Avoiding An Ugly Business Divorce

"....if anyone knows a reason why these two should not be joined in holy matrimony, speak now...."

Meet Scott and Greg.

Scott is an avid gardener who is bored with being trapped in a cubicle at his day job. Greg has decided that after 15 years as a landscape architect at a large company, he is ready to start his own. The two were old friends, and they decided to go into business together. Their complementary talents were a perfect match for running the new company and success would surely blossom. They married Scott's operational, sales and marketing prowess with Greg's enthusiasm, education and field experience and formed a full-service landscaping company. Eager to start planting and mowing lawns and bolstered by their respective successful track records, Scott and Greg avoided the legal fees involved with preparing a shareholder agreement opting instead for generic, fill-in-the blank template to get them going.

In short, they by-passed the "business pre-nup".

See the weeds of conflict begin to take over

Scott and Greg soon learned that they had differences of opinion on important issues. They disagreed about the division of responsibilities. Scott resented the time he spent dealing with clients who didn't know the difference between clover and grass, and Greg was unhappy with the amount of paperwork he found himself buried under. Their enthusiasm was dwindling as their start-up costs mounted. Because they each owned 50 percent of the business and had not properly outlined the details of their shareholder agreement, there was no roadmap to resolve these issues. Stalemate after stalemate quickly dried up their creativity and productivity. What once had seemed like the Garden of Eden had evolved into a struggling company and a tense business relationship. Since their shareholder agreement lacked a buy-sell provision, there was no easy way to unwind the dying partnership. Scott and Greg found themselves "unhappily married" with no business agreement to resolve their issues or mechanism to obtain a business divorce. It is no surprise that Scott and Greg reached this point – a recent report from the Harvard School of Business put the failure rate of business partnerships at a staggering 70 percent.

Learn how to avoid the same fate

At a minimum, an effective operating or shareholder agreement should address:

- Controlling ownership: There are pros and cons to partners having equal control (the usual 50 percent each) versus one of the partners having majority ownership and therefore being able to control all business decisions when push comes to shove. This is perhaps the most significant decision partners can make when going into business together.
- Capital: Decide who is required to put in capital and how much. What rate of return does capital receive? What priority return does it receive? Is it secured or unsecured? What if additional capital is needed?
- Distributions: How are profits and losses to be allocated from both a tax and cash flow standpoint? Owners often assume that cash distributions are made in accordance with ownership percentage. This is not necessarily correct.
- Buy-Sell Agreements: While no one likes to consider the end of the relationship while still at the beginning, it is critical to contemplate. What triggers a mandatory buy-sell? What triggers an optional buy-sell? How is the price determined? What are the terms of payment?
- Adding Additional Members: Consider under what terms and conditions an additional member or shareholder can be brought into the company. Do all existing owners need to agree? Can an existing owner sell his interest without permission from the other owner(s)?
- Restrictive Covenants: If one of the owners is essential to the operation of the business and the other is providing capital, the owner providing capital should consider restrictive covenants to prevent his partner from leaving the business and taking valued customer and/or employee relationships.

Far from being a warning of a predicted end to a business relationship, the business pre-nup might be one of the greatest gifts that business partners can give each other. It will provide a roadmap for business operations to help avoid an ugly business divorce and the accompanying weeds also known as exorbitant costs, damaged reputations and risk of business failure.

Article provided by Jaburg & Wilk; For additional information you may contact Scott Richardson at 602-248-1000.