

Starting Your Own Business

Part III -- Entering into Agreements with Other Owners of a New Business

Doing It on Your Own

This is the third in a series of articles that look at the issues that arise when a new business is started. The first article dealt with developing a business plan, and the second article, published last month, dealt with choosing the form of organization. This article will focus on the issues that should be considered in entering into a partnership, corporate shareholder agreement or LLC operating agreement with other equity owners in the business.

Most new business organizations involve the investment of time and money of more than one individual. These individuals have to structure their relationship with each other so that all are satisfied that the arrangements are fair and provide for management of the new enterprise, the manner in which important decisions will be made, and the way in which money will be shared if the business is successful.

Where these issues are not considered in advance, there is likely to be conflict among the owners when decisions are made that are not agreed upon by everyone. The failure to have an agreement may also create problems in the future when one or more of the owners decide that they want to leave the business, or an owner decides that the contribution of the owners is not fairly recognized or compensated by the business.

How Can This Happen? I Thought You Had to Have an Agreement to Start a Business with More Than One Owner.

Of course, there does have to be some agreement among the owners, or otherwise they would not be in business together. The problem arises when the agreement is oral (or established only by bare bones documents, such as form articles of incorporation, form by-laws, or a limited partnership certificate), and the owners never establish a formal written agreement to nail down their relationship to each other.

Certain entities, like corporations, limited partnerships and limited liability companies, must have some formal documents to be organized under state law. But these documents do not require the owners to resolve many issues that affect the operation of the business or the interests of the owners.

There is no requirement, however, that partners have a written partnership agreement, or that shareholders in a corporation have a written shareholders' agreement. Where no written agreement exists, the relationship of partners to each other will be controlled by the partnership law of the state (usually a version of the Uniform Partnership Act, or a similar law covering limited partnerships), and the relationship of shareholders to each other will be controlled by the state's corporation law. Similar state laws exist regarding limited liability companies and associations.

These state laws provide some protection against unfairness and improper conduct of the owners, and, certainly, it is much less expensive to rely on state law than to engage an attorney to draft complicated agreements. Nonetheless, many important issues may not be adequately dealt with if state law is relied upon, and the owners do not enter into a written agreement.

OK, Who Owns What?

With a corporation, upon issuance of stock, the relative ownership interests of the shareholders is clearly established. A shareholder agreement, however, can make sure that these respective ownership interests do not change in the future, without the consent of all shareholders. Such a change can occur by the company issuing new stock to existing or new shareholders.

A corporation can discriminate between different shareholders by paying different salaries, but income distributed as dividends must be divided in accordance with share ownership.

Absent a contrary agreement, ownership rights in a partnership will be presumed equal among the partners, and distributions of money and profits will be similarly handled. Tax treatment of these distributions is very complicated and will depend on many factors, including the partners' initial investment of money or property in the partnership. If the partners are other than equal in all respects, then some agreement is needed to specify the respective percentage ownership interests of the partners, and to provide for how income and losses will be allocated for tax purposes, and how cash will be distributed, among the partners.

I have seen many situations where the partners have a dispute over who owns what, and the best evidence turns out to be the percentage interests shown on the partnership's tax return. Usually, the tax return will have been prepared by the partnership's accountant, who may or may not have had the interests of all the partners equally in mind. (Moral: Beware of letting the other guy's accountant prepare the tax return for your partnership!)

Its Time to Put Up the Money. Who Puts Up What?

Normally, the owners of a new enterprise each contribute or invest money or property in the company. How do you know who is supposed to contribute what?

A properly drafted shareholder agreement, partnership agreement, or limited liability company operating agreement will specify what amounts are supposed to be contributed by each owner, what each owner gets in ownership interest for making such contribution, and when each owner may be required to contribute more money to keep the company afloat or to avoid a "squeeze down" where the owner's percentage interest in the company is reduced because of his or her failure to contribute money when required.

In some cases the owners may want money to be contributed in the form of a loan, with interest, rather than as an equity investment.

The agreement also may have to take account of potential tax consequences created by allocation of profits, losses and cash in a manner different than the percentage ownership interests of the partners or shareholders in the company.

An Owner Dies or Drops Out. Who Gets the Stock and at What Price?

Typically, owners do not want to have the stock of an owner pass to someone outside the ownership group, or remain with an owner who leaves the business. Most shareholder or partnership agreements provide for a buy-out of an owner's stock or partnership share upon death, disability, termination of employment with the company, bankruptcy, or some other creditor problem which may subject the owner's ownership interest to an attachment by creditors. Equitable distribution rights in divorce proceedings also may affect ownership interests in a business enterprise.

In many instances the agreement may differentiate between an owner's retirement, resignation, termination without cause, or termination with cause. For example, the buy-out price may be lower if the owner is terminated with cause.

Owners of a business may want to make a buy-out optional in some circumstances (termination of employment) and mandatory in others (death or retirement after a certain age).

Where a buy-out right exists, the question needs to be answered as to who will buy the selling owner out? Should it be the company? The other owners?

Disputes also may develop over what is fair value for the purchased interest of the selling owner. The agreement among the owners may specify that the price is the initial investment of the selling owner, book value of the seller's interest, a formula price, or a price determined by agreement or appraisal.

Once the price is determined, the agreement will provide for how the price is to be paid. In the event of the death of an owner, the agreement may have required insurance so that insurance proceeds will be available to pay the purchase price. In other cases, the price may be paid in cash, or over a period of time, and evidenced by a promissory note (usually with interest added). The company's payment obligation under a note may be deferred if company income is not at or above a specified level.

An Owner Wants to Sell or Gift His or Her Interest. What Happens?

