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They Say It's About Dollars, But It's Often About Emotion

How to Use Mediation To Restore Business Judgment To Business Disputes

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FOUR REASONS BUSINESS DISPUTE DO NOT SETTLE AT MEDIATION

Business executives are supposed to be creatures of logic, carefully weighing costs and benefits. Yet some mediations fail even when there are several sensible alternatives, any of which would offer the disputants as good or a better a result than each of them would expect from other likely outcomes of the dispute.

Puzzling as their behavior may seem, business partners may sometimes reject settling a dispute, preferring instead to have a litigated result imposed upon them by a third party such as a Judge, Jury or Arbitrator. There are four common reasons for this seemingly illogical behavior. Each reason relates to very recognizable human emotions and perceptions.

First, one of the disputants is simply not ready emotionally to give up hopes, future options and expectations of a better result, even though the likelihood of such a favorable occurrence is small and the anticipated realistic costs are greater.

Often the source of this emotion is a fear of making a mistake. A mediator can often successfully address this fear by providing more information or protective assurances. Through patience and persistence the mediator can keep open the avenues for constructive communications and defuse destructive hostile acts or words, allowing the disputant to accept a mutually agreeable outcome prior to trial.

Second, a party may insist on proceeding with a dispute in which there is relatively little hope of prevailing. This often occurs when the expected marginal cost of going forward to a litigated outcome is not as great as the expected marginal benefit of a highly lucrative outcome, even though that chance of winning is exceedingly slight. Commonly this occurs when one disputant is facing bankruptcy unless a very lucrative outcome is obtained.

The continued litigation can sometime be resolved, even under such circumstances, when the other disputant finds a process to help the financially disadvantaged disputant get on with his or her life without the disruption of bankruptcy.

Third, disputants often face significant social pressures from a spouse, friends, business associates or others with whom there are valued relationships. The disputant often fears

that a spouse or valued relationship will be angry or upset with the a settlement that would otherwise be acceptable to all litigants. The fear or social pressure most commonly expressed, in private caucus, is that the spouse or valued relation will believe it is important "not to lose" or to concede the 'moral high ground' by being willing to settle.

A mediator should always explore this real and not infrequent barrier. Repeatedly, I have seen mediations suddenly move towards settlement after an appropriate amount of time and encouragement has been given to a mediation participant to speak privately with a spouse or a trusted advisor. Usually, the spouse or valued relation is happier to see the matter completely settled, than to have a continuation of the costs, stress and risks of litigation.

Finally, mediation may fail if one of the disputants highly values negative emotions such as revenge or retribution.

The usual ways of dealing with such a disputant are well discussed in the literature of cognitive and behavioral psychology. In many cases a successful mediation outcome can be attained by allowing a hostile and angry person other avenues to express and relieve the need for "revenge" and "retribution," so that a mutually agreeable outcome is reached. Some methods to accomplish this include:

(a) Creating a "just result" through a combination of financial compensation, a genuine recognition by the offending party of the wrong done (sometimes including a public apology), an adequate assurance or protection against the injuring party committing such wrongful conduct in the future, and a commitment of personal time by the wrongdoer to appropriate community service.

(b) Recognition by the angered and hurt party that the costs of "revenge" or "retribution" often include unintended and significant harm to innocent family members, co-workers or others, or to the hurt party, his or her family and friends.

(c) An accurate, but sensitive, evaluation, of how much better of the aggrieved party and his or her family would be if the amount of money spent in seeking "revenge" in a litigated case were instead spent on needed family matters, such as a child's college education or a sabbatical for oneself or one spouse, or time off from work to retrain for a more desirable future career.

In my experience, the most commonly expressed reason given for going to trial over a partnership or equity dispute is that – "The other side is too unrealistic in assessing the value of the dispute." As often as not, the side, which makes this statement, is the side which is being unrealistic; and further, when both sides take this position, generally, both sides are too unrealistic. The solution, of course, if an unnecessary trial is to be avoided is working more diligently with each side, by serving as an effective "Agent of Reality."

LEARN THE PARTNERS' ORIGINAL EXPECTATIONS TO DISCOVER THEIR REAL INTERESTS

Learning about each partner's perceived reasons for entering into the business or partnership relationship play a role in potentially resolving the dispute through mediation. In most small business partnerships, the individual partners have significant personal, professional or business reasons for entering into the partnership.

