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FIRE, AIM...READY PARTNERSHIP

THE START AT THE END APPROACH TO CRUSHING COMPETITION, CRAFTING CULTURE AND CEMENTING RELATIONSHIPS

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PREFACE

Over the course of my career, I have started companies, served as chief operating officer for a hugely successful software company, and started, managed, and run law firms. For 27 years, I have served as counsel for companies of every size and description from mom-and-pop stores to some of the most successful and recognized organizations in the country, and I have worked with them through every aspect of their formation and growth.

I have received more phone calls and emails than I could possibly count imparting news ranging from the excited, "We're taking on a new partner!" to the grief–stricken, "My partner and friend died today." I've guided companies of all sizes and virtually every industry through these transitions, as well as those less dramatic and more common partings of the ways – both amicable and not.

In all of that time and in all of those transactions, I've never found a better secret to well-formed partnerships, smooth transitions, and successful partings of the ways than what I have taken to think of as *"fire, aim…ready.*"

That's the secret I'm going to share with you now.

"Partnership" versus Partnership

From a legal perspective, the term "partnership" is very specific. When a lawyer uses the word "partnership," he or she is specifically referring to entities such as limited partnerships, general partnerships, and limited liability partnerships (LLPs). Business people tend to use the term as a generic description of co-ownership, whether the co-owners are fellow stockholders in a corporation or members of a limited liability company (LLC). In putting this book together, I decided to write like regular people speak. Here, I am using the term partnership broadly to describe all ownership- and leadership-based relationships between individuals and entities. (This is what's known as a "CYA" paragraph. I wrote it for three reasons. First, I want to clarify how I use the term. Second, I want to let readers know that this book applies to every type of business entity. Third, and no less importantly, I wrote it to keep lawyers out there from jumping on my back when I use the word "partnership" even when talking about corporations. After all, you know how lawyers can be!)

THE EPIPHANY OF “FIRE, AIM…READY” FOR PARTNERSHIP

Most people think about business partnership much like they think about marriage – they see the excitement and the unlocked potential of taking on a partner, co-owner, investor, or fellow traveler in business.

However, most people have it wrong. When it comes to partnership, they should really start by thinking about divorce.

I say this not because I’m cynical. It’s not that I view partnership negatively or sit on the sidelines waiting for bad things to happen. I say this because my perspective is shaped in part by the sheer number of times I’ve been on the receiving end of the call: “This isn’t working out. Get me out of this company.”

If there are two things I’ve learned after decades of working with companies of every size and description, they are these:

1. Partnerships eventually come to an end
2. The most successful partnerships plan for the end from Day 1

I came to realize that I was spending far too much time thinking about what I wish my clients had done – even long before they actually called me. I finally understood that the place I should start with any client contemplating a partnership is with the call that would inevitably come at the end.

The fact of the matter is that when it comes to partnerships, “’til death do us part” is only one of a number of outcomes – and even that one, if you’re lucky enough to get that far, envisions an end. Still, comparatively few partners ever plan well for the end of their partnership at the point when they should – at the beginning.

What’s more, the vast majority of clients who do try to plan – those who sit down with me to discuss drawing up an actual agreement – tell me right out of the gate that “we’re in agreement as to all the major points, we just need you to draw it up.”

That would be all well and good if they actually were in total agreement. But, the reality is, none of them ever are. It just takes them a while to realize it.

They didn’t mean to deceive; they just didn’t really understand the ramifications of all the “major points” and how they would play out in real life.

I wrote this book to help business people form better partnerships designed to withstand all the things, expected and not, that life has a tendency to throw at us…often at the least convenient times. The secret? To do that, to be truly ready, you have to fire first, and only then take aim.

Let’s get started.

PART I: FIRE

CHAPTER 1:

The Five Great Lies of Partnership

I joined my father's law practice immediately after graduating from law school in 1987. He was a sole practitioner and maintained his office in a small town about half an hour from Annapolis, Maryland. As a sole practitioner, and like many lawyers back in those days, he pretty much took whatever came in the door. He worked with clients on adoptions, wills, guardianships, DUI defense, workers compensation, small estates, divorce, and personal injury. Even back then, before lawyers advertised on television, personal injury cases were the easiest money and he wanted more of them, except that he disliked trial work. That's where I came in.

