



The Essential Business Prenuptial

By Kenneth W. Hart

Business Partnerships are Like a Marriage

In many ways, a business partnership is like a marriage, and as anyone who has been there can tell you, when things aren't working, it can be just as painful and fraught with peril as any marriage gone bad. Of course, choosing the right partner, whether in business or romance, is key to avoiding problems down the road, but often that is not enough.

Good business people always have a plan, so before you enter into a business relationship, sign a "business prenuptial" agreement -- a written operating document for the company that spells out in detail what will happen if the relationship does not work out as you hoped. For reasons beyond anyone's control, relationships sometimes simply need to end, say in the event of an untimely death or a financial downturn. So your business prenuptial should not only provide for how the company will conduct business, but also for when and how ownership interests in the business must be sold or transferred back to the company or to other owners. This is known as the "buy-sell" clause.

Without the protection of a well-thought-out operating agreement, minority owners are particularly vulnerable to tactics designed to drive them out of the business or least make them irrelevant.

Typically, minority owners already lack the ability to exert much control over the business and when disputes arise, the majority owners may use their position of control to take away all meaningful

decision-making power from minority owners, effectively freezing them out. With their voting power, majorities can dictate the agenda at meetings and pack the board of directors. If you are in the minority, before you know it you may have lost your seat on the board, your salary is cut, and your office relocated to the janitor's closet down the hall. The new board might use its authority to prevent dividends from being declared, and instead use money that would have gone to the shareholders to provide perks, bonuses, or salary increases to loyal employees or to themselves.

The ultimate goal of the "freeze-out" might be to squeeze a minority owner out of the company. Even if majority owners cannot literally force a shareholder to leave, they might make it too unpleasant to stay. Thus, the freeze-out may be used as a negotiation tactic, not only to encourage a minority owner to sell, but to sell at a lower price or on better terms.

When conflict arises between shareholders of a small corporation, the company's attorney is frequently placed in an awkward position. The corporate attorney has an ethical duty to look out for what is in the best interest of the company not individual shareholders. So you cannot necessarily expect the company's attorney to be helpful in resolving shareholder disputes, and you'll want consult with your own outside counsel.

A well-crafted operating agreement can help level the playing field between majority- and minority-

interest owners. The agreement could include a supermajority voting requirement for certain actions that have a direct, adverse impact on minority owners. These might include admitting new shareholders or issuing additional stock, either of which could dilute stock ownership and voting power for minority owners. It might be appropriate to have two classes of stock, one voting and one nonvoting. This way, profits could be distributed according to shareholder percentages while voting power is shared equally, allowing majority owners to enjoy profits in proportion to their ownership, but empowering everyone to have an equal say in company affairs.

Under a voting-trust agreement, shareholders could be required to vote their shares to always elect certain individuals to the board of directors and appoint certain individuals as officers. Voting trusts can be particularly useful in family-owned businesses where the owners wish to gift stock to their children but still need to maintain control of the company until the children are ready to take the helm.

In companies where ownership and control are divided evenly or when certain important decisions require a unanimous vote, deadlock is always a possibility. Impasse can stymie the company's ability to grow, prosper, or even function. To avoid this problem, the operating agreement should include a tie-breaker provision. The agreement may specify mediation as a means to break an impasse, followed by binding arbitration.

Sometimes a shareholder loses his or her ability to continue to effectively function within the organization. This might be due to physical or mental disability; alcohol or chemical dependency; or a criminal conviction. The agreement should provide for the right to force the sale of the affected shareholder's stock to the company or other shareholders. An often-overlooked issue is whether a shareholder who is also an employee should be allowed to continue to own shares if they quit their job.

Don't Forget Why You Invested In the First Place

Most people invest to make money. So it's surprising how often people will put money and time into a business without a clear plan outlining how to get a return on their investment. If you invest in an enterprise as a silent, minority owner and just assume you will receive dividends when the company makes a profit, you could find the company never pays dividends. Instead, the majority owners take all of the "profits" for themselves as salary, benefits, and bonuses. This problem can be avoided with a business prenuptial, so before you put in your money, you'll need to understand how the company should be structured to return profits to the owners.

Phantom Income

Perhaps the only thing worse than not receiving a return on your investment, or even losing your money, is having to pay income taxes on your share of the company's "profits" you never received. It's not uncommon for a business to show a profit for tax purposes, but have no actual cash to distribute as dividends to shareholders. Instead, the money is tied up in capital improvements, in inventory, or used to pay off debt. If the corporation has elected to be taxed as a flow-through entity under Subchapter-S of the federal tax code, you may owe income tax on your share of the company's "paper profit" even though you didn't receive a dime.

Combine this with the possibility that as a minority owner you may have no say in whether the company distributes available cash to its shareholders, and you could find yourself in the worst of all worlds. The problem of "phantom income" can be solved by including what is sometimes referred to as a "gross-up clause" in the shareholder agreement, which requires the company to distribute at least enough cash to its shareholders to cover their taxes.

