BREAKING UP
IS HARD TO DO

By Paul Kellogg

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Most often, a business divorce occurs when one owner feels that he or she is doing more than the other owner, or that the co-owner is mismanaging the business. Or one owner may discover that the other has been using company funds for personal expenses. (One of my clients claimed that his co-owner collected a salary but never came to work because he was practicing to be a bass fishing pro!) Sometimes, owners simply disagree on the direction of the business or develop personal conflicts. By the time I encounter these broken relationships, a business divorce is often the only solution.

Make a Clean Break

The challenge is making the divorce quick and relatively painless. The corporate document that governs the company's internal affairs (e.g., the bylaws, partnership agreement, and/or company agreement), which we'll call the "governing document," should provide a road map or rulebook for resolving conflicts. When owners know the rules ahead of time, they can implement a plan that is rational, neutral, and unemotional. One of the hardest things about a divorce—business or marital—is getting past the individuals' sense of hurt, anger, betrayal, and foolishness. When a relationship breaks down and the finger pointing starts, it becomes extremely difficult to create a plan for the break-up. There isn't any reservoir of trust to build on, and the individual who feels that he or she has been taken advantage of wants one thing—revenge, preferably kept in a jar on the desk. And neither party is likely to see the situation objectively: each owner typically overstates his or her contribution to the business and understates the co-owner's contribution. For this reason, it is critically

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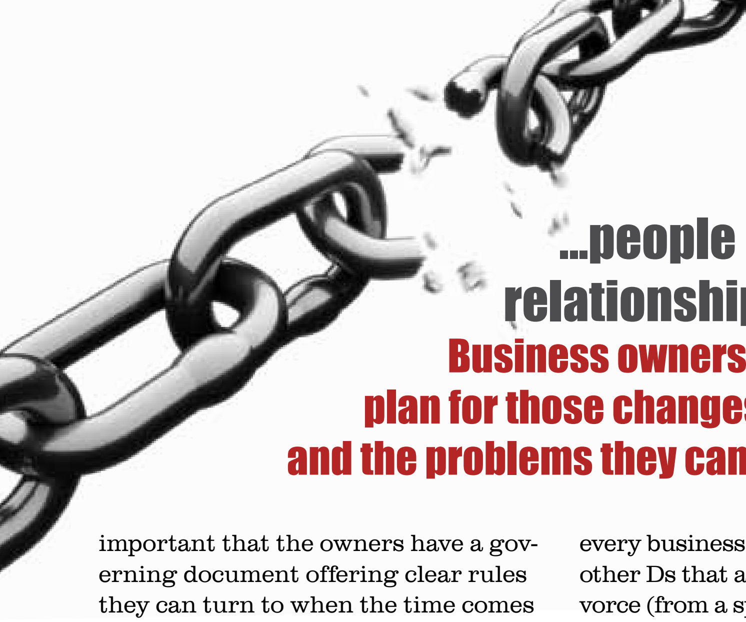

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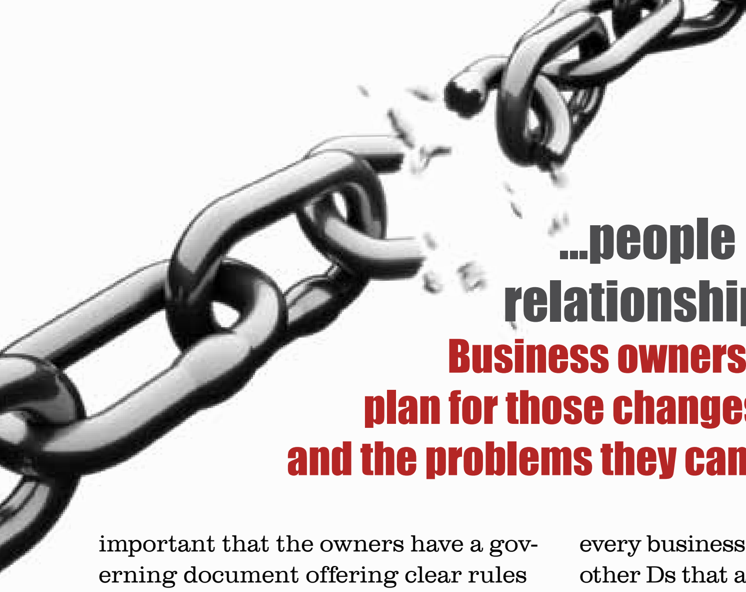

