

The Entrepreneur's No-Nonsense Nuts and Bolts New Venture Legal Guide

Critical legal insider information You need to know about:

- ❑ **Corporations,**
- ❑ **Limited Liability Companies,**
- ❑ **Liability Protection for Your Personal Assets,**
- ❑ **Contracts to Protect Your Business, and**
- ❑ **Co-Owner (Shareholder Buy-Sell) Agreements.**

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Introduction

This guide discusses some of the basic nuts and bolts legal issues you need to know to protect yourself from business debts and creditors, vendors, customers and your partner.

First, it provides key information and answers many of the commonly asked questions about the two most popular business entities:

- the **Corporation**; and
- the **Limited Liability Company**.

Then, because liability protection is usually the main purpose of having a business entity, this guide also shows you some **common liability mistakes that can result in you losing that liability protection, putting your personal assets at risk to business losses**.

Finally, because *'an ounce of prevention is worth a pound of cure,'* this guide also gives you **the insider information about other critical concerns to make your business successful**: the need for clear written agreements to avoid lawsuits, liabilities and other serious problems, and the need for an agreement between business partners.

This information will help you avoid problems that could cost you thousands, whether because a business creditor wants to sue you personally or you and your business partner split up.

Why am I the guy to write this guide? Good question.

I've been a business attorney for over 15 years. And, for 7 years before that, I was a marketing manager for a publicly traded technology company and a systems engineer.

Through that time I've seen literally thousands of deals and businesses – the good, the bad and the ugly.

I've seen things go incredibly (and profitably) right. And I've seen disasters that resulted in thousands lost and emotional wrecks.

Through it I found that problems often arose because the entrepreneur was missing key information or experienced advice.

So I took the information and boiled it down to the true nuts and bolts that you, the new venture entrepreneur, need to know.

This information won't get you to Fortune 500 status. And it certainly can't replace experienced legal and accounting advice. But, just knowing it will put you way ahead of the typical entrepreneur.

So, lets start with the first step in the process, your business entity.

Business Entities.

Many business owners use a corporation, limited liability company or other business entity to protect their personal assets from business debts and creditors. When a business entity is created, structured and used properly, a business owner can limit her risk to money she's invested and left in the business entity.

In addition to asset and risk protection, other reasons to use a business entity are separating ownership and management and for tax reasons. Separating ownership from management allows a business owner to get investor capital while still managing (and controlling) the business. And, depending on certain characteristics of the owners, choosing one entity form or another can save (or cost) thousands in taxes, and double taxation, each year.

There's literally an alphabet soup of different business entities you can chose from: GP, LP, LLP LLLP, LLC and INC to name a few. So, do you need a business entity and, if so, which is right for your business?

Do you need a business entity?

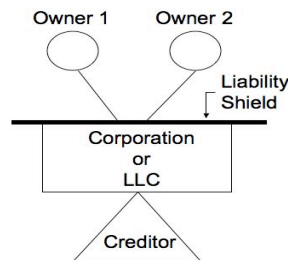
The answer is definitely "Yes," if your business is one where:

- you'll enter contracts for meaningful amounts of money;
- you're looking for outside investors;
- you sell products;
- you're in a construction trade;
- you're a consultant or coach;
- there is a high chance of being sued; or
- you have employees or subcontractors.

However, I believe the answer is usually “yes” because, as you’ll learn later, you can form an LLC for little initial and ongoing expense, and the IRS can treat it just like you operated as a sole proprietor. This means that, for minimal expense and ongoing maintenance, and without additional taxes, you can have the same liability protection as a larger business. Why not take advantage of that?

How does “Limited Liability” work?

With limited liability done right, a business entity is equivalent to a liability shield (as shown on the following figure).



Business owners are protected from business claims and creditors “piercing” through the shield, unless the business owners agree to guarantee the business obligations or do something wrong. And the creditor can only get the assets that are in the entity (the box, above). If nothing (or not enough) is in the box, the creditor cannot then go after the owners.

The things that can go wrong are discussed in detail in the section:

“Business Owner Liability Mistakes:
How to Get FULL Liability Protection from Your Corporation or LLC.”

Now that you’ve decided you need an entity, let’s take a look at the corporation first.

Corporations.

A corporation is separate and distinct from its owners, who are known as shareholders or stockholders. A corporation can enter contracts, sue and be sued. It is, literally, an artificial entity that has rights and obligations that are different from the rights and obligations of its shareholders.

There are three key groups of people involved in a corporation: shareholders, directors and officers.

Shareholders.

Shareholders are the owners of the corporation. Each shareholder has rights to do or get some or all of the following:

- receive dividends and distributions (profits);
- vote for directors; and
- receive the assets left over after the corporation is liquidated.

Shareholders can also have other rights and things known as preferences. Preferences give one group of shareholders the ability to get ahead of other shareholders when things happen. This might happen when the corporation is dissolved and one group of shareholders gets their money out before another group. These preferences are written into the articles of incorporation and apply to classes and series of stock.

Different “classes” and “series” of stock and the rights of each shareholder who owns that stock are described, exactly, in the articles of incorporation.

There can be one shareholder, a few shareholders, or thousands or millions of shareholders.

Directors.

Directors are the people who make “policy” decisions for the corporation. These are decisions about what business the corporation is in and other high level decisions. Directors are elected by the shareholders (at the annual shareholder meeting) to serve terms typically between 1 and 3 years.

Usually there are between 1 and 9 directors that make up the Board of Directors of the corporation. Any more than 9 members and the Board of Directors becomes too large to be effective.

The Board of Directors has regular meetings to review the business of the corporation, financial results and to make important business decisions. The Board of Directors also elects the officers of the corporation.

Officers.

The officers of the corporation manage the day-to-day business of the corporation.

Officers can include a president, vice-presidents, secretary, treasurer, chief executive officer (CEO), chief operating officer (COO) and any other title the bylaws (described below) provide.

No particular officers are required to be appointed by the Board of Directors of a Florida corporation. But, because the corporation can only act through the officers, there needs to be at least one for the corporation to be able to operate its business.

Each officer has the responsibilities described in the bylaws. Most often, the secretary keeps the record books of the corporation and of the meetings of the Board of Directors and shareholders, and the treasurer is responsible for the corporation’s accounts. And, the president or chief executive officer is the highest ranking officer in the corporation and reports to the Board of Directors.

In small business corporations (sometimes referred to as closely held corporations or close corporations), a few people (or one) may fill all of the roles. One, two or three people could be the sole shareholders, directors, officers and employees of the corporation. This is entirely permissible and doesn’t result in a loss of the limited liability benefit.

And, as discussed above, because management (officers and directors) is separated from ownership (stockholders), a corporation can have “investor” shareholders who do not take part in the daily operation of the business, but benefit from the increase in value of the corporation’s business and properties.

