly, with respect to ABC Stationery, whether as a corporation or an LLC, the parties might reach a compromise on the ownership of the Westchester business and continue working together. They may even agree on a structure for future discussions about contentious issues so that they can resolve matters before tensions escalate. The net effect is that within a relatively short time frame, the business can continue in whatever form the parties can agree is best for them.

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¹ Randall Kiser, *Beyond Right and Wrong: The Power of Effective Decision Making for Attorneys and Clients*, (Springer Science + Business Media LLC New York publ.) (2010)