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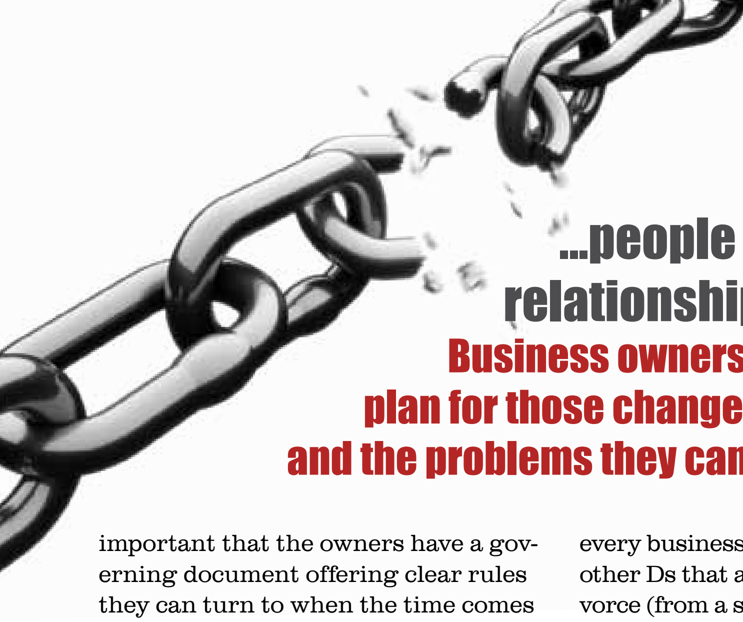

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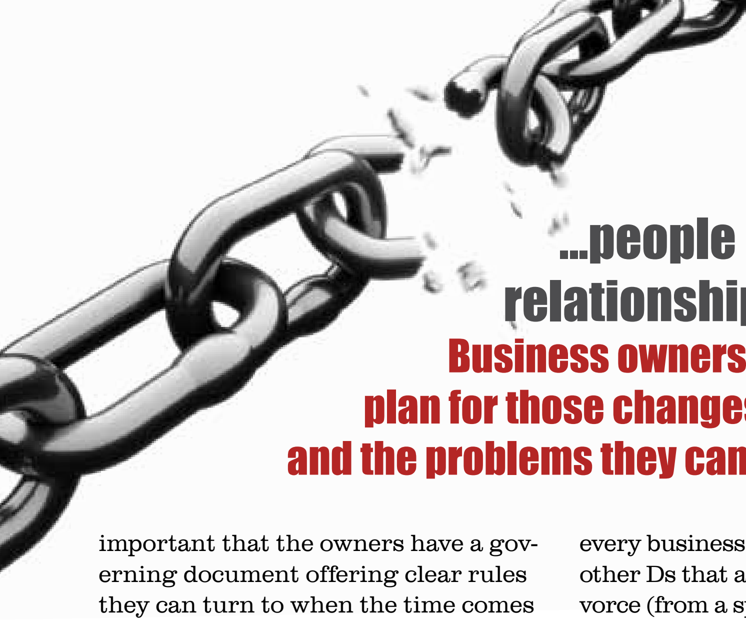

