Merging Businesses Beware: MD Court Case Demonstrates Importance of Signed Legal Corporate Documents

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A recent decision by the Maryland Court of Appeals serves as a cautionary tale for business owners in Maryland. In *MAS Associates v. Korotki*, the parties intended to merge their businesses with an existing limited liability company (LLC), but never signed the requisite corporate documents to solidify their intention. When a dispute arose, two of the owners claimed a partnership existed while one disagreed. Taking their dispute to the courts, the Court of Appeals ultimately determined that, while intent can be explicit or based on the parties' conduct and the surrounding circumstances, there was insufficient evidence of a partnership here. Thus, the failure to document the relationship proved fatal to the argument of the majority owners.

Background

During the economic recession of 2009, Harry Korotki sought to initiate a merger with the mortgage lending company he owned, Savings First Mortgage, LLC ("Savings First"), and two other licensed mortgage entities: Greentree Mortgage Corporation ("Greentree"), owned by Joel Wax ("Mr. Wax"), and MAS Associates, LLC d/b/a Equity Mortgage Lending ("MAS"), owned by Saralee Greenberg ("Ms. Greenberg") and Ken Venick ("Mr.Venick"). Post-merger, the three companies were to operate as one, with MAS absorbing Greentree and Savings First, and becoming the surviving entity.

In an effort to memorialize their merger, each party was represented by its own counsel. However, due to complex regulations governing mortgage companies, the parties selected an independent regulatory counsel to navigate the merger process. At the time of the pre-merger negotiations, it would have been impossible to combine all 3 businesses without some interim steps for the purposes of licensing. Accordingly, the independent regulatory counsel prepared an "Issues Outline," which served as an outline for an "Interim Agreement." It included arrangements, obligations, and the structure of the business prior to the completion of the merger.

During the fall of 2009, the independent regulatory counsel drafted a new agreement between the parties, memorializing their intention to "ultimately change the membership of [MAS] and the membership percentages . . ." However, the parties intended for this agreement to take effect once the requisite regulatory approvals had been obtained, which was slated to be three years or more. The agreement was intended to provide time for each jurisdiction to process such approvals, namely MAS' change in ownership paperwork, and to act as a limitations period to insulate MAS from potential creditors.

The independent regulatory counsel circulated the initial draft agreement to the parties and their attorneys for review. Two days later, regulatory counsel forwarded the parties a draft Operating Agreement for the new MAS. Negotiations over the terms of the agreement and the Operating Agreement lasted for several months. However, an agreement over the language of the documents was not finalized, and the parties decided to proceed with business operations without executing the agreement. ***The parties concluded, because they were not generating revenue, it was not financially sound to continue absorbing legal fees with the regulatory counsel. Rather, they decided to proceed without signing any documents (except for a lease between Wax Properties and MAS).***

By summer 2010, the combined mortgage lending business had finally begun turning a profit. Shortly thereafter, the parties agreed to start receiving a salary of $10,000.00 per month each. At that time, they informally agreed that all business decisions and day-to-day executive functions of MAS were to be unanimously approved between them.

At the end of the year, the three men divided MAS's profits evenly among themselves, each receiving $120,000.00. The next week, they each made an additional contribution of $125,000.00 to the business. Then they drew a second profit distribution, totaling $64,500.00 each. Thereafter, as MAS began to grow, so did its need to secure additional lines of credit. As collateral to secure a line of credit, Mr. Greenberg and Mr. Wax agreed to pledge their own, personal resources. However, Mr. Korotki refused to be personally liable for any amounts exceeding his one-third share; which eventually led to the unraveling of the venture.

In the spring, Mr. Korotki informed Mr. Greenberg and Mr. Wax of his decision to quit. When Mr. Greenberg and Mr. Wax allegedly refused to negotiate the terms of his departure and buyout, Mr. Korotki filed a complaint in the Circuit Court for Baltimore County for breach of contract and declaratory judgment under RUPA. After several years of litigation and the associated legal costs, the trial court ruled that the parties intended to form a partnership.