Formation.

Forming a corporation begins with the filing of articles of incorporation with the secretary of state by an incorporator. The incorporator, the person who forms the corporation, signs the articles of incorporation and files them (usually through an attorney).

In Florida, the filing fee for the articles and statement identifying the registered agent is \$70.00.

Once the articles are filed, the corporation is technically formed. But, if you do nothing more, its like building a house and forgetting to put up interior walls. You're sealed against the outside, but it isn't a great place to live.

It is therefore, important to completely form the corporation by:

- having an initial meeting of the board of directors;
- transferring assets to the corporation;
- adopting bylaws;
- if appropriate, signing a shareholders (or buy-sell) agreement;
- issuing stock; and
- filing the appropriate tax forms with the IRS and Florida Department of Revenue.

Frankly it's surprising to me how often these steps aren't done properly.

In one case a person (lets call him Tim¹) invested approximately \$100,000.00 in a corporation. The incorporator, sole officer and sole director, Jack, Tim's "friend," told Tim that Jack's trucking business, including the trucks and trailers, had been transferred to the corporation.

¹ A word about client confidentiality is in order here. Client confidentiality is of utmost importance to me. It's part of why people use a lawyer – they know their story and information won't get leaked. So, the names and other unimportant information in my examples have been changed to protect client confidentiality. If you read this and think you know who I'm talking about, you're wrong. Any recognition is pure coincidence; the situations described in these examples happen so often that you're probably thinking of an entirely different occurrence.

Tim did some analysis of the trucks and decided that his investment was less than the value of the trucks. So, even if things didn't work out, Time figured he'd get his investment from the sale of the trucks and trailers.

Things didn't work out.

Only when Tim wanted to sell the trucks to get his investment out did Time find out that the trucks were still owned by Jack personally. Because Jack was in debt up to his eyeballs and was behind on his payments to the bank and other creditors, Jack couldn't sell the trucks and give any money to Tim.

Tim lost his entire investment because the proper paperwork hadn't been fully completed.

A similar scenario is played out when stock isn't properly issued.

Without share certificates and proper board of directors actions, the shareholders can fight over the number of shares and percentages that they should properly own. Sometimes, it isn't until years later that they realize the numbers are incorrect.

Online Formation.

One option for forming a corporation is to use the online service at www.sunbiz.org.

However, this option uses the most basic form of articles of incorporation and does not contain certain protective provisions that I would normally include in the articles of incorporation, such as indemnification of the directors and officers for lawsuits arising from the corporation.

And, as described above, merely filing articles of incorporation does not complete the formation and address all of the necessary tax issues.

What is the difference between "S" corporations and "C" corporations?

There is no corporate difference between an "S" corporation and a "C" corporation, except the way they are taxed. (See the next questions and answers for more details.)

The term "S" corporation refers to an election the directors (before shares are issued) or all of the shareholders can make about how the corporation will be treated for tax purposes. Generally, a "C" corporation pays taxes on its net income and

an “S” corporation passes the obligation of the net income through to its shareholders who have to pay the taxes themselves. Otherwise, “S” corporations and “C” corporations are just corporations.

All corporations are treated as “C” corporations by default. To be treated as an “S” corporation, all of the shareholders of the corporation must qualify to be “S” corporation shareholders, the corporation can have only one class of stock, and IRS Form 2553 must be signed by the required people, then properly and timely filed with the IRS.

What is an “S” Corporation?

The election to be taxed as an “S” corporation is made by filing IRS Form 2553 with the IRS. Once that is properly completed, the corporation is taxed as a “pass through” entity. That means the “S” corporation almost never pays taxes itself.

Instead, the “S” corporation files its tax return (on IRS Form 1120S) with the IRS and issues all of the shareholders K-1 statements. The K-1 statement shows the shareholders portion of the net income of the corporation for which that shareholder will be taxed.

For example, if a shareholder owns 25% of the issued and outstanding stock of an “S” corporation and the corporation’s total net income for the year is \$200,000, then that shareholder’s K-1 statement will show \$50,000 of income allocated to that shareholder. In this way the corporation’s income “passes through” to its shareholders.

It’s important to note the income passes to the shareholders whether or not any of them actually get the cash from the corporation. In other words, the K-1 doesn’t necessarily come with a check.

Rather, the allocated income is phantom income to the shareholder. The income is recognized by the IRS, but it is unlikely that the shareholder received it.

Why? Well, the net profit of a corporation will almost never be present in the corporation’s bank account at the end of the year. Instead, that money is used to continue or grow the business operations.

As a result, the corporation may not have the funds to pay the shareholders any amount. Furthermore, the corporation isn’t actually required to distribute any of the profits to the shareholders.

The benefit of this arrangement is that only the shareholders pay taxes on the corporate income. This reduces the maximum tax rate to approximately 31-35%, saving at least 9.75% of net income from taxes. For most people (who are in the 28% tax bracket), the savings will be greater.

The big drawback with an "S" corporation is that the shareholders have to include their share of the corporate income on their tax returns and pay tax on that money. If the corporation distributes cash to the shareholders, this may not be a problem.

But, there are instances when a corporation may not distribute its cash to the shareholders. First, cash and net income (or profit) are quite different. The corporation may have a net income, but not have the cash in its bank account. Or, if the corporation is controlled by other shareholders, it may decide not to distribute cash to its shareholders.

However, even if the shareholder never receives any money from the corporation, he must pay the tax on his share of the corporation's net income. The shareholder could have to pay those taxes by dipping into savings or selling other assets.

Of course, if the corporation has losses, the shareholder may be able to offset those losses against other income. The shareholder must, however, have "basis" in the shares of the corporation in order to do this.

What is a "C" Corporation?

A "C" corporation pays taxes on its net income. It files form 1120 with the IRS (as its tax return) and pays federal (and possibly state) taxes based on its net income. The maximum corporate rate is 35%.

In addition, when a "C" corporation distributes profits to the shareholders through dividends, the shareholders pay income taxes on the dividends at a rate of 15%. This results in a double taxation, with an effective maximum tax rate of approximately 44.75%.

To avoid the double taxation, the shareholders of a closely held "C" corporation will "bonus out" the profits of the corporation so that the net profit shown on the corporation's tax return is zero and no corporate taxes are paid. Of course, the bonus, as earned income, is subject to FICA taxes (up to the FICA maximum) and Medicare taxes and income taxes.

The "bonus out" arrangement works only so long as the profit of the corporation is not too large (that is, the bonus is reasonable). If the profit is too large, the IRS will ignore the bonus and treat it as profit, subject to the double tax.

Do I need to form a Delaware or Nevada corporation?

