Successful Business Partnerships

By Robert W. Olson Jr.

The concept of a business partnership is an attractive one. This is certainly true given recent technological advances: think about how the now-ancient synergy of telephones and cars and late-night munchies created the business behemoth of Domino's Pizza.

Success in business partnerships requires the right business plan, and partners with the ability, capital, time and drive to execute that business plan. However, even the right business plan, financial backing, and partners with the right skill sets, are nowhere near enough to give you a good shot at a financially successful partnership. Certainly, the shifting sands of the free market, technology and consumer demand will always be a risk factor in any business endeavor. However, beyond these typically understood dynamics, it is also crucial to understand that partner personalities and their interpersonal dynamics are an even greater risk factor.

Beyond their finances and skill sets, partners have their own unique (and frequently conflicting) desires, outside responsibilities, interpersonal skills, temperament, blind spots, and myriad other human traits. People are human, and so will bring to a partnership all the benefits and burdens that go with that. Therefore, when a client is ready to jump into a business partnership, my 30+ years of legal practice prompt this advice: *"To protect the partners and their families, your partnership needs to be set forth in a written agreement that is fair, comprehensive, and reduces potential disagreement among the partners."*

Without that written agreement, the partnership has little chance to succeed in the long run. If the agreement doesn't clearly address what happens in a disputed situation, it becomes nearly impossible for the partners (and their families) to agree to what is "fair" once that situation arises. At this stage, lawyers may have to get involved, and resolving the situation becomes a slow, expensive and psychologically damaging process.

What is Included in a "Fair" Agreement?

So, what constitutes the "fair" terms in a partnership agreement? One that includes the following elements:

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Capital Contributions Equal to Ownership. Fairness is far easier to see when each partner contributes amounts of money proportional to their ownership rights. However, many business partnerships rely on one partner providing start-up cash for their share of ownership while the other partner promises to contribute work for their share of ownership – frequently called "sweat equity." Unfortunately, this approach has many pitfalls. It is an unreliable method of equalizing capital contributions, since the working and non-working partners almost always have different perspectives on how hard the working partner is actually working. It also gives the non-working partner equal control and ownership before that equal position has been earned, which reduces the working partner's incentive to do the actual work. Finally, this approach has unexpected and severely negative tax consequences for each partner.[1] Therefore, when a new partner can't afford to buy their full equal share up front, there needs to be specific timetables and pricing for the new partner to become an equal partner over time, including (if applicable) the timing and process of awarding sweat equity.

Equal Control. Ownership and control generally go hand in hand, but even if ownership is not equal, control must be equal. Many prospective partners fear that their partnership will not be able to act if one partner (the one who raises the issue) doesn't have a final say in disagreements. While this is literally true, it is important that the partners be forced to discuss and compromise on matters of disagreement. Leaving one partner in complete charge makes discussion meaningless and compromise unnecessary, leaving the other partner as a permanent subordinate who is subject to all the business liabilities but lacking any control over the business. This situation is a guaranteed recipe for disputes, and almost always leads to an acrimonious breakup.

No Passive Investors. Another, but even more important, reason to keep equal management rights is to stay on the right side of federal and state securities law. Ownership

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in a business with no control over operations turns that ownership right into a “security.”[2,3] When someone sells a security, the seller is required to disclose all the relevant risks of the buyer’s investment.[4] Failure to disclose those risks can have devastating effects on the seller and the business. Not only can a “failure to disclose” finding force full repayment of the buyer’s investment, that finding can also result in criminal charges![5] DON’T go there.

Compensation in Two Parts. Each partner needs to be paid for the work they actually do, as if they were an employee rather than an owner. Then, after all other business expenses are paid, the balance is paid to the partners in proportion to their ownership.

- **Equal Work Rights.** A corollary of two-part compensation is the requirement of equal work rights. When a partner’s main source of partnership income is their workload, each partner needs to have workdays and hours in the same proportion as their ownership rights. The bulk of the business’ value usually is in cashflow, and a junior partner will be unwilling to pay for cashflow that the senior partner keeps for itself. There are some exceptions to this requirement (such as work that requires specialized skills, specific insurance coverage, or regulatory compliance) that may require that work be allocated to the partner meeting those requirements. The partnership may also allow for reduced hours (and reduced compensation) requested by a senior partner without negatively impacting the “equal work” requirement.
- **Equal Time Commitment.** On the other hand, when a partner’s main source of partnership income is based on their ownership rather than workload, partners need to have time commitments to the partnership commensurate with their ownership. This approach can be difficult to enforce when the partners have very different roles in the partnership.

