

# NJBIZ

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## FACTORY RESET

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# STRESSED OUT

## How COVID-19 has affected Shareholder/Membership Disputes

BY MICHAEL S. HORN AND DYLAN R. NEWTON

The world has been turned upside down as a result of the pandemic and social unrest. Now, your business may be in for some unrest, especially if you have a partner, shareholder or member who is out of control.

Because of the stress on a variety of businesses, there has been a rise in the number of partnership disputes. If you sense that a dispute is afoot, there are a number of strategic moves that you can take to protect your business. You must trust your instincts. Once you sense something is wrong with your partnership, you need to act fast. You need a lawyer who specializes in these disputes to guide you through the minefields ahead. Your uncle who dabbles in litigation or your nephew who is a “jack of all trades” lawyer will make too many novice mistakes.

Next, you need to dust off the entity documents because documents such as a shareholders’ agreement or operating agreement will be your businesses’ constitution. Some of the most important provisions involve how profits and losses are distributed. For instance, even before the pandemic, many small businesses in New Jersey survived on hairline thin profit margins. However, after the virus hit and certain businesses were forced to temporarily shut down, and New Jersey Executive Order No. 183 was issued limiting indoor businesses to a maximum of 25% of the company’s overall building capacity, some businesses saw their profits shrink by more than 70%.

The recent falloff in profits has resulted in fights

between partners, but those fights can be easily resolved by examining and following the entity documents which should outline how profits and losses are distributed. If your partner refuses to abide by the entity documents, the key is to memorialize that position in an email for use in court.

Since many partners are strapped for cash, your partners may forget that they owe the company a fiduciary duty. New Jersey law imposes special fiduciary requirements on certain individuals to act with care and loyalty to the business and minority shareholders. This duty is not diminished during difficult economic times. If your partner is not acting in the best interest of the company, it is time to consider a change in management or possibly dissolving the business. Keep in mind that if you “give someone an inch, they will take a foot.” Once you sense that your partner is acting against the interests of the business, it is time to act immediately rather than giving your partners the opportunity to deviate from those obligations in more substantial ways.

Problems with a partner often get worse if not addressed quickly. In fact, during the pandemic there has been a substantial uptick in the number of partnership disputes regarding allegations of fraud. According to the Association of Certified Fraud Examiners, there are multiple reasons for the surge during the pandemic. Using the “Fraud Triangle” which consists of three factors that must be present for business owners to commit fraud – pressure, opportunity and rationalization – the ACFE explains that companies and employees have felt more financial pressure, have had a greater

opportunity to commit fraud while everyone’s focus is centered on the pandemic, and that business owners are more likely to bend their moral compass and rationalize their actions during an economic crisis. Commercial real estate is particularly vulnerable. The ACFE reported that real estate experiences the second highest median losses attributable to fraud. To protect yourself and your business you must not overlook small unexplainable transactions. Once fraud is suspected, you must immediately take action to stop it.

If you have not experienced any issues with your partner, now is a good time to be proactive. No one thinks it will happen to them until it does. Check your entity documents and make sure that they clearly outline the roles and obligations of each shareholder and/or member of the business. Consider having a procedure for reporting, monitoring, and documenting the company’s financial health through an independent company such as an accountant. Transparency will help quell any disputes since suspicions run deep in the middle of darkness. Also consider having a quick and less expensive method to resolve disputes outside of court such as expedited arbitration process.

The businesses that survive the aftermath of the pandemic and social unrest will flourish when the dust settles. Until that point, you must protect your business from enemies lurking within.

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