Most small business should create corporations in the state where they're based. This is because a "foreign" corporation – one from a state outside your home state – must be authorized to do business in your home state. To be authorized it must file papers with the state and pay filing fees. Usually, those fees are as much as the fees to form a corporation. Therefore, you **pay twice** to form the same corporation.

Now, You might ask why, are publicly held corporations usually Delaware corporations? And why do some people suggest Nevada corporations?

Delaware's corporate laws tend to favor "management" (the board of directors) and enable the board to more effectively control the corporation. This isn't important to you as a small business owner because you usually already have control. If you're the only shareholder, you have complete control. If you're one of a few shareholders, you should have a shareholders' agreement to control management of the corporation.

Nevada corporations are touted for their secrecy provisions and tax protection. It's my opinion that you should go offshore if you want secrecy. Further, secrecy with a Nevada corporation is usually a myth for small business owners. Unless you'll have an agent who'll act by and for the corporation, someone is going to know you're an employee, officer or director. They'll probably assume you're a shareholder as well.

As far as the tax issue goes, in Florida there is no state income tax on "S" corporations or their shareholders. So, the effect is the same.

In other states, however, if the corporation owns property in the state or does business from the state, it must pay taxes on that portion of its income that comes from the state. So, if you have a Nevada corporation that owns a retail shop or service business in New York, the corporation must register as a foreign corporation in New York and must pay taxes in New York – no tax savings.*

What are the ongoing costs of a corporation?

In Florida there is an annual corporate fee of \$150.00, if paid before May 1 of each year. In addition to the fee, you'll have accountant's fees for preparation of the corporate tax return, costs of a bank account and attorney's fees for the annual corporate housekeeping. Those costs will depend on the activities of the corporation.

* Remember, hoping not to get audited (i.e., caught) is not a tax planning strategy. It's hope.

What is a shareholder's agreement and why have one?

A shareholder's agreement is a contract between the shareholders where they deal with the process of leaving a business.

You may have heard that there are two sure things in life: death and taxes. I add another. You can also be sure that you're going to leave your business one day. You might leave it vertically or you might leave it horizontally, but you'll definitely leave.

A shareholders agreement makes sure that when one owner leaves, it is done orderly and with minimum impact on the business.

Shareholders agreements are discussed in detail in:

“Why Every Business with More than One Owner Needs a
Co-Owner / Buy-Sell Agreement NOW!”

Limited Liability Companies.

A limited liability company (an “LLC”) is a business entity that is a cross between a partnership and a corporation. It provides the liability protection that the owners of a corporation receive with the close business relationship that would normally exist in a general partnership. Unlike a corporation, the owner of the LLC – known as a “member” – typically has both ownership and management rights.

Limited liability companies are extremely flexible and offer the ability vary the arrangement between the owners in a myriad of ways as well as to chose from up to 4 different tax structures. Of course, limitations exist and all options are not available to every LLC.

Limited liability companies provide liability protection that is exactly the same as a corporation, with the close business relationship of a general partnership. So, the LLC is often appropriate for closely held businesses or where the entity will hold real estate. An LLC can also be used for subsidiaries within a larger business.

Members manage the LLC business and receive LLC profits. The members can also elect to have the LLC managed by “managers.” Managers are a cross between officers and directors from the corporation.

An LLC is usually not used when there are to be outside investors or key employees are to receive options to buy into the business.

Like a corporation, an LLC separate and distinct from its owners. It can enter contracts and sue and be sued without involving its owners.

Unlike a corporation, all aspects of the ownership interest of an LLC (a membership interest) are usually not freely transferable. A member may transfer his or her economic interest (e.g., the right to receive profits) at will. But, members usually have to get permission of the other members before a transferee can participate in the management of the LLC business.

And all of the other members have to agree if a member wants to withdraw from the LLC. This often comes as a shock to members who want to “walk away” from a business.

Is the limited liability company a new form of business?

No. In Florida the LLC has been available since 1982. Unfortunately, tax issues often kept people from using an LLC. Until 1998 the LLC had a Florida income tax of approximately 5% of net income. Since that was changed, though, the LLC has become a very popular form of business and investment entity.

Members and Managers

The owners of the LLC are called its members. Members typically have the right to manage the business of the LLC, receive a share of LLC profits (through their capital account) and receive any assets left over after the LLC business has been wound up and liquidated. Membership can be divided into different classes with various rights and preferences.

The members can also elect to have the LLC business managed by “managers” who are elected by the members. The managers manage the day-to-day business of the LLC. Often, managers are given titles that are similar to the officers of a corporation (e.g., President). No managers are required.

It is possible to have a single member LLC without loss of liability protection. For this reason and the tax issues (discussed below), most, if not all, sole proprietors should transfer their businesses to an LLC.

How is a LLC created?

Forming a LLC begins with the filing of articles of organization, signed by a member or the member's authorized representative, with the secretary of state by an incorporator. In Florida, the filing fee for the articles of organization and statement identifying the registered agent is \$125.00.

Once the articles are filed, the LLC is formed. The members should then enter an operating agreement that addresses allocation of profits, transfers of membership interests, and other key elements of the management and operation of an LLC.

Does a LLC issue stock certificates?

No. Since the LLC does not have stock, no stock certificates are issued. Sometimes, a LLC issues membership certificates. But, these are not required.

An option for forming a limited liability company is to use the online service at www.sunbiz.org. However, this option uses the most basic form of articles of organization and does not contain certain protective provisions that I would normally include in the articles of organization, such as indemnification of the directors and officers for lawsuits arising from the limited liability company.

I was told that I should use a corporation because creditors can more easily “pierce” through an LLC and hold me personally liable. Is this correct?

No. In Florida, a statute provides that the same rules that apply to corporations and the liability of corporate shareholders also applies to members of an LLC (Section 608.701, Florida Statutes). Therefore, there is no difference.

How are LLC's taxed?

Depending on the number of members, a LLC can elect to be taxed as either:

- a sole proprietorship (i.e., as a disregarded tax entity);
- a partnership;
- an “S” corporation; or
- a “C” corporation.

First, to be taxed as a disregarded tax entity (sole proprietorship), the LLC can only have one member. If done, the income and expenses of the LLC are reported on the tax return of its member. For individuals, this means on Schedule C to their Form 1040. This is the default selection for the single member LLC.

To be taxed as a partnership, the LLC must have more than one member. It would file a Form 1065 with the IRS and issue K-1 statements to its members. This is the default selection of the multiple member LLC.

An LLC can also elect to be taxed as a corporation. This must be done by filing form 8832 with the IRS and, for “S” status, form 2553.

Do I need to form a Delaware or Nevada LLC?

The situation described above for corporations (in “Do I need to form a Delaware or Nevada corporation?”) also applies to limited liability companies.

