**Using an Arbitration Clause to Resolve Corporate Deadlock**

**By Erica B. Garay**

It is a familiar story: two owners of a business cannot agree on its future. One owner wants to buy another entity or to sell a division and the other does not. These disagreements concerning the future of the company sometimes arise because there are intergenerational disputes. The older owner may be very happy to keep the status quo or wish to sell. The younger generation wants to expand and invest in the business. Often these differing visions can lead to a toxicity that prevents the company from functioning in an optimal way. The deadlock – whether it is among shareholders, members of a limited liability corporation ("LLC"), or co-managers – leads to accusations that the other owner is breaching fiduciary duties and the parties' agreements. In a family-owned business, the lost or damaged relationships can cause great harm, affecting other family members and relationships as well, and can impair the future health of a business. The next step may be litigation or arbitration of the claims.

These deadlocks can be addressed, however, without litigation. Consider the use of a broad arbitration clause that provides that an arbitrator will cast the tie-breaking vote in the event of an impasse. A typical arbitration clause provides for arbitration if there is a "controversy, dispute or breach arising from or concerning the agreement." A broader clause, such as the following example, can give a party the opportunity to commence an arbitration in the event that there is a deadlock:

> All claims, disputes, deadlocks and other matters in question between the parties arising out of or relating to this Agreement or the breach thereof which have not been resolved through good faith negotiation between the parties … shall be decided by arbitration.

Such a clause permits a party to commence an arbitration to use an arbitrator to break the deadlock. Or, the parties can use a more limiting clause that provides that, in the event of a deadlock or the failure of a party to provide consent to a corporate action or approve a budget, "the dispute shall be presented to the arbitrator for resolution." Of course, one can also include a requirement to use pre-arbitration mediation and/or principal-to-principal negotiation to resolve the dispute. The clause could also name a person to serve as arbitrator. This article addresses the use of arbitration to break a deadlock.

Sometimes co-owners or co-managers have equal voting rights (concerning some or all issues), even if there if they do not own equal shares of the entity. An owner may negotiate for a requirement of a supermajority or unanimity to take certain corporate actions, such as buying or selling a company, taking on debt, termination of employment of an owner, or other major decisions. Such voting rights can be at the owner level (whether members of an LLC or shareholders in a corporation) or at a management level of an LLC. Drafting an arbitration clause broadly enough to ensure that it covers deadlock can be important – especially since a mere deadlock may not be addressable by statutory remedies such as dissolution, breaches of duties or breaches of contracts.[1] A clause that merely addresses breaches and disputes may not address deadlocks or an impasse. Many times, the claims that are in pleadings cannot be proven.

**How to Use Arbitration to Break the Deadlock**

Either party can file and serve a demand for arbitration. (The parties could also file a single demand, jointly, to request intervention.) The demand should lay out what the issues are that require the deadlock to be broken, provide a brief factual background, and annex the arbitration clause. The demand is filed with the entity that is administering the arbitration (such as the Nassau County Bar Association ("NCBA") Arbitration Panels, JAMS or American Arbitration

Association) or provide it to an independent, ad hoc arbitrator chosen by the parties. The filing usually also advises what type of qualifications the arbitrator should have. The arbitration clause can specify what the background of the arbitrator should have – such as providing for an attorney, or an accountant, or retired judge; it can name the arbitrator. The clause can go further, for example, providing for experience in a particular industry (such as fashion or hospitality). Even if the clause does not express the qualifications, the filing with the arbitration provider can request a particular background. It is important that the arbitrator fit the needs of the particular issues or industry involved. This is one of the primary advantages of arbitration. Some clauses permit arbitrators to hire their own experts to assist them in analyzing issues providing independent information. If the clause does not provide for such, an arbitrator can always ask for such authority and, if the parties agree, then there is authorization for such retention.

Most importantly, a deadlock-breaking arbitration can avoid finger-pointing and prevent damages; it is not based upon legal claims of breach, and can be brought before harm has been caused.