Cash Calls

Most shareholder agreements include what is known as a “cash-call” provision, which requires each shareholder to contribute a pro-rata share of capital needed by the company to cover emergencies. You’ll need to understand how these provisions work and how to negotiate for limits on, or perhaps exclusion from, the requirement to meet cash calls.

Even if you’ve done your homework and have created a good business prenuptial agreement, don’t forget you need to follow it or risk undoing what you accomplished. Many times key provisions of the company’s operating agreement are routinely ignored for a long time. Then, if there is a dispute and one party tries to enforce the agreement, the argument is made that, by their course of conduct, the shareholders have modified or even abandoned certain provisions of the agreement.

Of course, it is often necessary to adapt to changes in your business and personal needs. Just be sure to keep your operating agreement current. Suppose, for example, that you and your business partner had agreed to always have equal control over the management of your business. Later on you need more operating capital and decide to bring in a new shareholder, but fail to either modify your operating agreement or get your new shareholder to agree to be bound by the original control provisions. You may have unintentionally invalidated those control provisions, and instead given the new owner a say in how the business will be run.

Shifting the Balance of Power

Many state statutes include provisions requiring a specific percentage of shareholder approval for certain corporate actions. In Washington State, the statute requires a two-thirds majority vote in a privately owned company for these actions: merger, share exchanges, the sale of all or most of the company’s assets, and dissolution. These default provisions can be modified by agreement, however,

so a business prenuptial allows you to devise alternatives that better suit your specific needs. For example, if you plan to own less than one-third of the stock in a Washington corporation, you may want the agreement to include supermajority requirements for certain shareholder actions so your vote is required for approval.

What’s Your Exit Strategy?

The time may come when you want to take your investment in a corporation somewhere else or retire and play some golf instead. Unless you’ve planned ahead through a business prenuptial, here are some of the obstacles you may face in withdrawing from the company.

Unlike a publicly traded stock, you can’t simply liquidate your position in the company with a call to your broker. Although the shareholders agreement may allow you to sell your stock, there is not likely to be anyone outside the company interested in buying it, particularly if you own a minority interest in a small or family-owned company. If you do find someone who is interested, most buy-sell provisions will require you first offer your stock to the company or other shareholders. By then your buyer may have gone elsewhere

A minority share of a small company is usually considered to be less valuable because minority owners lack control of the business. Therefore, unless the operating agreement provides otherwise, the sale of a minority interest may be subject to a “minority discount,” even when it is the company or other shareholders who are buying it. That means a 20 percent shareholder may only get 15 percent of the company’s fair market value for his or her stock. Some agreements include a price penalty if a shareholder withdraws before some predetermined date.

Uncertainty about the value of a company’s stock

can generate disputes at the most awkward times. So it is crucial to know ahead of time how the price of shares will be calculated. Valuation methods include fixing the stock price based on the book value of the company's assets, or on a weighted-average of profits. The operating agreement could require a professional appraisal or could simply say the shareholders will attempt to agree on a value when the time comes or will submit the matter to binding arbitration if they can't agree.

It's important to consider where the money will come from if the company has to buy out a shareholder, because an unexpected and unfunded obligation could cripple the business. Here are some options. Life insurance can be put in place to fund the purchase of the shares of a deceased shareholder. Be sure, however, you consult with an experienced insurance professional who knows how to structure the plan so the company can deduct the cost of insurance for tax purposes and the shareholder's estate won't have to pay tax on the insurance proceeds. For those situations where there is no ready source of funds, the operating agreement should include fixed buy out terms, specifying the required down payment and a payment plan, including terms and interest.

The business prenuptial should also include provisions to protect the intangible value of the company after a buy out has occurred. After leaving the company, a shareholder should be required to keep business secrets and other proprietary information confidential for a reasonable time, if not indefinitely. Even without a confidentiality agreement, the Washington Trade Secrets Act provides some

limited protection. The Act makes it unlawful to disclose confidential information that derives its value from not generally being known outside the company like a pricing formula, customer list, or unique way of doing business.

You also don't want to have bought out a shareholder only to have them compete with the company after they leave. As a condition of any buy-out, therefore, the departing shareholder should be required to not compete with the company. To be enforceable, a noncompetition agreement must be reasonable in scope, geographic area, and time.

If a shareholder dies, advanced planning could make things much easier for the surviving family. The sale of stock can create liquidity in the decedent's estate as well as fix the value of the decedent's company shares for tax purposes. For estate-planning purposes, the buy-sell provisions in an operating agreement may be key, therefore, to ensuring there is a ready purchaser for an asset that might otherwise be difficult to sell.

Small business owners might want to have their successors contribute start-up funds when the business is formed. This capitalization is usually minimal, and successors could end up owning a significant portion of the business that will not be taxable if the business owner dies. Unfortunately, an estate-planning attorney often is contacted well after a business is established, when is too late for a successor to buy shares inexpensively.

All of these are excellent reasons to have a business prenuptial in place before entering into a business partnership.

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