Reducing Disagreements: Succession Planning

There are structural ways to reduce sources of disagreement among partners that are not addressed in this article.[6] Other than structural solutions, the most likely source of conflict in any partnership agreement is upon the buyout of a partner who leaves the partnership, whether willingly or involuntarily. Even if the partners are extremely patient, accommodating, and fair with each other, I can guarantee you that their spouses and children will not be, given that everybody will then know which partner is departing and the reasons for that departure.

My overall goal in partnership succession planning is to protect both the remaining partners and their continued ability to operate the business profitably, as well as the family of a departing partner who no longer brings in their expected income. The question then becomes “what details do we need to cover in that succession plan?”

- **Buyout Price.** If not set by agreement or formula, the price may be set by a lender or business broker as of the triggering event (e.g., death, disability, loss of license or other wrongdoing, insolvency, retirement). Generally based on fair market value, that value is discounted if the departing partner is “at fault” for the departure.
- **Manner of Payment.** If no loan or insurance proceeds are available to fully fund the buyout, a detailed payment plan needs to be included, with a specified term, interest rate, monthly payment, and security for payment.
- **Buyout Timing.** Loss of a professional license or death requires specified buyout time limits under state law. Disability or retirement buyouts may not have legal urgency, but for the family of a disabled partner, like that of a deceased partner, that loss of income can be a severe blow. All partners need to be mindful that it could be their families that are put in this precarious position when negotiating buyout timing.
- **Post-Buyout Behavior.** Except when the departing partner is deceased, the buyout price assumes certain behavior by both sides after the buyout. A purchase agreement covers all these things, but the two sides are unlikely to be reasonable once they know their position. Therefore, all those behavioral matters should be specified within the partnership agreement. These behavioral matters include non-competes, accounts receivables collection, uncompleted repair work, use of the departing partner’s name, and many other matters.
- **Other Issues.** There are so many other issues that should be discussed as part of succession planning in the partnership agreement. Included in those issues are timing and payment for intermediate purchases, treatment of liens and personal guarantees, whether the purchase optional or mandatory, what assets are included in the purchase, and tax allocations.

Practitioners need to be very careful, thorough, and thoughtful when preparing and finalizing partnership agreements. They need to use precise and consistent language throughout that partnership agreement, since each and every ambiguity gives plaintiff's attorneys something to dispute when disagreements arise. They also need to ask their clients, and think through in great detail, **(1)** what is important to each partner under current circumstances, **(2)** what will be important to each partner under possible changes in future circumstances, **(3)** what would be important to a departing partner, the remaining partners, and their respective families, when the inevitable buyout situation occurs, and **(4)** what would each partner and their family members consider the "fair" procedure for that inevitable buyout.

For each of these considerations, the parties' positions should be considered as if under the veil of ignorance: of not knowing what their respective positions will be. Each could be a senior or junior partner, the departing or remaining partner, or a family member of a senior, junior, deceased or disabled partner.[7] Fairness is not a mere abstraction when working with partnerships, and as attorneys we cannot treat it as such if we want our partnership clients to survive and thrive. Professionalism demands nothing less. ■

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Endnotes

1 These tax ramifications are addressed in my January 2012 article in Santa Barbara Lawyer "Tax Ramifications of Sweat Equity in Professional Partnerships."

2 15 U.S.C. §78c(a)(10) defines a security (in part) as: "any note, stock, … certificate of interest or participation in any profit-sharing agreement or in any … investment contract … for a security …."

3 *SEC v. Howey Co.*, 328 US 293 (1946), defined an investment contract as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or a third party."

4 15 U.S.C. §78j(b) and 17 C.F.R. §240.10b-5.

5 *Janus Capital Group, Inc. v. First Derivative Traders*, 131 U.S. 2296 (2011), and *Prousalis v. Moore*, 751 F.3d 272 (4th Cir. 2014).

6 Structural techniques for reducing partner conflict is addressed in my November 2013 article in Santa Barbara Lawyer "Professional Group Practice Options."

7 Also known as the "original position" in John Rawls' 1971 book "A Theory of Justice." See also Immanuel Kant's "categorical imperative" in his 1785 work "Groundwork on the Metaphysics of Morals."