What You Should Include in Your Business Ownership Agreement

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PHIL KIRCHNER

Protect Your New Business Before You Start It

So, you and a friend have decided to start a new business. 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. The main reason you will want to form a business entity is to protect your personal assets from exposure to liability for the obligations of the business. In most states, the most common choices are partnership, corporation or limited liability company (LLC). Although each of these business types offers the owners 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 distributions to the owners, and each is governed by a different body of laws. A business attorney experienced in forming business 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. The agreement 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 business attorney experienced in drafting such agreements. While a custom agreement is more expensive than an off-the-shelf variety, it is well-worth the investment and will save you money in the future when you are able to use the agreement to resolve a crisis facing the company. 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. Management authority and responsibility, on the one hand, and ownership interests, on the other, are two separate questions, and both should be addressed in your agreement. Although voting interests will often be divided among the owners in the same percentages as ownership interests, they need not be, and often there are good reasons why they should not be. For example, one of the owners might be a "silent partner", whom you want to own a share of the company, and be entitled to be paid a share of the profits, but not have management authority, except, perhaps, on certain major decisions. Similarly, if there are multiple owners, it might be too unwieldy, expensive, and inefficient to require every owner's vote on every day-to-day decision. You might decide that some types of business decisions, like day to day operating decisions, should 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 all 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. The ownership agreement should not only identify the owners and their ownership shares, but it should also designate the initial officers (CEO, president, CFO, treasurer, secretary, etc.), and define their duties to the company, as well as their authority to make decisions for the company. The agreement should also address who has the authority to terminate an officer and a mechanism to appoint a replacement. Finally, you should consider whether your company needs or is required to have a Board of Directors and the decisions reserved to the Board. Your attorney can help you with that decision.
4. There is a legal requirement in some cases 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.
5. 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 company. The agreement should specify what happens in such an event. For example, the owners might 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. If the agreement is silent as to this crucial issue, you will probably find yourselves fighting in court and wasting the business's and its owners' money. I have litigated many such disputes; trust me when I tell you that no one will be happy with a court's resolution of the dispute, whatever it is.
6. The agreement should clearly describe what is being contributed by each owner. Perhaps, for example, one owner will contribute cash or credit to the business, while another contributes "sweat equity." Under that scenario, the 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.

7. Similarly, if the business later needs additional capital, whether for expansion, capital improvements, or whatever, 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.
8. The agreement should also specify how and when proceeds of the business will be distributed to the owners. For example, will any of the owners be paid a salary for their work for the business before profits are calculated, or, conversely, will owners' compensation be limited to their respective shares of the profits? 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. Your accountant can help you with that decision.
9. 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, with or without the company's approval, 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, inability or unwillingness of an owner to contribute to a capital call, 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, whether the company or the remaining owner(s) will be entitled to purchase the departing owner's interest, and the method for raising the cash to buy out a departing owner.
10. One crucial decision that deserves special attention in the agreement is what happens upon the death or disability of an owner. For example, will that owner's interest be transferable to another family member and, if so, whether the family member will receive any voting rights or just the right to receive a share of the company's profits? It is one thing to share profits with a deceased owner's spouse or child; it is quite another thing to allow that person a say in how the business is run in the future, especially if they have had no prior involvement in the business or managing the company.
11. If an owner is contributing intellectual property to the new company, such as, for example, a patent or trademark, customer lists, vendor contact information from another business, or a name for the business, the agreement should specify whether the intellectual property is being donated, sold, or licensed to the new company, how it will be valued and paid for, and what happens to it upon dissolution of the business. Similarly, if any of the owners is contributing equipment or other tangible property, its ownership and valuation should be addressed in the agreement.
12. 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 (state or federal) that will apply, all in as much detail as possible, and a mechanism for dissolving the company and disposing of its assets and distributing the proceeds.

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 business 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 and address such things at the formation stage of the business, rather than when the company is faced with an unanticipated crisis. A business attorney, who has formed business entities in the past, especially in your particular industry, can help the owners identify other potential issues and decide how they will address them if and when they arise.

TAKEAWAY: Address the above crucial business decisions up front before you start operating your business. Once you start operations, everyone will be too busy working the business to have the time or inclination to make the decisions that should be made before the business gets underway to protect it in the future when one of these issues arises. Do yourself a big favor and tackle these issues BEFORE you start operating. You will thank yourself down the road when one of these issues arises.

P.S. It's never too late to create a custom agreement for your business. If you own or operate a business without an owner's agreement, stop right now and consult a business lawyer about creating one before a crisis occurs.