What are the ongoing costs of a LLC?

In Florida there is an annual corporate fee of \$150.00, if paid before May 1 of each year. In addition to the fee, you may also have accountant’s fees for preparation of a tax return.

Is a members agreement required?

No. With an LLC, the operating agreement contains the provisions that would be contained in the bylaws and shareholders agreement if the LLC were a corporation. As a result, it is imperative that the operating agreement contain all of the essential terms and conditions agreed to by the members and that it be signed and followed.

How long does it take to form a business entity?

A limited liability company or corporation can be formed in one day in many situations. Typically, however, the paperwork and filings are completed over a one to two week period.

Why use an attorney to form my business entity?

Using a business lawyer to form your business entity ensures it will be done correctly and fully completed. This means you know your assets are fully protected to the extent possible and you won't have unpleasant surprises.

Unfortunately, business owners only find out that they haven't properly formed a corporation (and protected themselves) when they need it most. No one will tell you there is a problem until its too late - after a claim against the business has been made.

Business Owner Liability Mistakes: How to Get FULL Liability Protection from Your Corporation or LLC.

As was mentioned above, business owners form business entities, such as limited liability companies and corporations to protect their personal assets from business debts and obligations. Usually, the owner's risk is limited to the amount invested.

However, you can get into trouble with your entity and business liabilities can become your personal liabilities if you don't follow certain rules with your corporation or LLC.

First, whenever you're doing business it must always be in the exact corporation or LLC name. If you're in business as *Acme Industrial Enzymes Corporation*, that exact name should appear on all of the company's checks, contracts, invoices and employee business cards.

Never use a shortened name, such as AIE Corp., or any other name unless you've filed a fictitious name registration with the state identifying that the name is owned by Acme Industrial Enzymes Corporation (and not the Acme shareholders). And, even then, the full name should still appear on all business documents. Also, make sure the fictitious name is actually owned by the entity and not its owners.

Next, when signing for your business, make sure all contracts are in the entity's name, always include your title with your signature (John Smith, President) and cross out terms making the signer a personal guarantor.

Recently, I heard of a situation where an owner was sued when he signed a contract in a slightly different corporate name and didn't include his title. The creditor claimed the owner was acting as a sole proprietor and was personally liable when the corporation didn't pay. The owner paid a settlement when a few simple changes would have protected his money.

Third, remember that if you, personally, do something that injures another, even on the job, you're probably personally liable.

Take, for instance, a one-person bakery. Our entrepreneur rises early to bake the bread, then drives around town making deliveries to local shops. One morning he causes an accident. Even though the bakery owns the truck and operates the business, the entrepreneur will be liable because he was driving.

So, you should always have adequate risk and casualty insurance.

Fourth, you can't treat the entity as your personal slush fund. Being in control, you could be liable to its creditors for paying out or taking money improperly.

For example, you can't pay yourself a dividend, remove assets or bleed the entity dry, leaving it penniless so it can't pay creditors. You also can't pay debts the entity owes you and other "insiders" before paying outside creditors.

You can, however, pay yourself your usual salary and other customary expenses. But, be careful about giving yourself a raise as the ship is sinking.

Fifth, make sure you follow the formalities of your entity.

Pay the annual fee so your entity is not administratively dissolved or terminated. Keep your entity records and documents properly. Actually have member / shareholder and manager / director meeting minutes. Issue stock certificates and adopt bylaws.

After all, you won't know you have a problem until you need the protection!

Finally, avoid guarantees whenever possible.

Many times I heard business owners suggest that they sign guarantees but "know" they're not enforced. Wrong. Guarantees are enforced all the time. If the company fails, the holder of the guarantee will come after the business owner.

Years ago another lawyer told me that 10 feet of water over his client's head was the same as 1,000 feet. Many owners take comfort in this theory when considering a guarantee. But, remember, even if you can't pay it, a judgment will prevent you from borrowing money to buy a home or car.

You probably won't get out of guarantees for banks. But don't accept them as "standard" in leases and supplier contracts. Often, you can provide a larger deposit or play one supplier off against another to avoid the guarantee.

If you pay attention to these areas, you can get the most liability protection from your business entity.

**Detailed Written Contracts:
The key to avoid lawsuits, liabilities and other serious problems.**

When it comes to liability protection, the issue of contracts is, in my opinion, number one on the list of small business nightmares.

Here are a couple of quotes from business owners:

“I want the contract to be no more than 2 pages.”

“The other side won’t sign any contract longer than 3 pages.”

“I don’t understand why this has to be so complicated. This should be simple.”

I always love when I hear those things. The length of the contract has no bearing on its purpose. And, sometimes what you want to accomplish may sound simple but actually be complicated to accomplish.

A contract is the right length when it fulfills its purpose. It need be no longer and no shorter.

So, when does a contract fulfill its purpose? Or, why have a written contract?

There are three reasons actually:

1. To be sure all of the issues are fully addressed.
2. To have a record of what actually was agreed upon.
3. To be able to make the other party live by the agreement.

Let’s take them in order.

Addressing all issues.

By far, the most important of the reasons is the first. By making a detailed record of all of the issues we can anticipate now, we’re making sure that your expectations are the same as the expectations of the other side.

I'm not talking about seeing the future. If I could do that I'd be wildly rich from trading in the markets.

No, I'm talking about using the past as a guide for the future. Or, as a broker I know recently put it: "There's a drop of blood for every paragraph of this contract." Well stated.

Business disputes arise over missed expectations. Business disputes are costly (whether or not you litigate) and take your eyes off your main purpose – making money.

Lets say you want me to paint your house. You tell me the color and I tell you its \$2,500.00. You agree and we shake hands. A contract is formed (shaking not required).

The next day I show up asking for my \$2,500.00. You look at the house, noting its not painted, and retort that I'll get paid when the job is done.

While this may seem like an obvious issue to be dealt with, I have see hundreds of contracts that state how much is to be paid without saying when or under what circumstances.

You can imagine when the deal gets more complicated what other issues must be considered before all expectations can be addressed.

Of course, merely addressing an issue is not enough. You have to make sure that exactly what the parties have to do (or not do) in all variations is written in the contract. If you miss something, you don't get a second chance to get it right.

A recent Florida court case, *Coastal Loading*, is a great example of this problem.

In 2003, Mr. and Mrs. Williamson, the owners of Coastal Loading, a roof tile loading and hauling business, put it up for sale. In early 2004, two people decided to buy the business and negotiated a contract for purchase and sale. Among other things, that contract stated that the Williamsons would agree "not to compete with the business being sold."

