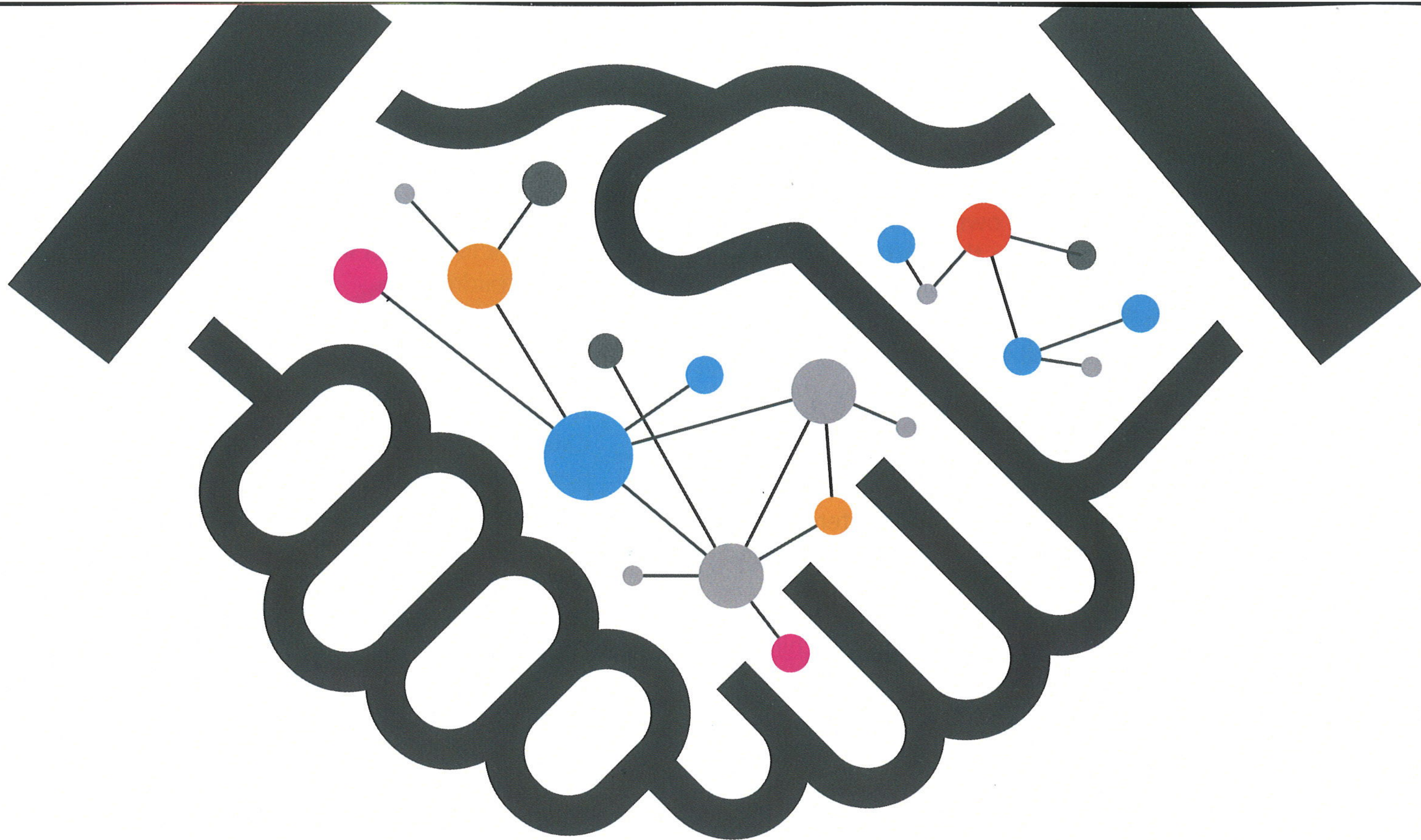

DO's AND DON'Ts OF PARTNERSHIP

By Erin K. Tenner

It is common, when joining as a partner in a business or forming a partnership (whether in a corporation, limited liability company or general or limited partnership), to think about only the benefits and to want to keep it simple. However, not thinking things through can be very costly. Writing down what the partners agreed upon and signing an agreement provides an opportunity for planning and reduces the chances that things will go wrong. This article will give some do's and don'ts of partnering, some planning tips, and a sampling of issues that are often missed even when partners do have a written agreement.

