Slow Down – How to create a successful restaurant partnership, and make it last

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So, you and a friend have decided to open a new restaurant. You have agreed on a concept and found a location you think is perfect. You've even talked to your banker about financing, and you are excited to get started with your dream business. But slow down for just a minute. Before you spend a penny, sign a lease or loan document or go any further with your plans, you owe it to yourself and your friend to make sure you have a good, strong ownership agreement in place.

The first step is to decide what form of business you should create. In most states, including New Jersey, the most common choices are partnership, corporation or limited liability company (LLC). Although each of these business types offers you personal protection from liability for the obligations of the business, they differ in many important ways, especially with regard to the taxation of income generated by the business and distributed to the owners, and each is governed by a different body of laws. A business attorney experienced in forming restaurant entities and your accountant can help you decide what type of organization best fits the needs of your business.

Regardless of the type of business entity you create, you should always have a written agreement between or among you and your co-owners. That agreement will take the form of a Partnership Agreement, LLC Operating Agreement or Shareholders Agreement, depending upon the type of business entity you choose to form. That document will govern all aspects of the relationship between or among the owners of the business. Because no two businesses are alike, your agreement should be custom drafted by a skilled business attorney familiar with restaurant issues. While a custom agreement is more expensive than an off-the-shelf variety, you can help control its cost by discussing with your co-owners some of the basic ingredients of the agreement before meeting with the lawyer. Regardless of the type of business entity you form, here are some issues that should be addressed in your agreement:

1. First, the founders of the business need to decide who will own the business and in what shares. Ownership interests govern who gets paid and how much they get paid when the business or any of its assets is liquidated and who is entitled to what share of the profits while the business is operating. The agreement should clearly delineate who owns what shares of stock if the company is a corporation, or the percentages owned by each owner if it is a partnership or LLC.

2. Next, the owners should decide how various management decisions will be made. Voting interests will often be divided among the owners in the same percentages as ownership interests, but they need not be. For example, one of the owners might be a "silent partner", who owns a share of the company and is entitled to be paid a share of the profits, but who has limited or no management authority, except, perhaps, on certain major decisions. Similarly, some types of business decisions, like day to day operating decisions, might be made by a Managing Owner, while more important, "life of the business" decisions, such as

decisions to admit or terminate an owner or to sell or dissolve the business, might require a majority or even super-majority vote of the owners. In all cases, the owners should clearly provide in the agreement how various types of decisions will be made and who gets to vote on which decisions.

3. There is a legal requirement that, if the business is a partnership or LLC, it designate a "Tax Matters" owner with accountability for handling certain tax issues for the business, and that owner should be designated in the agreement. Your accountant or lawyer can explain the legal responsibilities of the Tax Matters owner.

4. Depending upon how the voting interests are distributed, there could be a stalemate on an issue of importance to the business. If not resolved, such a stalemate could threaten the continuing viability of the restaurant. The agreement should specify what happens in such an event. For example, the owners could agree to abide by the decision of a trusted neutral third party to break such deadlocks (e.g., the company's accountant or lawyer), or they could agree to mediate deadlocks or be bound by the decision of a specified arbitrator. Alternatively, the agreement could provide that the company will terminate upon a deadlock regarding an issue of importance to the future of the business. Regardless, the agreement should specify how voting deadlocks will be resolved.

5. The agreement should clearly describe what is being asked of each owner. Perhaps, for example, one owner will contribute cash or credit to the business, while another contributes "sweat equity." Under that scenario, the two owners need to decide how to value the sweat equity contribution for purposes of allocating ownership interests. Failure to think these issues through clearly at the inception of the business could lead to resentments and accusations of unfairness down the road.

6. Similarly, if the business later needs additional capital, the agreement should specify how that capital will be raised, whether the owners are required to contribute it, and, if so, in what shares, and how those additional contributions by the owners get credited. What if one owner contributes but another does not? There are several possible answers to this question. For example, the contributing owner's interest could be increased relative to the non-contributing owner, or the inability or refusal of one owner to contribute capital could trigger a buyout opportunity by the contributing owner. Regardless which outcome you choose, it should be spelled out in the agreement.

7. The agreement should also specify how proceeds of the business will be distributed to the owners. For example, will any of the owners be paid a guaranteed salary? Will owners be entitled to take draws against their anticipated share of the profits of the business and, if so, in what amounts and at what frequency? In addition, the agreement should delineate how the business's books will be kept.

8. The agreement should address a whole host of issues relating to changes of ownership. For example, the agreement should delineate the procedure and vote needed to admit new owners, the procedures for an owner to buy out another owner's interest, whether owners' interests are transferable to non-owners, and, if so, the mechanism for doing so. The agreement should try to anticipate all of the many life events that can interrupt or change business relationships, such as the death or disability of an owner, divorce of one of the owners, or the inability of one of the owners to legally hold a liquor license. In all such cases, the agreement should specify the mechanism for transferring ownership and voting interests, the method to be

used to value those interests, and the method for raising the cash to buy out a departing owner.

9. If an owner is contributing intellectual property to the new company – such as, for example, special recipes, customer lists, vendor contact information from another business, or a name for the business -- the agreement should specify whether the property is being donated, sold or licensed to the new company, how it will be valued and what happens to it upon dissolution of the business.

10. Finally, every agreement should specify a mechanism for resolving disputes among owners, designate a tribunal for resolving such disputes, and identify the body of law that will apply, all in as much detail as possible.

Although it is impossible to anticipate every issue that will arise during the life of a business, the issues discussed above occur so regularly as to be predictable, which is why these basic provisions should be in every restaurant ownership agreement. In addition to the above, there are numerous other provisions that can be included in an ownership agreement, depending upon the nature of the business and its owners. It is much easier and cheaper to think about such things at the formation stage of the business, rather than when it is faced with an unanticipated crisis. A business attorney, who has dealt with these issues in the past in the restaurant industry, can be very helpful in helping the owners identify potential issues and deciding how they will address them if and when they arise.

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