**How Does the Arbitration Work?**

During the initial call with the arbitrator, the parties should discuss not just the issues presented, but also the structure of the arbitral proceedings, and schedule the hearing. If there needs to be discovery or an exchange of information, then the schedule should address such. At the very least, there should be an exchange of witnesses who will testify and exhibits that will be used at the hearing. (The list of witnesses is important so that the arbitrator can advise if there are any conflicts that are posed by a witness and disclose any relationships.) If reports and testimony of experts is to be used at the hearing, then a pre-hearing schedule for the exchange of reports should be set.

While a typical arbitration may be less formal than judicial proceedings, it usually has much in common: opening statements, sworn witnesses and cross-examination, admission of exhibits, and closing statements and/or post-hearing submissions, leading to a decision (called an award). In order to break a deadlock, however, the format of the arbitration may look quite different. The format should be flexible and fit the needs of the case and the issues presented.[2]

One way to handle the arbitration to break a deadlock can be to hold a hearing in the form of a board meeting. Each side would present its case on the issue. The witnesses at the sessions of the arbitration should be sworn in, as sworn testimony is a requirement of arbitration. The witnesses need to be available for cross-examination, even if the examination is more in the nature of asking questions in order to elicit the information that the arbitrator will need to cast a deciding vote, so that due process requirements are met. Witnesses should expect that the arbitrator will be asking questions as well.

Commented [SC1]: We try to avoid using he/she. I think this sentence could be omitted altogether – it seems redundant.

Let's look at an illustrative example. The co-owners or co-managers of an entity owns property that it intends to develop. The parties cannot agree on whether a hotel and commercial space should be developed or whether it should be a residential condominium development. At the arbitration hearing, conducted as though it were a board meeting, each side would make a presentation, explaining why the arbitrator should adopt its view. Witnesses would present time-lines for development, construction budgets, and the expected cashflows and what the resulting values of the property would be. Experts can provide testimony, too. All witnesses would be questioned by opposing counsel (or party) and the arbitrator. The evidentiary portion of the hearing can be preceded by counsel's opening statements (and/or pre-hearing briefs) that preview the issues. Once the witnesses' testimony concludes, counsel can summarize in oral and/or written presentations. The arbitrator can make an inspection too, by visiting a site or business operation

that is germane. The arbitrator will then decide the issue, which must be in the form of a written, final award that can be the subject of post-award confirmation or vacatur applications.[3] Thus, the arbitrator cannot merely vote at the conclusions of the presentations but will provide a written presentation that conforms with federal or state arbitral law. Even if the arbitration hearing is informal, it is important that the witnesses be sworn in and that there be presentations of testimony and exhibits, along with the opportunity to cross-examine. This is because the arbitrator's award can be vacated if a party is not given due process at the hearing.[4]

**Conclusion**

Transactional lawyers who are preparing shareholder agreements and operating and other agreements used by LLC's should consider including arbitration as a remedy for deadlock. Best practices should include speaking with an attorney who is well-versed in arbitration law when drafting the specifics of the arbitration clause for use in breaking a deadlock. The use of a well-drafted agreement to arbitrate deadlocks can ensure that the parties' relationships can survive the disagreement and provide a full and fair opportunity to air their respective positions. The use of the arbitration clause to resolve the dispute can help preserve the assets of the company and the relationships among the owners and managers.

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[1] *See, e.g.,* Bus. Corp. L. § 1104(a).

[2] *See* CPLR § 7506(b)(providing that the parties be given notice of the hearing); CPLR § 7506(c)(stating that each party is entitled "to be heard, to present evidence, and to cross-examine witnesses"); 9 USC § 7.

[3] CPLR § 7507 (requiring an award to be in writing and affirmed by the arbitrator); 9 USC § 9 (same).

[4] CPLR § 7511(b)(1);9 USC §§ 9-11.

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