Shareholder agreements

How to settle disputes when business partners get 'divorced'

INTERVIEWED BY ROGER VOZAR

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Business partnerships are often compared to marriages and business "divorces" can get nasty if details haven't been worked out in advance.

Just as couples have prenuptial agreements to protect interests in the event of a separation, business partners can create documents that serve the same purpose.

"If no plan has been put in place, it can get very heated when a separation occurs," says Elizabeth G. Yeargin, a partner at Brouse McDowell. "It's usually most heated in family businesses because there's so much emotion involved. Unfortunately, those also are the situations where business partners tend to think everyone will get along and they don't need to have an agreement prepared in advance."

Smart Business spoke with Yeargin and Kate B. Wexler, an associate at Brouse McDowell, about common provisions in shareholder or member agreements and how they can help avoid costly litigation.

Is drafting a shareholder or member agreement a standard practice when forming an entity?

Not everyone does it, but it's a good idea. It doesn't need to be entered into the minute you form the entity; you can be going along for 10 years and realize that you should put one together.

Usually, the need to refer to a member or shareholder agreement is triggered by a deadlock on a big decision like investing more capital, adding another shareholder or taking on a new project.

Agreements should contain a procedure for resolving deadlocks, especially if there are only two partners or an even number of voting partners. Whether it's having a third party make the decision or nominating an arbitrator or mediator, some type of plan for breaking deadlocks should be included.

Should an exit strategy also be part of the agreement?

That's an important provision to include and should address how people can act if they want out of the business. Will the company or shareholders buy them out or can they sell to a third party?

A 'put right' allows an interest holder to require the company or remaining business partner(s) to buy out the interest under certain circumstances, while a 'call right' allows the company to require the interest holder to sell ownership back to the company or remaining partner(s).

It's also important to determine how those interests will be valued because the person wanting out will want the business to be worth more, but those remaining will want to pay out less. It's essential to establish a valuation formula.

It saves on expenses to have a formula that doesn't rely on an expert, but the agreement can also provide an avenue for using an appraisal or business valuation firm.

Some businesses have provisions in their agreements that require them to meet every year to set a price for their equity and if they fail to do that for a consecutive 24-month period, it reverts to a valuation from a third party.

The method of payout should also be addressed; otherwise, the company may have to take out a third party loan, which many companies want to avoid. Usually, there's a lump sum payment with a promissory note to pay the remainder with interest over a period of time. This is especially common with 50/50 shareholders because chances are the remaining person can't afford to buy out the other half immediately, even if the company is doing well.

While no agreement can cover every eventuality, the best time to discuss these matters is when the venture is just getting started and everyone's excited about it. That's when everyone is working toward the same goal, as opposed to later when interests may conflict.

A shareholder or member agreement can address a variety of topics, so long as its provisions fall within the parameters of the Ohio Revised Code. No one ever hopes to use the agreement, but the more specific it is, the easier the process will be if or when something goes wrong. ●

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