

WHEN THE HONEYMOON IS OVER

By Paul A. Rianda, Esq.

Over the years I have been an attorney, I have seen a lot of businesses forced into dissolution when the owners cannot agree on how to operate the company. It usually stems from a situation where there are two owners of the company and their disputes have risen to the level where they are no longer able to communicate and agree on a direction for the company. At that point the owners are often forced to hire separate attorneys to battle it out over the assets of the company. In this article which can be described as a “cautionary tale”, I will describe the common circumstances that often lead to this situation and some tips on how to avoid a nasty business divorce.

The Set Up:

As mentioned above, most of these types of disputes occurs when there are two people who each own 50% of the company; be it a corporation, limited liability company, partnership or other entity. The important thing about the 50-50 ownership is that it leaves no one person with the ability to make a unilateral decision, since no person owns a majority of the company. A majority is generally required to make any decisions in a company. Since no owner owns a majority unless both owners agree on a particular decision, no decision can be made. For that reason I often warn my clients that equal ownership may not be a good decision. As you can imagine, many of my clients believe they can work together with the other owner and choose to proceed with equal ownership despite my advice to the contrary.

Having decided to move forward with the venture, the owners begin to operate the business. Most of the time they are in such a hurry to get started and make money, they do not do much in the way of planning. Instead of defining the owners’ duties and roles in the company, and making sure both agrees agree on those terms, they start operating the business and leave that for a later discussion. This can lead to some issues down the road.

Be it two months or five years after the company is started, quite often there are some disagreements about how the business should operate. One owner may want to spend a lot of money on a new marketing effort, while the other owner wants to try a more conservative approach. Spouses and relatives may be hired by one owner to the chagrin of the other owner. Of course the profit split between the owners is always a concern.

One of the most common issues leading to the break up of companies is the relative effort the owners put into the companies. I have seen it many times in insurance companies, law firms and in our industry. What usually happens is one of the owners that has been working diligently for many years decides he or she no longer wants to work as hard. The one owner who continues to pour his or her heart and soul into the company gets extremely resentful of the other owner who is not putting in equal effort. No matter what the cause, the result is an impasse whereby the parties decide they in effect want to get a business divorce.

How to Divide the Property

The problem is that when the two owners start communicating through attorneys, there is a severe impact on the value of the asset they have worked so hard to build. Fees needed to pay to the lawyers can mount quickly. The usual way to force the other side to divide up the business is to start a dissolution proceeding in the courts. This can lead to a receiver being hired at the expense of the company to run the business, who will not be as motivated to build the business as the actual owners. In the end all these expenses come out of the owners pocket and serve to reduce the value of the company.

The end result of the dissolution process is also not a very good proposition. In most cases where the owners cannot agree on a price for one owner to buy the other one out, the dissolution will necessarily end in a sale of all the assets of the company, so that the proceeds can be divided equally between the owners. In the bankcard industry, that means selling the main asset of the company which is usually the residual streams. Residual streams usually sell for a substantial discount compared to the value to the owners were they just to continue to collect the residuals, especially in the current market. And any buyer will know you are in a desperate situation, hardly the best time to sell. So, the end result is that the residuals will be sold and the owners will end out with far less than if they had continued to receive the residuals or sold under more favorable circumstances.

How To Avoid a Bad Break Up

Seeing how bad an ownership break up can be, the question becomes how can you avoid such a result? The first thing to do is try to date before you get married. By that I mean if you are going to work with someone, don't start out with a jointly owned company. Try instead to work together while the both of you operate your own companies separately. Make sure that you clearly define what will happen if the arrangement does not work out so that you can avoid a costly fight for dissolution of the venture.

Some people decide to have a trusted advisor take over a small percentage ownership of the company. This trusted advisor then becomes the swing vote. If one owner and the trusted advisor agree on a decision, they have a majority vote that allows the company to continue to operate instead of being stuck in a 50-50 deadlock situation.

If you decide to both own a company together on a 50-50 basis, make sure you clearly define roles and responsibilities. One owner might be the person providing the capital while the other owner will run the day-to-day operations of the company. Both owners should write down in detail what they expect of their potential co-owner and share it with the other party. It is often a very enlightening process to see that the owners share completely different views of their roles. By going through this process the owners can define their respective roles.

From a legal perspective, one of the most important contract provisions to draft is the buy-sell provisions that define the circumstances under which one owner can buy out the other owner. Buy-sell provisions are usually found in a shareholder agreement for a corporation or as part of the operating agreement for a limited liability company. There are various acts that can trigger a right for one owner to buy out the other owner. Events like death, disability or bankruptcy often trigger such a right. But, the important triggers for our discussion are usually the continued employment of one of the owners by

the company. So, if the owner quits working, or if the owner ceases to perform to a certain level, that owner can be bought out to keep the parties from having to fight it out in court.

In such a buy out, the value of the buy out is important. To keep the owners working hard for the company, you can add in the buy out provisions that the purchase will occur for less than 100% of the value of the owner's interest in order to motivate the owners to work hard and penalize them if they do not.

Another useful provision is one where the owners can make an offer to buy each other out in the event they are deadlocked on how to continue operating the company. Owner number one makes an offer to buy owner number two's ownership interest in the company. The twist is that if owner number two wants to, he can buy owner one's interest for the same price offered by owner one. This keeps owner one from making a low ball offer and results in owner one being motivated to make a fair offer in order not to lose his or her ownership interest.

There are many ways to approach these issues as set forth above. The best advice I can give is date for a long time before you get married, communicate during the relationship and if you find it necessary to get a divorce, try to be as civil as possible.

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