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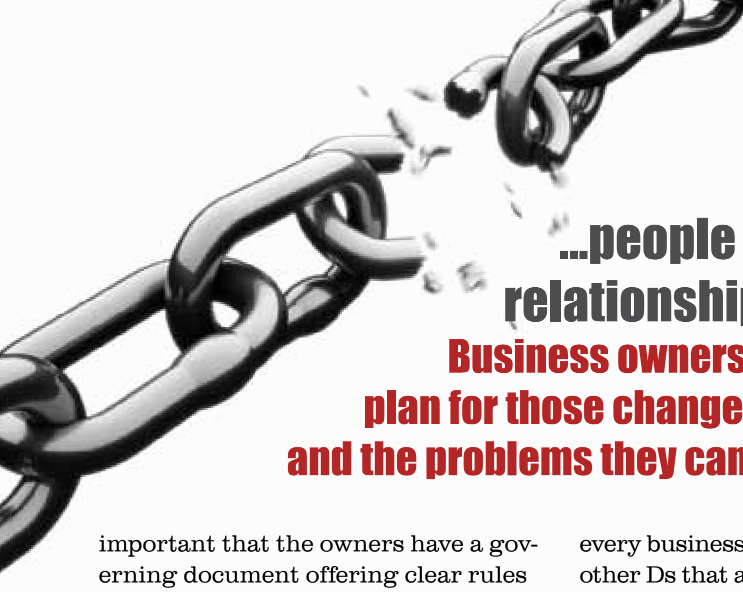

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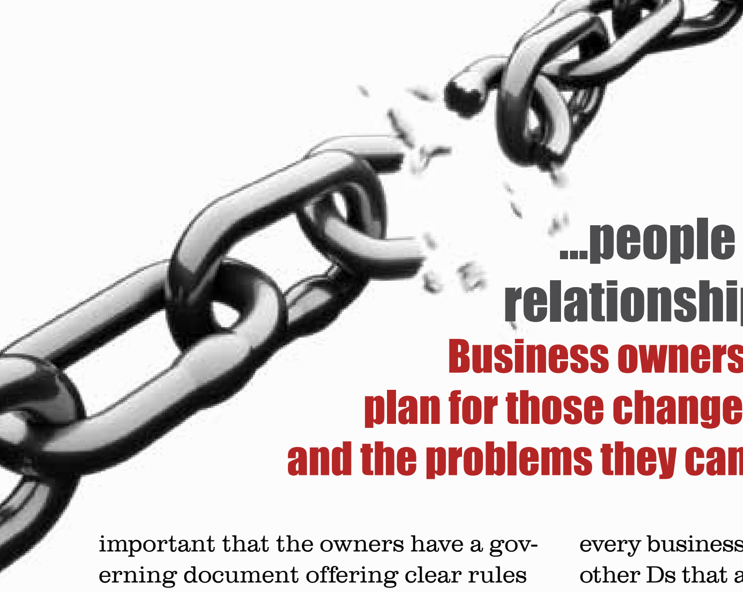

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D Is for Dysfunction

Business-owner disagreement is not the only thing that can disrupt or destroy a small business. At some point, every business must deal with three other Ds that affect owners—death, divorce (from a spouse), and disability.

When an owner dies, his or her ownership interest passes to his or her spouse or heirs. Unless you want to be in business with your partner's spouse or your co-owner's possibly ne'er-do-well son, you need to buy out that ownership interest. (Remember, too, that the spouse usually has a community property interest in the shares.) In a family divorce, the ex of your co-owner may wind up with some or all of the shares. You do not want to share your company or your board meetings with the ex.

Long-term disability is a bit different. A disabled owner may need a continuing stream of income to pay for health care, so a buyout may not be appropriate; in addition, the other owners may feel an obligation to keep that person involved in the company. In any case, the disabled owner should not remain on the governing board, because a consistently absent member will make it difficult to establish the quorum of members necessary to hold a lawful meeting.