As often happens, the buyer and seller signed the contract before they closed the deal. So, at the closing a few months later, the Williamsons and buyers negotiated and signed a separate non-compete and non-solicitation agreement. That

agreement said the seller would not compete in the “roof tile loading” business for 5 years and would not “call on or solicit” seller’s customers.

A few months later the buyers discovered that Mr. Williamson had hauled roof tiles for a former Coastal Loading customer. Mr. Williamson said the customer had called and requested his services.

The buyer was, understandably, unhappy. Eventually, the buyer filed suit to stop future competition. A trial court ordered the Williamsons not to engage in the roof tile hauling business and not to do business with any of the Coastal Loading customers.

The Williamsons (sellers) appealed.

In Florida, non-compete and non-solicitation agreements are enforceable only if they meet certain statutory requirements. One of those requirements is that they be in writing and signed by the person who is restricted.

After reading the written agreement, the appeals court decided that the Williamsons did not breach it.

Instead, the court said that roof tile *hauling* and roof tile *loading* are two separate businesses. The agreement only referenced roof tile loading. So, the Williamsons were not prohibited from roof tile hauling.

To add insult to injury, the court also decided that the word solicitation in the written agreement meant that the sellers had to market or sell to the Coastal Loading customers. And, because the former Coastal customer contacted Mr. Williamson directly, the court ruled that there was no violation of the written agreement.

So, because the written agreement did not include the word “hauling” and because it didn’t say Mr. Williamson couldn’t work with any of the Coastal Loading customers, he can haul tiles for customers who call him.

The buyers paid good money for a business and now have to compete with the sellers. And, the Williamsons get money from selling the business and can make more money competing against it.

Why? All because of a few missing words in a contract.

Avoid this situation by fully addressing all issues.

Written Record.

As I said above, I can't tell the future. Rather, I use the "blood spilled" in past deals and the things my client and the other side have discussed as a guide to writing up the present deal.

Invariably, things will come up that no one has considered.

When things are going well or normally, everyone puts the contract in the drawer and forgets about it. But, when a problem crops up, they usually break out the contract, blow off the dust and begin to read.

So, how does a contract help when the problem isn't addressed in the contract?

To understand that, it's helpful to first look at human nature.

Witnesses in court routinely recount events where one witness tells a completely different tale than another witness (that is, you'd say that one has to be lying). But studies have revealed that both witnesses were being truthful – neither had an intent to deceive.

How could this be? There could only be one set of facts about an event, right?

Not when it comes to the human mind. The human mind filters memories and those memories eventually "revise" the event in the light most favorable to the person holding the memory.

In the house painting example above, I might remember that I told you the \$2,500 was due before I began the work and you might remember it was due only when the work was completed. And neither of us would be lying!

A written contract helps prevent this phenomenon in two ways. First, it is clear that the parties never addressed the issue because it was not in the written contract. This is not a matter of memory – either it's there or it isn't.

Second, the written contract gives the parties the accurate (because it's written) understanding of where they started. So, they're more likely to compromise or find a resolution both parties can live with. This means the relationship continues to the benefit of both parties and there isn't the time and money sucking abyss of litigation.

Make the other party live by the agreement.

Speaking of the time and money sucking abyss of litigation, whenever I mention this people will typically say, “That’s not an issue for me. I’m not going to sue on this contract.”

While that may be true, you can’t control the other side. What if they sue you.

I know, they say they’ve never done that before. And, you know so-and-so who knows them and has only great things to say.

A client of mine a few years back – let’s call him Phil – created a partnership with a friend– let’s call him Roger. Phil and Roger were such good friends that when they met with an attorney friend of mine, Jim, who suggested that they have a written partnership agreement, they actually laughed.

Phil said “Why would we need that? Roger and I have known each other for more than 20 years. I’m putting up the money and Roger will work the business. It’s simple. Let’s not complicate things with a contract. Besides, that’ll slow us down and make us have to pay attorney’s fees.”

So, no written partnership agreement was created.

Things went great. Roger knew how to work the business and bring in customers.

At the end of the year Phil asked to see the books and get his cut. Roger said he was getting things together. A month went by. Then two. Finally, after more than four months Phil got a check in the mail. The check was for the original investment plus “interest” and was marked paid-in-full.

Phil got on the phone. Roger claimed that he was repaying Phil for the start-up loan. Roger said Phil was only entitled to interest on the loan, but not any profits. And, Phil wasn’t entitled to look at the books.

Litigation ensued and, after many tens of thousands of dollars in fees and costs, the dispute was finally resolved. All of it could have been avoided, though, had they entered a written partnership agreement.

A lot of money can change the way people behave. Even if you’ve known them a long time.

If you do have to sue or you get sued, a written agreement will help you win your case.

Certain provisions in the agreement can make sure that the lawsuit happens only in your home court. While this won't give you a leg up with the court, it'll certainly be cheaper than fighting on the other side's turf.

And, if drafted properly, the agreement will spell out your rights and obligations objectively – that is specifically and without flowery language. Any person with a reasonable intelligence will be able to read the contract and know what was to be done by both parties. No more “he said, she said.”

Finally, with a detailed objective agreement, the other side may decide that litigation isn't worth the effort. The other attorney won't be able to play as many games in litigation (or, as I call it, throwing garbage against the wall to see what sticks – its much easier to knock out that garbage).

A few other contract issues: Writing Skill, Forms and Crooks and Bad People.

Writing Skills.

Writing a legal document is an acquired skill. It is not the same as writing prose or business writing.

When lay people write contracts they are often ambiguous, non-specific or filled with inconsistencies and repetition. For example, they use words like “top quality” or “quick” or “to customer's satisfaction.” Or, they leave out key topics like intellectual property ownership, payment terms and dispute resolution methods. Think *Coastal Loading* from above.

To obtain the benefits described above, a contract must be specific, comprehensive and objective.

When a prospective client brings a contract they've written, asking me to review it and provide suggestions, it almost always takes more time than me drafting the agreement myself. Why? First, the language is not specific or, worse, ambiguous. The contract will have terms that change, are not defined or poorly defined and that don't address all the issues.

Also, a layperson may review an agreement and think it looks fine. But what isn't there may be as important as what is.

For example, independent contractor agreements must have a clause that assigns intellectual property to the engaging company. Without that clause, the independent contractor usually owns that intellectual property and can sell or license it to another person.

Without the assignment clause, you could find yourself paying to develop software, for example, that the independent contractor could license to your competition. Not a good result.

Writing properly is covering every angle. This is an acquired skill – considering what can go wrong, what are the implied expectations and applying the pain of past situations gone bad.

Forms.

Second, is because of the use of “forms.” Over my time practicing, I’ve developed certain starting points for documents – known in the legal profession and by layman as forms.

It’s important to distinguish what forms are – tools for experienced lawyers – and what they are not – fill in the blank pre-printed templates you’d buy at an office supply store.