First, *DON'T* agree to sell an interest in your business without considering how it will affect your ability to handle and distribute cash. Do make sure that when you take in a partner in a S corporation (known as a stockholder or shareholder), all distributions from that point forward are proportionate to the ownership interests of the respective partners. For example, if one partner owns 25% and the other owns 75% of the S corporation, any money paid out from the corporation to a shareholder that is not paid as salary or bonus must be paid in proportion to ownership interests: 25% to the 25% shareholder and 75% to the 75% shareholder. Failure to do this entitles a shareholder who received less than his or her proportionate share of the distributions to damages and could result in loss of the S election resulting in huge tax liability. Partnering in a limited liability company ("LLC"), on the other hand, can be different than partnering in a S corporation. Distributions from a LLC can be disproportionate if the Operating Agreement provides for disproportionate distributions.

Second, *DON'T* make any agreements without first considering the tax consequences. Do take out any cash you already paid taxes on before taking in a partner. Owners of S corporations, and limited liability companies ("LLC's") that are treated like partnerships for tax purposes, pay taxes on their earnings even if they are not distributed. The income that was taxed and not distributed goes into an Accumulated Adjustment Account, also known as a triple A account. This is the

equivalent of retained earnings in a C corporation. Distributions can later be taken from the Triple A account without paying tax – because it was already paid. Before taking in a partner an owner will want to make sure they take out their money that they already paid taxes on – otherwise, they may never get it. This means there has to be cash on hand that can be taken out. As most business owners know, retained earnings, or Triple A earnings, often do not equal cash on hand – and cash on hand is often less. The owner will essentially lose the right to take the tax free distribution (of income on which they already paid taxes) without paying taxes on the same money again because the new partner will be entitled to some of that distribution if some planning is not done in advance.

Third, *do* make sure any agreement to buy or sell an interest in a dealership is in writing and detailed to provide exactly what is being transferred and for what price and how the price will be paid. With no agreement, or vague terms, problems arise. Keeping things too simple can create many complications and expensive litigation. For example, it is not uncommon to see litigation over stock option agreements with no purchase agreement attached, or stock purchase agreements with no owners' agreement attached. A stock option agreement may not be enforceable if there is no stock purchase agreement attached.

Fourth, *do* make sure an owners' agreement (aka Shareholders' Agreement, Partnership Agreement or Operating Agreement) is attached as an exhibit to any purchase agreement given to a new partner so that when the ownership interest transfers the owners' agreement can be signed without requiring further negotiation. Otherwise it may never be signed. Why is that a problem? An owners' agreement, if done properly, will provide what happens if a shareholder dies, becomes disabled, loses their interest in a divorce or to a creditor, is terminated from employment, or just wants out.

If an owner dies and has no written owners' agreement, their partners will not have any right to take control of the deceased shareholder's ownership interest. Instead, the interest will go to the heirs of the deceased owner leaving surviving owners with a partner they may not want. It could be someone who knows nothing about the business but wants a say in it – or someone very litigious and paranoid who always thinks they are being denied something to which they are entitled. Minority owner rights under the law give these partners a basis for litigation. These kinds of disputes can be very disruptive and costly.

Likewise, if an owner gets divorced they could lose their interest to an ex-spouse who then becomes the partner with the other owners. An owners' agreement would give the divorcing partner the right to buy out the community property interest of an ex-spouse as well as any interest lost to the ex-spouse in a divorce. If done properly, the spouse would have agreed to the arrangement when the owners' agreement is signed. If the divorcing partner does not elect to buy the interest, the other partners will have the right to buy it.

Owners' agreements also give the shareholders the right to buy the stock of any shareholder who loses their stock to a creditor, whose employment is terminated, or who just wants out. If done correctly, it lays out price and terms.

An experienced transactional attorney will know how to draft these agreements and button up loose ends so litigation becomes unlikely or at worst, much easier to resolve and will have solutions for how to accomplish goals that may seem unattainable. For example, often auto dealers want to sell a minority interest in their business to a valued general manager who can't afford the purchase price to buy in. The lack of funds does not need to prevent a transfer. Often owners will agree to sell the stock in return for a promissory note for payment. If a 10% interest is sold the buyer will be entitled to 10% of the income distributions. The purchase agreement can require that the distributions be used to pay the new owner's share of taxes, and that the balance be used to pay down the promissory note.

In summary, spending a little money to have a well written purchase agreement and owners' agreement is important to protect the rights of all owners and can save a lot of money down the road. A partner should never be added without a purchase agreement (which will require factory approval) and an owners' agreement to protect the rights of all owners.

Keeping it simple is a great idea, and there are ways to simplify documents that could be very complicated without sacrificing quality, but too much simplicity is generally not a good idea and often leads to very expensive and complex litigation and/or expensive tax problems down the road.

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