Often one partner provides the capital and the other(s) provides the idea or invention or intellectual property rights, or perhaps also the management and/or the labor to commercialize the idea or invention, product or service.

After a period of time, tensions often arise between the expectations of those providing the start-up capital, those who provide the idea, invention, product or service, those who provide the management and those who may be doing most of the day-to-day work. Those differences in expectations can cause one or more to want to depart from the ownership of the business or partnership.

Usually this desire is fueled by a perception or belief that the departing partner will better fulfill his or her business and personal needs by competing with the existing entity, by being bought out at a "fair" value, by having the business entity sold at a "fair" value, or by buying out some or all of the balance of the owners so the business can be run the way the dissatisfied partner or owner prefers.

Mediation of disputes like this is often most likely to be successful through dealing directly with these personal beliefs and perceptions. Successful mediation outcomes most often arise from:

(a) Redefining the expectations of the participants to more realistically view the individuals involved, their resources and the marketplace competition.

(b) Creating practical options for refinancing or replacing the capital partner(s) or the working partner(s) through a structured buyout.

(c) Restructuring the disputing equity partners into non-competing businesses or into competitive business with a stipulated agreement as to how client and customer lists, intellectual property rights and existing employees will be handled.

(d) Restructuring the business product lines or territories so the equity owners receive more profit or have less conflict or both;

(e) Empowering equity holders in management or technical or sales with more effective support, better business options or different (more realistic) compensation and incentives.

Two recent examples of successful outcomes in my mediation practice were based on the above premises.

One, a business-generating general contractor made a seemingly implacable demand for an accounting and a partnership buyout to his partner, the "Mr. Inside" of their company, who had been an outstanding project supervisor for nine years. The hard-working project supervisor was managing several projects at once, spending about 50 % more time on the job than "Mr. Outside," who brought in the business. Yet, the parties were able to reconcile once Mr. Inside recognized how important Mr. Outside was as a business generator for their highly successful partnership.

Both men had asked not to be in the same room with each other. After several private caucuses, Mr. Outside was helped to realize that he had never done so well until his nine-year partnership with Mr. Inside. The partners then agreed to meet in the same room and explore an arrangement that better compensated the working partner who had the ability to deliver on the sometimes extravagant promises of performance that Mr. Outside made to land their customers.

Another partnership dispute was headed towards a public sale of the business assets, when mediation crafted a solution that better met the disputants' needs.

The party forcing the sale needed substantial funds. The parties resisting the sale believed the business should be expanded rather than sold. In mediation, several options were explored that met each of the disputants' conflicting interests. Ultimately the parties agreed to refinance the business, permitting one party to take substantial monies out on a tax-free basis (as much as would have been netted on an after-tax basis from a public sale). In exchange, the partner receiving the cash from the refinancing agreed to a future buyout of his equity interest on a formula that, if the company grew in value, would give most of the future appreciation to the remaining partners.

In each of these examples, these favorable outcomes would not have been available in arbitration or in civil litigation. To achieve such results generally requires a practical understanding of how realistic each of the owners were in forming the partnership or business and in undertaking the original business plan, compared to what actually happened. As often as not, one or more of the partners feels a sense of betrayal or a profound lack of trust based on disappointed business or personal expectations.

The anger and hostility these feelings engender usually must be de-escalated in order to explore rational and principled decision-making that will maximize the overall value of the business or partnership entity or entities, as well as the differing interests of the litigants.

DE-ESCALATE HOSTILITY TO RESOLVE OTHERWISE EXPENSIVE CIVIL LITIGATION

Mediation can be an effective way to de-escalate the seemingly irreconcilable tensions between capital and labor interests over what is a fair return. In most business dissolutions, even when there is a highly profitable business entity, there are serious underlying conflicts about who is or was fairly entitled to the cash flow being generated. This situation is often complicated by the fact that the partners or co-owners may have

commenced from a friendship marked by trust and (unrealistically) high expectations, which the vagaries of life and business competition have upset.