High on the list of concerns of multiple owners of a business is the worry that one of the owners may sell his or her interest to a third party, or gift or transfer the interest directly, or upon death or divorce, to family members who know nothing about the business, or who may be hostile to the other owners.

A provision found in most shareholder and partnership agreements restricts the right of the owner to sell or transfer his or her interest in the company to anyone without the consent of the other owners and the company. In some cases there are negotiated exceptions to this restriction, such as gifts for estate planning purposes to a trust for relatives, or transfers within the existing owner group.

To protect owners from being locked into their investment forever, and losing all leverage to sell their interests in the company for a fair price, many agreements provide a right of an owner to sell to a third party, provided that the company or the other owners, or both, are given the opportunity to match the price offered by a bona fide third party purchaser. This is called a right of first refusal. Typically, the right of first refusal price will be the price and terms offered by the outside buyer, but sometimes the

agreement may permit the then owners to buy at an agreed or formula price stated in the agreement, notwithstanding a higher third party offer.

Where ownership is divided among several or many owners, it may be unfair to prevent a sale of the entire company where there is an independent bona fide third party purchaser willing to pay a fair price. Accordingly, many agreements provide that if a specified percentage of the ownership interests votes for a sale of the company, all of the owners may be required to sell their ownership interest to the buyer or go along with a sale of the company's assets to the buyer. This is called a "drag-along" right.

Another similar right often included in shareholder agreements or LLC operating agreements is the "tag-along" right, which gives all owners the right to require a buyer from any one of them (or a buyer purchasing some minimum percentage interest in the company) to offer the same deal to all owners in one transaction at the same price.

The Company Wants to Issue New Ownership Interests. Who Must Approve?

As companies grow, and require additional capital, or employ new key employees, there may be pressure to issue new ownership interests to investors and others. The existing owners, of course, may have a concern that this new equity will reduce their stake in the company. Most ownership agreements restrict the right of the company to issue new shares of stock (or debt convertible into stock), or bring in new partners.

The agreement among the owners can require that if any new ownership interests are sold to investors, the existing owners will have a right to purchase additional interests themselves, at the price being paid by the new investors. This gives the existing owners the opportunity to invest more money in the company and maintain the percentage of their ownership interest in the company. This is called a "preemptive right". State corporate law may require preemptive rights for shareholders unless such right is excluded by the articles of incorporation of the company.

How Are Key Issues in the Management and Control of the Company Decided? How do the Owners Divide the Pie?

In the course of operation of a company, many important issues will come up that must be decided by the managers and owners of the company. If all company decisions require the approval of all owners, this may hamper the ability of the company to operate. On the other hand, if key decisions, such as sale of the company, or borrowing large sums of money, are made by only a majority of ownership interests, the rights of the other owners may be adversely affected.

In many cases the owners will agree that a high percentage of ownership interests must approve certain important transactions, such as (i) the issuance of additional shares, or the sale or merger of the company, (ii) the hiring or termination of the employment of key persons, (iii) the borrowing of money by the company in excess of a specified amount, (iv) the entering into any "material" contract by the company, and (v) the determination of employee compensation.

The owners may also want to agree that certain persons will be designated as managing partner (or managing member for an LLC), directors, and officers. The owners may want to place certain

conditions on persons continuing to be appointed or elected to these positions (for example, not being terminated from employment with cause).

A frequent point of contention among owners of a business is the compensation and benefits paid to owner-employees. It may be appropriate to agree in advance on these compensation issues, and many entities enter into separate employment agreements with owner-employees.

Another point of contention is whether an owner-employee who is terminated will be subject to restrictive covenants, prohibiting the employee from competing with the company, or from soliciting company employees to leave the company, during and after the employee's employment with the company. These restrictive covenant agreements may be contained in a shareholder or partnership agreement, or in a separate employment agreement. Without a binding non-compete agreement, an owner (other than a general partner) who leaves or is terminated will not be prevented from competing with the company, even if he or she continues to own an interest in the company. General partners in partnerships have fiduciary duties to the other partners, which make the obligations of a continuing general partner different from the obligations of a shareholder in a corporation, a member in an LLC or a limited partner.

For S corporations, which are taxed similarly to partnerships, the shareholders should have an agreement to cover certain points that are important to S corporation shareholders, such as making the "S" election with the IRS and state taxing authorities, not taking any action that would terminate the "S" election without the consent of all shareholders, and providing for payment of dividends to shareholders sufficient to permit them to pay the income taxes that will be due on the income of the corporation attributed to them for tax purposes.

OK, How Much Does All This Cost?

Drafting agreements for multiple owner business enterprises is fairly complicated, and requires the selection of attorneys and accountants with substantial experience. Although most attorneys have forms of these agreements that typically are prepared for a new business enterprise, there are many questions that must be answered so that these agreements can be tailored to the nature of the business, the relationship of the owners and other special factors that may affect the new business. This requires a lot of professional thought and input, and careful drafting of these key agreements.

In my experience, the formation of a new multiple owner business entity, and the drafting of the necessary agreements and documents, will cost the owners approximately \$5,000 to \$7,500, depending on the number of owners and the complexity of the arrangements. In complex situations, or for companies in highly regulated industries, this cost may be much higher. This estimate of cost also does not include costs that may be incurred to satisfy securities law requirements if capital is raised by the sale of securities (stock, limited partnership interests, LLC interests, and non-bank debt instruments). Although the cost may appear high at the beginning, a later litigation could cost the owners 10 or 20 times as much, and ultimately destroy the business.

The next installment in this series will discuss the legal and business issues that arise in raising investment capital for new businesses.