A good form is one that has many of the common issues of a transaction addressed and requires customization for your deal.

They’re similar to a tool in the hands of a skilled craftsman. I’m no carpenter. So, when I use a chisel the results aren’t usually what I’d planned. Sometimes I remove too much wood or take away wood in the wrong place.

On the other hand, Norm from “*This Old House*” fame is a true master craftsman. When he uses a chisel the result is pure art.

The use of forms by attorneys is great for clients. If attorneys had to draft agreements from scratch each time they wrote one, it would take more time, the costs would be high and the resulting agreement would not be as complete and be more likely to have mistakes. Attorney forms result in greater accuracy and a more complete contract, and they enable attorneys to focus on the key issues of the deal.

An experienced attorney using a form applies his legal skills and experience to create a good contract in much the same way that a builder uses plans to construct a house.

The use of forms by lay people, on the other hand, is a disaster. A form off the Internet or office supply store is generic or prepared for a different deal. You risk the very purposes of having a contract when you adopt a form without applying legal skills and experience to customize it to your deal.

In particular, Internet forms often come from public company filings. Public companies and small businesses are in two different worlds and play by two different sets of rules. Things that are important to public companies may not be important to your business and there are probably things that are key for your business that a public company isn't concerned with (and, therefore, are not in the form).

What isn't in the contract can be as important (or more important) than what is in the contract.

For example, in a Florida case the buyers of a cement plant claimed that the sellers said that the plant could produce up to 250 cubic yards per day. Based on the production capacity and the price, the buyers purchased the plant.

After they took over operation, the buyers realized the maximum production capacity was 40% of the promised amount. The sellers refused to adjust the price so the buyers sued.

The court ruled in favor of the sellers because the contract contained no promises about the capacity of the plant. So, there was no breach of contract and the buyers were not entitled to a price reduction.

Now, I don't know if they used a form contract. But, when you're involved in an important deal, you want to be sure all of the key promises and statements are in the written contract.

Crooks and Bad People.

All of what is discussed assumes you're doing business with people who genuinely want to do the right thing and meet their contract obligations.

After practicing law for 15 years, I believe that most business people will meet their contract obligations (as they perceive them) if they can do so without going broke.

But, there are those who consistently leave a trail of broken promises and bad deals in their wake. Like the leopard, these people don't change their spots; they keep doing the same things over and over again.

Of course, none of the broken deals are their fault. There's always some person, situation, circumstance or other justification that they truly believe gives them permission to break yet another contract obligation or deal.

If you do business with any of these people, you'll be the next victim. Period.

The problem is that when the other party breaches your contract, you usually only have the right to file a lawsuit and, if you prove your case only get a judgment – a piece of paper stating that the other party owes you money. Then you (not the court) have to collect on that judgment.

An attorney writing a demand letter cannot make a reticent contracting party adhere to their contractual obligations. And, in most cases, a court can't do it either.

Having a court compel the other party comply with her contractual obligations is called "specific performance." Your ability to ask a court to do this is limited to certain situations. And you usually have to spend a lot of money in attorney fees and court costs to get there.

That means that a contract – even the best written contract - is not a substitute for knowing the other party and protecting yourself in every other way possible. This is known as due diligence.

Of course, the amount of due diligence depends on your deal. If you're selling widgets for cash up front, little or no due diligence is required (but a contract with at least warranty terms is).

On the other hand, going into business with someone (in other words, getting married to them economically) requires a lot of due diligence.

Going back to Phil and Roger discussed above, during the course of the litigation, Phil discovered that Roger's business dealings around town were similar to what he'd done to Phil. Phil didn't know this because they weren't business associates, but friends. Phil wasn't in the same line of business as Roger so he never heard the stories.

On a core level, if your gut is telling you something isn't right, don't ignore it. As the book *Blink* vividly shows, your gut is probably right. We make snap judgments based on perceptions and evaluation that is not part of our conscious train of thought. They're based on experience and clues and they're often right on.

So, a contract is “right” when it addresses all of the parties expectations, is customized for your specific deal, is accurate, object and complete, discusses all of the known situations that might come up, anticipates situations that could arise, describes how to deal with them and can be used to enforce or defend your situation.

If that only takes 2 pages, then that is the right size for your deal. But, you can’t judge a contract by the number of pages.

Why Every Business with More than One Owner Needs a Co-Owner / Buy-Sell Agreement NOW!

Here’s a situation I see all the time:

“When my partner and I started this business, we’d been friends for 10 years. I trusted him and he trusted me. We didn’t need an agreement between us. We just did the right thing.

Things have changed. Now, he’s only in it for himself. I do all the work and he’s taking more than his share. What can I do?”

Why have a Buy-Sell Agreement?

There will be a time when you or your partner will leave the business. It might be horizontally (on a stretcher) or vertically (walking out the door). But, like death and taxes, you can be certain you will leave.

And, of course, getting all expectations in writing makes for a better and longer term partnership.

Special Note: Co-owner Agreements go by many different names: shareholders agreement, buy-sell agreement, operating agreement, management agreement, etc. To make things easy, in this section I’m refer to all co-owner agreements, whether for a corporation or LLC, as “shareholders agreements,” all owners, whether members or shareholders, as partners or shareholders, and all ownership interest, whether shares or membership interests, as shares. You can convert the terminology to the entity that you select.

In my opinion, however, dealing with owners who leave is the most important reason to have a shareholders agreement. Business divorces – breakups between partners – can be messy, costly and time consuming. They can also kill your successful business.

To avoid a messy business divorce and protect your business, you must have shareholders agreement in place long before any problem comes up. If you wait until the business is “successful,” it’s probably too late.

Shareholders agreements come in a variety of sizes and shapes.

Unfortunately, most of them don’t work.

Why? Instead of providing a fair and orderly method for a partner to leave, the agreement doesn’t permit anyone to leave at all, making an already bad situation worse.

The standard or stock shareholders agreement permits a partner to sell her stock to an outsider only after offering it to the other partner at the same price. In theory a “fair price” is then set by the market.

What is usually missing, though is the outside buyer.

Who in their right mind would buy part of a small business, especially one where the partners are fighting?

Think about that if you were the outside buyer. Before you’d buy a business and have a partner, you’d want to make sure you knew the partner well. And, you’d want some control or agreement in place that protected you. Or, you’d only pay a small fraction of the value of the stock.

Yet, if there were an adequate agreement, the partners would need the outside buyer. Sounds like a catch-22 to me.

So, there are no outside offers. And, without an outside offer, the already unhappy partners can’t agree on a withdrawal price. The one leaving thinks the business is a gold mine, and the one remaining thinks it’s a toxic waste dump.