The appeal by MAS Associates was elevated to the Maryland Court of Special Appeals. The ruling at the Court of Special Appeals affirmed the trial court. Specifically, the Court of Special Appeals ruled that the parties entered a "joint venture" in the short period of time between not signing the agreement and when they couldn't agree to the terms of the merger.

MAS Associates appealed to the Maryland Court of Appeals and Judge Adkins reversed the lower court, holding: *"The party asserting the existence of a partnership bears the burden of producing sufficient facts to conclusively demonstrate the parties' intent to form a partnership. Intent can be explicit or based on the parties' conduct and the surrounding circumstances. Sharing profits and losses, equal management authority, making capital contributions, and whether the parties were concurrently seeking to form another type of business entity can all be factors the courts consider when evaluating intent.*

Here, the trial court made an error of law when it concluded that Harry Korotki's $275,000 in payments to Saralee Greenberg were capital contributions for a new entity, and to the extent that it applied a presumption of partnership based on receipt of profits, it also made an error of law. As for the other factors and evidence, taken together, the record lacks competent material evidence to conclude the parties formed a partnership and the trial court was clearly erroneous in concluding that they did."

The Court of Appeals concluded that the parties, throughout the course of their business relationship and dealings, demonstrated that they never abandoned their pursuit of acquiring the membership interest in MAS. Specifically, the Court ruled that it is a contradiction of Maryland law to simultaneously sustain the dual intention of acquiring an existing LLC's membership interest and of forming a partnership or joint venture. The Maryland Court of Appeals reversed the Court of Special Appeals (and the trial court).

Important Factors for Businesses Considering a Merger

1. **Hire Business Law Counsel**
   The parties in this case hired independent regulatory counsel to guide them through the merger as well as personal business law attorneys. The regulatory counsel devised a plan whereby the parties would eventually become members of the LLC.

2. **Negotiate and Execute Agreements**
   The regulatory counsel drafted documents per the instructions of the parties, the parties just couldn't come to an agreement with certain aspects of the agreements – so instead of resolving them, they just never signed them and conducted business without certainty.

3. **Understand the Risk of Operating a Business Without Executed Agreements**
   Independent counsel warned the parties and their representatives that it would be difficult to determine their rights and obligations without signed agreements. While the parties disagreed over some points, namely liability, had they executed the agreements or more effectively communicated with regulatory counsel, it could have protected their interests as it related to their business relationship with one another. Instead, the parties conducted business activities as though an agreement was executed – in other words, they didn't let the lack of a signed business contract get in the way of transacting business. Despite their regulatory counsel's repeated recommendations and warnings, they ignored his advice.

4. **Trusted Business Law Advice May Reduce Your Future Legal Fees**
   The lesson here is that your actions and conduct today can potentially be used either against you, or in your favor, in the future. In the absence of signed agreements, the Court had to look to the actions and conduct of the parties. The parties ignored the independent regulatory counsel's warnings and advice because they didn't want to pay the legal bills (based on the testimony of one party). A trusted business law attorney makes sure their clients understand that they are looking out for their best interests. Clients are better served by paying legal fees to structure their business appropriately, rather than incur problems and costly litigation later.

Chris Young is an associate in the Business & Tax practice at Miller, Miller & Canby. He focuses his practice on corporate legal agreements, business formation, tax controversy work and helping clients deal with new tax regulations. He may be reached at 301-762-5212 or via **email**. View more information about Miller, Miller & Canby's Business & Tax practice by **clicking here**.

Michael Campbell is a partner in the litigation group at Miller, Miller & Canby. He

focuses his practice on commercial, real estate and construction litigation. Please feel free to contact Mr. Campbell at 301.762.5212 or **send him an email** for an inquiry. For more information about the firm's litigation practice, **click here**. For more information about the firm's business and contract law practice, **click here**.