Not Only is Loyalty, Honesty, & Square Dealing Good Policy, When It Comes to Your Business Partners, It's the Law!

It is amazing how often I talk to people who are partners or shareholders in a closely held corporation who don't realize the obligations that they owe to their fellow partners and shareholders under Colorado law. Many are surprised to learn that the duties they owe are beyond those memorialized in the operating agreement or shareholder agreement. These extra duties are known as "fiduciary duties" and are automatically recognized under Colorado law. Therefore, it is critical for anyone who is a partner or shareholder to know what those duties are.

Fiduciary duties arise from "special relationships" and are the highest duties owed in law. Fiduciary duties are owed where the law recognizes a "special relationship" between persons, such that a set of extra - higher - duties are owed between them. One well-known "special relationship" from which these duties arise is between the trustee and the beneficiary of a trust. A trustee must act in the beneficiary's best interest and can never spend monies or take action within the trust to benefit himself or herself at the beneficiary's expense.

The fiduciary duties owed include the duties of loyalty, honesty, good conduct, square dealing of the highest degree. In Colorado, partners stand in a relationship of trust and confidence to one another and are bound by the standards of good conduct and square dealing. For example, each partner has the right to demand and expect from the other a full, fair, open and honest disclosure of everything affecting the relationship. The duty owed is even greater when the one acting to benefit himself is a director or manager or is a shareholder/partner with a controlling interest in the entity. Those persons have a duty to act with "an extreme measure" of candor, unselfishness, and good faith in relation to the remaining shareholders.

Partners and shareholders of a closely held corporation are involved in a "special relationship" such that the law recognizes fiduciary duties owed between them. You would expect this fact to be equally well known. However, when you see on a regular basis (as we do) how often partners act to their own benefit without any regard for the harm they are causing to their partners, you wonder if this is so. Believe it or not, there is a reason you call them "partners".

The case law in Colorado even supports fiduciary duties of self-disclosure to your partners. The best example of a case in Colorado involving this principal is the *Van Schaak* case. In that case, one set of partners learned important new information, unknown to their fellow partners, that the value of the partnership was far greater than they all had previously believed. Armed with this new information, and knowing that the minority partners were interested in selling their interest, the partners in the know made an offer based upon the "old" value of the partnership. The partners-in-the-know then opened the financial book and gave the minority reams of paperwork and information about the business. What they did not do was disclose the precious new information that was motivating the partner-in-the-know to do the deal. The minority partners then sold their interest to the partners-in-the-know at the "old" value. When they learned they were duped, the minority partners sued.

At the Colorado Supreme Court, the partners-in-the-know argued that they had made no false statements and had provided the minority with all of the information necessary to figure out the "new" value on their own. The Colorado Supreme Court did not agree. That kind of disclosure is acceptable in the marketplace, where "arm's-length transactions" are the norm. But when you are dealing with your partners, the duties owed are greater than that (think, instead of an arm's length transaction - a transaction with all parties in a full embrace!). Instead, the Court ruled that the majority owed the minority a fiduciary duty to "fully disclose all material facts and circumstances surrounding or reflecting a proposed transaction."

Fiduciary duties are well established in the law. The best description of the fiduciary duties owed comes from the famous Justice Cardozo, while sitting on the New York Court of Appeals in 1928. He wrote as follows:

> *Many forms of conduct permissible in a workaday world for those acting at arms length are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace.* ***Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.*** *Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the distinguished erosion of particular exceptions. Only by this has the level of conduct been kept at a higher level than that trodden by the crowd.*

Moral of the story - Be Careful Out There! When you are the one taking action, it is not always easy to see what conduct may violate these duties. What you may believe is perfectly appropriate may appear underhanded and harmful by your partner. Many times, the appearance of impropriety alone may result in prolonged litigation, expense and a visit to the courtroom. To avoid litigation, it is best to be open and honest with your partners about the business, and to expect the same from them in return. If that simple advice fails, its time to contact us.

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