Companies must also deal with owners who file for bankruptcy, which causes the owner's shares to become subject to the bankruptcy case—meaning that you have a fiduciary duty to the bankruptcy trustee as the holder of the shares, and the trustee is entitled to make decisions that owners make (but not necessarily as a governing person). All of this activity is subject to the approval of the bankruptcy court, with all the expensive complications and delays that involves.

Finally, you may have an owner who simply wants to retire or cash out.

In all of these scenarios, the objective is to have rules that require the ownership interests to be transferred only to the company (buy-back) or to other members. The most important task is to establish the value of the ownership interest. The value can be set in a variety of creative ways, including setting a deliberately low value (e.g., "book value") to discourage owners from leaving (and make the asset less desirable to the ex-spouse or the bankruptcy estate), or making the value a multiple of average earnings over a certain period (say, the past 36 months), or using independent valuation (which can be expensive). There are also ways to prevent a "low-ball" buyout offer or cut off a seller who is insisting on an unreasonably high value.

If an owner happens to receive a legitimate third-party offer, the company or other members should have the right to match the terms and keep the shares "in the family." This will prevent strangers and interlopers from disrupting established personal relationships or trying to take control of the company. The payout should be spread over a few years, so that the cost doesn't bankrupt the company or make it difficult to meet current financial obligations.

In some situations, the departure of a key member may require dismantling the company, especially if the firm is heavily dependent on the member's personal skills and relationships. Alternatively, the company could be sold as a going concern. In either case, the governing document should provide for the fair sharing of proceeds from selling or winding down the business.

Don't Butt Heads

Another common mistake made by new business owners is to set up the governing body as a two-person board, each with one vote. This is a recipe for disaster so dire that I rarely allow my clients to do this without a strong "pressure valve" in the governing document. The reason is this: almost all governing documents (and the state laws that "fill in the gaps" not covered in the governing document) require at least a majority of the governing body to agree on an action. If you each have one vote, you cannot obtain a majority unless both of you agree to the action. That's certainly egalitarian and protects each owner's interest, but what do you do when one owner wants to pursue a promising new business opportunity and the other doesn't? What if one owner needs a distribution of profits in order to pay a personal debt, but the other wants to keep the money in the company to fund its growth? In essence, each owner has a veto—in other words, the ability to kill any proposal he or she doesn't like. A sustained disagreement about the direction of the business, the use of funds, or any other substantial matter can and usually will destroy the business. Then both owners have nothing.

I recommend having an odd number of board members. Board members do not have to be owners of or officers in the company. In fact, it is beneficial to have board members without a financial stake, as long as their commitment to the business is strong. "Outside" board members can also serve as trusted advisors, mentors, and a connection to sources of capital and relationships with other businesses.

If the owners insist on having a two-person board, I add provisions in the governing document to deal with "deadlocks." For example, if an issue cannot be resolved at three consecutive board meetings, it will be referred to mediation or arbitration. One client actually had a person "on the sidelines" to cast tie-breaking votes as needed. This neutral third party could be a trusted business advisor, attorney, banker, accountant, or other person familiar with the business and the individuals involved.

Start Right or Get Right

All of these planning strategies can be implemented within the corporate structure, but the flexibility of partnerships and limited liability companies (LLCs) makes the task easier. On the other hand, each kind of entity offers tax and accounting benefits, so the choice should be made in consultation with both an attorney and an accountant.

Partnerships and LLCs are also useful when one or more of the founding owners is going to contribute "sweat equity" instead of capital. The governing document should specify what that person is expected to do, the objective metrics that will be used to assess goal achievement, and the milestones at which the person will earn part or all of the ownership interest. This simple process helps to avoid one of the worst (and most common) disagreements small businesses face: the question of who is working harder or contributing more to the success of the business.

It is critically important to lay the right foundation and pay the money required to set up a governing document that addresses these issues. If you're already in business, plan now, before problems arise. In my experience, fixing a problem costs at least 10 times as much as planning ahead. An ounce of prevention is well worth the cost. **N**

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