No one can leave and no one can stay. So what happens? In the end the business leaves instead of the owners!

Because most small businesses required the daily interaction and work of the owners, the dispute between them wrecks the business. Soon nothing is left and the partners are off on their own to new businesses or worse, left holding the bag for business debts they’ve guaranteed.

The important this to know to avoid that scenario is that a buy-sell agreement is not “one size fits all.” (You know the kind: straight from the Internet or bought a an office supply store.) Because you, your partner and your business are unique, your shareholders agreement must be tailored to your business and your goals.

Other reasons to have a shareholders agreement include:

- Protects the surviving shareholder if one dies. Do you want to be in business with your partner’s spouse, or worse, children?
- Make sure you know who you’re in business with. The Agreement will allow you to prevent your partner from transferring her stock without you approving the purchaser. Would you go into business with anyone?
- Protects you from “K-1 Revenge.” K-1 Revenge is a nasty way for majority owners stick you with a tax liability on business profits without giving you any cash to pay those taxes.
- Gives the partners an orderly way to retire from the business.
- Sets each partner’s responsibilities and positions. Avoids having one partner live off the efforts of the others.
- Helps avoid a deadlock on managing the business.
- Ensures a majority partner (or partners) can’t run rough shod over the others or drain the business bank accounts and assets for their personal benefit.

The following are some issues to consider when preparing a buy-sell agreement.

Buy-Out Causes.

The causes for a partner to leave a business fall into two categories: voluntary and involuntary.

Involuntary causes include death, disability or the involuntary transfer of a partner’s shares as a result of divorce or because a creditor levied (took control of) that stock.

Voluntary cause means that the partner decided to retire or pursue some other dream or vocation, the partner got an offer from an outside buyer he couldn’t refuse, or the partners are fighting (i.e., a business divorce).

Whether the reason for the transfer is voluntary or involuntary will, to maintain fairness, lead to the method you select to establish the buy-out price, how you fund the purchase; and the other terms and conditions of the buy-out.

Setting a buy-out price.

The value of a partner's shares is determined by first valuing the enterprise / business owned by the corporation. That value is then adjusted pro-rata for the ownership interest of the departing partner and, if that partner holds less than a majority interest, possible applying a minority discount.

Until a willing buyer and a willing seller agreed and complete a business sale, determining the value of any business is a guess. Sometimes that guess is educated and based on facts and objective criteria, and other times it is based purely on emotion (e.g., *'this is my baby and I'm not letting it go for anything less than \$5MM'*).

There are six ways to establish the value of your business for purposes of a buy-sell agreement:

1. Setting a contractually agreed value.
2. An auction between partners.
3. Using a formula based on the financial statements or other objective criteria of the business.
4. Getting an opinion of the most probable selling price of the business from a business intermediary.
5. Business valuation by a qualified business appraiser.
6. An outside offer.

The methods above are ordered in increasing cost and reliability (i.e., option one being the least expensive and the least reliable).

Contractually Agreed Value.

This method can be used for voluntary and involuntary transfers. With this method the partners agree to a specific value for the business and update that value annually.

There are two serious problems with this method. First, in 15 years practicing law I've never seen a situation where the partners actually update the value annually. When they don't, the first to die (and his / her family) loses.

Jim and Mary (not married) started a vending machine business in 1992. In 1993, Jim's financial advisor convinced them that a buy-sell agreement was a good idea. But, Jim didn't want to pay an attorney to draft the agreement. So, he got one from the Internet. That agreement valued the business through a "Certificate of Value" that the partners were to update annually.

As is typically the case, they updated it once, in 1995, when they believed the business was worth \$100,000.00.

In 2004 Mary was diagnosed with cancer. In 2006 Mary died. At that time the net profit of the business was in excess of \$600,000 and Mary's shares were conservatively estimated to be worth \$720,000.00.

But, because they hadn't updated the shareholders agreement since 1995, Jim bought Mary's stock from her children (heirs) for \$100,000.00.

Mary unintentionally gave Jim a \$620,000 gift.

Mary's situation also highlights the second problem with a contractually agreed value. What would have happened had Mary and Jim actually sat down to reset the contractually agreed value in 2005 after Mary had been diagnosed with cancer?

Knowing that the circumstances had changed, Jim might have artificially depressed his view of the value of the business. He might have refused to update the value at all. In either case the value would have been essentially stuck at the 2004 amount and, again, the first to die, Mary, and her family lose.

Auction between Partners or One Cuts, One Chooses.

This method works particularly well for voluntary transfers. I call it one cuts, one chooses.

I have two daughters. When both want the last piece of cake we have a custom for resolving the dispute. One of my daughters will be allowed to cut the cake "in half." Then the other daughter gets to choose first which half of the cake she wants to eat. I can assure you that when this happens my daughter making the cut is as precise in finding the 50% mark as a brain surgeon operating.

The same arrangement can be used in a shareholders agreement.

The partner wanting to initiate the breakup would make an offer to the other partner to buy the other partner's shares. That offer contains detailed information about price and terms and is presented, in writing, to the other partner.

The other partner then has a limited period of time to consider two (and only two) alternatives: accept the offer and sell his shares to the initiating partner; or turn the offer around and buy the initiating partner's shares on the terms and conditions described in the offer.

One Cuts, One Chooses works well because each partner has to be reasonable. The initiating partner has to make an offer that she is willing to accept herself.

And, the initiating partner can make an offer that will likely result in an outcome she wants. If she wants the other partner to buy her out, the initiating offer can be at a discount to the real value. Alternatively, if the initiating partner believes the business will exceed expectations, she can offer to pay a premium for the other partner's shares.

Also, no partner can cause financial stress for the business that they wouldn't be able to endure themselves. If a voluntary buy-out is based on a formula or valuation and one partner can trigger the buy-out, the remaining partner is put at a disadvantage because business cash flow is diverted from the operation of the business and dividends to owners, to paying the departing partner.

One Cuts, One Chooses doesn't work well when one of the partners is at a financial disadvantage.

If the initiating partner knows the other does not have access to cash or the ability to secure a loan, the initiating partner can make a low-ball all cash offer to the other partner and the other partner, because he can't get the money to flip the deal on the initiating partner, must then sell to the initiating partner at the low-ball price.

Formula Valuation.

Death or Disability of an owner.

There are three (3) methods to set a buy-out price for the death of an owner: a set price, one based on a formula and a full blown valuation. Like many things in life, the best alternative is the most expensive.

A set price (even one which is subject to updating) will usually result in a mess because it's often unfair to one person or the other. And, it's rarely updated. Furthermore, if one owner becomes ill, the likelihood of the price being updated to accurately reflect the value of the business becomes even less. As a result, the heirs of the first shareholder to die lose; they don't receive the true value of the deceased shareholder's interest.

