A business prenup

How to plan for a breakup with business partners before you even get started **Interviewed by Sue Ostrowski**

If you are in business with one or more partners, it is critical that you have the proper agreements in place in case something goes wrong. Too often, people go into business together without giving any forethought as to what might happen if things do not work out, according to Aaron Lepp, a partner at Stark & Knoll Co., L.P.A.

"If you are serious about starting a business, then you need to realize that it is a major commitment of your time, energy, money and life," says Lepp. "With so much at stake, you want to make sure everything is adequately protected, and this means you need to make sure you have an agreement in place to the extent that your business has multiple owners. It should not even be an option."

Smart Business spoke with Lepp about how to create an agreement that will help protect business owners, together with their businesses, from issues between co-owners.

Aaron Lepp
Partner
Stark & Knoll Co., L.P.A.

What should be included in an agreement between business owners?

The first is a management provision. This spells out who has the authority to manage and operate the business. Management provisions allow owners to define roles, streamline the business and operate more efficiently. For example, in a multiple owner business it would become burdensome if all owners had to meet every time the business had to buy equipment, order supplies, or hire and fire employees. Management provisions can delegate what authority and duties each owner has. And while a well-drafted management provision may give authority to one owner to unilaterally make ordinary course decisions on behalf of the business, it would not typically give an owner the unilateral authority to make non-ordinary course decisions, like settling a lawsuit, as some decisions are better left for the group.

What else should be in the agreement?

You need buy/sell provisions. When a person goes into business with someone they generally want to be in business with that particular person, not with some third party who they do not know. Buy/sell provisions help with this by placing restrictions on the ownership of equity and its transfer. That is, buy/sell provisions define who may own the equity of the business and under what conditions it may be transferred. Thus, they allow owners to control what happens to the equity should certain events occur, such as an owner dying or an owner's equity becoming subject to a court order in a divorce. An agreement might state that upon the occurrence of one of these events the remaining owners and/or the business have a first right of refusal to purchase the equity.

There would also be a provision establishing the purchase price for the equity and the payment terms. This allows owners to set the price and terms ahead of time, and thereby avoid arguments, which may otherwise arise at the time of sale without an agreement. Keep in mind that an owner who is being bought out is often in no mood to negotiate, and especially relative to price (e.g. if an owner is leaving on bad terms). The idea is to make sure that the owners have as much control as possible over what happens to the equity in their business.

Should a noncompetition clause be included in the agreement?

Noncompetition and confidentiality covenants are very important as they prevent competition from owners both during and after the period of ownership. The specific details depend on the particulars of the business, and it is not uncommon for restrictive periods to last after departure for up to five years. Further, confidentiality covenants often protect business information indefinitely.

What are the consequences of not having an agreement?

If a business owner is not acting as required, then, absent an agreement with well-defined parameters as to the expectations of the owners, it becomes much more difficult, if not impossible, to correct the failures of a non-compliant owner, or, if necessary, remove the owner from the business. Further, without an agreement with buy/sell provisions an owner may transfer some of his or her equity to a spouse, child or other third party. Thus, in either instance, the absence of an agreement may cause the other owners to find themselves trapped in a business with people they never intended, with no way to correct the problem. This often results in an ugly lawsuit, or corporate divorce. Conversely, a properly drafted agreement states the terms upon which an underperforming owner may be removed from the business, and clearly defines the persons to whom an owner may transfer equity.

What would you say to someone who argues that he or she doesn't need an agreement?

When the business begins, capital is short and business owners are trying to save money in order to spend what little they have on the growth and development of the business. I understand that, but as the saying goes, 'An ounce of prevention is worth a pound of cure.' They may say, 'We'll do it at a later date,' but too often the later date is too late.

It is better to spend a little money upfront, get something in place, and then when the business becomes more successful the owners can always go back and amend the agreement. Comparatively, the amount of money typically spent attempting to unravel bad situations between disputing owners without an agreement almost always far exceeds the amount of money that would have been spent to create an agreement on the front end. It is best to tackle the agreement issues at the outset of the relationship because the owners' collective interests are generally aligned at that time, whereas the further a business progresses the greater the potential for divisive issues to arise between owners, and the greater the potential challenge to get all owners to come to the table and agree on the terms of an agreement. <<

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