Working partners often feel disrespected and under-compensated for ‘round-the-clock efforts, ingenious and productive ideas or both. Further, the working partners are likely to want the capital partner to leave his money in the business, so they are not required to seek outside financing with its restrictive terms and higher costs.

The capital partner(s) may also feel taken for granted, and may believe that management is making unreasonable demands for more compensation and more capital as the business expands and becomes more profitable. The capital partner may feel entitled to be paid back in full and then have the business get outside financing so that the capital partner will have leveraged equity and little or no investment.

When a business is less successful, realistic options may be fewer and tensions are naturally greater. These tensions can trigger a perception of betrayal or injustice, the loss of friendships, name- or blame-calling and extortionate threats of disclosures or of disparagement. This in turn often leads to (i) a demand for a buy-out, (ii) a demand for dissolution or (iii) the establishing of a competing spin-off business.

The relative economic advantages of the wealthier partner often exacerbate hostile and destructive behaviors. Typical hostile actions may include withdrawal of needed financing, crippling disparagement of the business’ product or service, establishing a competing business using the trade dress of the original entity, soliciting existing employees or customers, and a variety of other potentially destructive behaviors.

Assuming the disputants failed to incorporate Early Mediation into their exit strategies or dissolution plans, mediation – often in combination with a subsequent arbitration – can be an excellent opportunity to de-escalate hostile actions and restore or maintain the value of a business entity while the underlying disputes are being expeditiously resolved.

Once litigation is started or even threatened, mediation usually works at three basic levels.

First, an experienced mediator will be able to get most, if not all, participants to acknowledge that there were pro-active communications and business choices each could have made which would have been less hostile, less destructive and possibly more in each disputants interests than the hostile acts that are occurring. With such an acknowledgement, each disputant begins to accept some responsibility for and ownership of the destructive choices that are being made. Once responsibility and ownership of the joint problem of destructive behavior is achieved, hostilities de-escalate.

Second, an experienced mediator will help each disputant evaluate a series of interim process steps that will (a) help reduce the time and economic costs of the dispute by avoiding unnecessary litigious acts of pleading or discovery while discussions continue, (b) obtain a short standstill agreement on hostile competitive acts and all disparagement,

(c) engage the principals promptly in direct or facilitated negotiations to bring about whole or partial agreements that are in their respective interests, and, if negotiations fail, (d) encourage the parties to use one of several expeditious arbitration alternatives with an appropriately experienced neutral fact finder and/or decision maker.

Third, and perhaps most important, an experienced neutral will not quit until ordered to do so by one of the parties. Countless times, after the initial session or sessions have not succeeded in achieving a mutually acceptable termination of hostilities, a mediator will succeed in assisting the parties to avoid a decision being imposed upon them by continuing constructive and creative discussions with one or both sides.

PUT MANDATORY EARLY MEDIATION IN CONTRACTS TO PRESERVE THE RIGHT TO ATTORNEYS FEES.

Early Mediation is a tool attorneys should know about for two reasons. First, it can be a very effective way to resolve a dispute before the costs to the disputants get out of hand. In addition, failure to use Early Mediation can result in a forfeiture of a right to attorney's fees in subsequent civil litigation.

Early Mediation is sometimes forced upon the disputants solely because the partnership or shareholder agreement requires a disputant to initiate mediation prior to litigation or arbitration in order to be entitled to attorney's fees. California courts have found such a provision reasonable and appropriate.

While many participants commence early mediation reluctantly, believing it will be a waste of time, experience shows it is often useful in reaching sensible interim agreements and in maximizing the value of alternatives to civil and not-so-civil litigation.

For example, I have seen partners in a media-related business, who were about to sue each other for an accounting and various breaches of fiduciary duty, agree to split up their business (including existing employees and customers) into non-competitive territories and agree to a compensating payment, if appropriate, after one year. Both businesses were successful. No litigation ensued, although a day of mediation was necessary after the first year to resolve some issues of overlapping competition.

In a physician partnership break-up, Early Mediation resulted in the professional partners buying out the departing doctor over a five-year period with a contemporaneous five-year covenant not to compete. The professional partners kept substantial work-in-progress and all of the departing partner's clients, each of whom received a strong letter endorsing her former partners. The departing partner's buy out, combined with the new job she took, provided her with an overall income and lifestyle far superior to the outcome of an accounting and a bitter litigation.