A better method is to set the price based on a formula using the business' financial information. For example, the business might be worth \$500 multiplied by the number of members. Or, it could be 3 times the net after adding back certain owner benefits such as company cars or club memberships, etc.

All the owners have to do is plug the current financial data into the formula to get the buy-out price.

The problem with a formula is it doesn't change when the business changes. So, if we are membership focused today, but the business changes and a better valuation would be based on net earnings, the formula is set and all owners have to be willing to change the agreement.

The best and most accurate (as well as the most expensive) method to set the buy-out price is a business valuation. A third party qualified business appraiser (the professional criteria to be put into the agreement) analyzes the business to determine a range of values with the median value being used for the buy-out price.

Third Party Offer.

In the case of bona fide third-party offer, the buy-sell agreement will typically required the owner who intends to accept the offer to let the other owners buy her out on the terms of the third-party offer (a right of first refusal). Therefore, terms and conditions of the purchase (e.g., cash or note, etc.) are by the third party offer.

The other co-owners review the third party offer. If they believe it a good offer or they don't want the proposed purchaser to become an owner, they can purchase the interest of the departing co-owner. Otherwise, they can let the third party become an owner.

Given the right of first refusal, it's important to limit who can be a bona fide third party. You may want to exclude competitors and other unacceptable parties.

Retirement or Opt-Out.

The price is set by the owner who wants out. While, at first blush, this might seem problematic, the way the arrangement is structured ensures everyone is honest.

First, the owner who wants to leave offers to sell his interest to the other owners at a specified price and terms and conditions. Then the other owners have a period of time, typically 30 days, to decide whether to: (1) buy the departing owner's interest, or (2) to sell their interests to the departing owner, but, in either case, on the same terms and conditions in the original offer (adjusted to reflect any different percentages).

By giving the other owners the option to sell their interest to the departing owner, the system keeps the departing owner honest. If she really wants out of the business, she can elect to offer them her interest at a slight discount. If she just wants to be out of business with her co-owners, she can offer a market rate. In the end, everyone can be assured that the transaction will be priced reasonably.

Involuntary Transfer.

Of course, the agreement should prevent the transfer of an interest to an outsider, but transfers can occur by operation of law or other process and it is important to provide a mechanism to get the unapproved owner out of the business. The price for the buy-out of an interest involuntarily transferred by an owner is usually set in the agreement at the lower of the consideration paid by the holder of the shares or book value.

Funding the Buy-Out.

Buy-out funding either comes from insurance proceeds or business cash flow.

For buyouts of deceased shareholders, it is imperative that the funding be through life insurance on the lives of the owners. Without the proceeds from an insurance policy, the likelihood that the buy-out will be completed is seriously reduced. The remaining owners, no matter how much good faith they have, will eventually tire of working for their deceased partner's heirs.

Furthermore, if the deceased owner was active in the business, proceeds from the policy can help to minimize the loss caused by the owner's death. This can help smooth the tough time and keep the business afloat.

For other buy-outs, the funding is typically the cash flow from the business operations or the profits allocated to the owners.

Management and daily operation of the business.

Are the owners “hands-on” people or would they rather play a more passive role? If one is hands-on and the other isn’t, this should be reflected in roles and salary.

Also, there can only be one person in charge of the business. Multiple owners claiming to be in charge will only confuse employees and the market.

Finally, who will be elected to the controlling management team. For example, in a corporation, the board of directors controls the company and in a manager managed LLC, the managers control the company, each with one vote.

As a result, a majority shareholder who, by agreement, only controls only one of three seats on the board of directors, doesn’t actually have controlling authority over the corporation.

Taxes.

The need to address taxes is another critical factor to be considered in preparation of a buy-sell agreement. Pass through entities, such as an “S” corporation and an LLC taxed as a partnership, cause income to be “imputed” to the owners. Thus, even though the owner gets no cash from the company, she may find that she has to pay the tax on her share of the net profits.

And, with an LLC taxed as partnerships, a transfer of more than 50% of the interests causes a “deemed termination” of the partnership for tax purposes. The IRS treats the business as having been terminated, all the assets given to the owners at their fair market value and the owners having re-contributed them to a new business. This means each owner pays taxes on the difference between her share of the fair market value of the assets and the amount she contributed to the business.

To avoid this situation consider requiring certain annual distributions to cover, in part, tax liabilities and limit the ability of majority owners to make a transfer that would result in a “deemed termination.”

Compensation.

How will the owners be paid. Salary and profits or profits only? How will the salaries be set? Beware of tax law requirements. Sometimes, owners must be paid a salary (in particular “S” corporations).

Also, it is important to limit the right of the board of directors to increase owner-employee salaries and other compensation beyond pre-agreed amounts. Majority owners (whether one or a group of owners) can use this technique to funnel money into their pockets that would otherwise go to minority shareholders as profits.

New shareholders or members.

How (if at all) and at what price are new owners to be brought into the business? Remember, if not prohibited, the board of directors can sell authorized and unissued shares of stock without the shareholders approval.

Disputes and resolution.

How will disputes be resolved without one of the owners leaving? Often, owners can have legitimate business disagreements without wanting to end their relationship.

Exit strategies.

What is the exit strategy? Where does each owner want to be in 3, 5 or 10 years? Is one talking about going public while the other is looking for a long term life style business?

If there is a majority owner, should the other owners have the right to “tag along” with the majority owner when he sells his stock? Likewise, can the majority owner “drag along” the minority owners if the majority owner wants to sell all of the company’s stock.

Growth.

How far and how fast do the owners want the business to grow? Are they willing to forego present income and benefits for long term growth? Either way,

General expectations.

Why is each owner involved in the business and what does each expect from the other?

An agreement between owners is essential to protect and maximize your business investment. With it you’ll be sure each owner is working towards a common goal, that changes in ownership will not harm your business and that you and your family will realize the benefit of your business investment.

**About the Author:**

Ed Alexander is an attorney who represents businesses and their owners, in the areas of corporate, business and commercial law, securities, technology and intellectual property licensing, and corporate finance. He is primary counsel to clients for business acquisitions and sales, financing transactions, licensing technology and intellectual property assets, and creation of partnership and LLC operating agreements, shareholder buy-sell and management agreements, employment agreements and stock option plans. Ed is a solo practitioner is admitted in Florida and New York and has been practicing since 1993.

Prior to law school, Ed held non-legal positions in the business world with technology companies, including a pacemaker manufacturer, custom integrated circuit manufacturer and laser bar code manufacturer.

In 1995, Ed was awarded U.S. Patent, No. 5,468,952, for his 1992 invention of a combined miniature high speed scanner and portable handheld computer.

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