In many residential and commercial real estate purchases and development ventures, early mediation is becoming a standard contract clause, which prevents a disputant from

being entitled to reasonable attorneys fees as the prevailing party unless that party agrees to an early mediation prior to the commencement of litigation or shortly thereafter.

MEDIATION CONFIDENTIALITY CAN HELP OBTAIN A FAIR OUTCOME WHEN BOTH SIDES HAVE SOMETHING TO HIDE.

In many business or partnership buy-outs or dissolutions, one – or more frequently – two or more of the disputants believe that he or she each has knowledge of unethical or illegal financial conduct by one of the other disputants. Many disputants believe that such knowledge will provide a tactical advantage, even though the claimed wrongdoing is not highly significant to the economic and business issues related to a fair buyout or to an orderly sale of the business.

Facts quite similar to the following example do occur in commercial mediation practices. By verbal agreement between two partners (Mr. Capital and Mr. Labor) two sets of books had been kept. One was for the government, aimed at minimizing tax liability, and one was so the partners could sort out an accounting of the "50-50 deal" between Mr. Capital and Mr. Labor. Mr. Capital was to receive his loans and invested capital back over 18 months, while Mr. Labor was to earn the same amount in wages. Following the 18 months the split would be based on performance. After two years, Mr. Capital had not quite received all of his investment back, and decided to call it quits. He demanded a full accounting and a buy-out of his interest or dissolution of the business, pursuant to the partnership or shareholder agreement.

Can Mr. Capital use ADR to obtain an accounting and fair buy-out price and still keep confidential the unlawful financial improprieties in which he and Mr. Labor have engaged? On the "extortion side of the ledger," Mr. Capital knows that an accurate accounting will prove that Mr. Labor under-reported receipts by $5,000 per month by accepting cash payment and kickbacks. But Mr. Capital is no fan of full disclosure, because Mr. Labor had agreed that Mr. Capital's housekeeper, gardener and chauffeur could be placed on the company payroll, saving Mr. Capital $7,500 per month.

Practically speaking, in Court neither side would be likely to receive much of a hearing, because the wrongful financial conduct will be revealed and will be damning to all concerned.

In mediation, the parties can negotiate a buyout figure in a confidential negotiation with a skilled facilitator exploring various business alternatives and financing options. If these standard mediation techniques fail, mediation may still serve a sensible "process" purpose, by have the disputing parties stipulate to have their mutual accountant prepare a clean set of books. The clean set of books will contain appropriate adjustments to restore the under-reported receipts to income and eliminate the wrongfully reported expenses.

In this way the parties may avail themselves of a financial arbitration, which may be conducted with competing experts and without any fear of embarrassing disclosures, while an appropriate valuation or buy out figure is calculated by the arbitrator. Of course,

in arbitration the parties will be able to select a knowledgeable arbitrator who is not likely to be shocked by some of the offsetting financial improprieties that do occur in certain small businesses.

CONCLUSION

People resolve disputes ***only*** when, in that personal and often uncertain calculation, the perceived benefits out weigh the perceived costs. Since ninety five percent (95%) or so of all business litigation settles prior to trial, the goal of mediation is to get to the anticipated settlement earlier, before there have been large amounts of time and money expended and some damage done to the litigants' business(es).

In most business partnership disputes there are one or more emotional components which must be successfully addressed so that the disputants will have greater certainty in evaluating whether the marginal cost of continuing the dispute outweighs the benefits of specific business and settlement alternatives.

Most disputants provided the opportunity of mediation are generally able to devise business alternatives that are significantly more beneficial than the anticipated litigation alternatives, fairly evaluated. Yet, to achieve a fair evaluation almost always requires dealing, directly and indirectly, with the emotional components that usually give the underlying passion and blind determination to pursue the business dispute.

Early Mediation is one simple way of "Putting Some Good into Good-bye," when business partners are demanding a buy-out, or threatening to depart and compete or about to force a business sale or dissolution. Moreover, mediation may be even more effective when it is coupled with a contractual obligation that provides for a forfeiture of attorneys fees, that may otherwise be available, when a party chooses not to participate in early mediation.

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