I had my first jury trial six days after having been sworn in, and I soon found myself working almost full-time as a personal injury lawyer. I didn't love the cases, but it was a great way to get trial experience.

Of all the clients I represented, only a few have made a lasting impression on me. One such client was a man named Ken Dawson. Mr. Dawson had been injured in an automobile accident, and his resulting back pain had placed him on what was more or less permanent disability. He complained constantly about how the accident had altered his life – how he could no longer bowl, lift his children, or sleep on a mattress. He slept on a wooden board on the floor near his bed.

Opposing counsel was a very experienced insurance defense lawyer. She was smart, cynical, and doubtful, to the point of being dismissive, of Mr. Dawson's claims.

Settlement negotiations broke down because Mr. Dawson was insisting on receiving enough money to compensate him for the surgery he was planning to have. Opposing counsel didn't believe him. She thought he would take the money and run, that his intent to have the surgery would evaporate once the check cleared. Not only did I disagree with her, but also, as a new lawyer, I was personally offended by her doubts about my client's voracity.

We went to trial in the spring of 1988 and won just about everything we were seeking. I was elated; Mr. Dawson could have his surgery.

One year later, I ran into Mr. Dawson at City Dock in Annapolis. I asked him about the surgery. It turns out he never had it. He somewhat sheepishly told me that his back had begun feeling better.

Not long after that run-in, I found myself at a bar association function talking to the judge who presided over the Dawson trial. He had remembered the trial and asked me about Mr. Dawson's surgery, and I told him. It was at this time that he put his hand on my shoulder and told me what he viewed as one of the great truths of the practice of law.

"Son," he said, "your clients will lie to you."

"All of them," I asked?

"Pretty much all of them, yeah," he replied. "It's not that they're bad people, most of them, or even inherently dishonest. Most of the time the lies don't matter, but they'll still lie. It's the way we're built. If a client is ten miles away from the scene of the crime when it was committed, he'll tell you he was twenty. If his injuries from the accident made it so that he couldn't join the bowling league he'd been planning to join, he'll tell you that he's been bowling for years and that it was one of the cornerstones of his life."

I've never forgotten the judge's words. I don't subscribe to them completely. More to the point, I recognize the cynicism that has to take root in a person who spends the better part of his career listening to people tell their stories when their backs are against the wall. That being said, in my view the judge was more right than wrong. I wouldn't describe the misstatements as lies. But clients, whether they are hoping to lessen the estimate of legal fees or just being guilty of wishful thinking, often don't know or can't communicate the real truth of their situations.

If these lies were told only within the sanctity of the lawyer's conference room, it would be one thing; but they're not. George Costanza in the sitcom *Seinfeld* once told Jerry that "it's not really a lie, if you believe it." That's what makes lies so destructive. When they're told to the lawyer, it's one thing. But when they are told to those outside the partnership – to employees, vendors, and investors – they have the potential to become truly devastating.

Below are the five "lies" business people tell themselves and others about partnership.

Lie #1: All Paths Lead to Partnership

This is a devastating lie that owners of companies often tell their employees and themselves. It's not malicious, as they don't intend it to be a lie, but it usually turns out to be one – with extremely damaging consequences.

From the lawyer's perspective, the worst part about this lie is being asked to draw up documents to facilitate it – to craft employment agreements and employee handbooks laying out a path of advancement based on accomplishments or tenure that leads to ownership.

The fact is that it may be perfectly valid to use accomplishments and tenure to calculate bonuses or vacation, but establishing ownership is a different matter entirely.

The promise of ownership may woo talented up-and-comers, but a good part of the decision of whether or not to admit somebody as a partner is something that does not fit into a metric. It's gut reaction, fit, and the "it" factor.

No agreement should ever be crafted that says otherwise.

Lie #2: Partnership Is a Reward

You see it happen with sports teams and once-great athletes. Aging athletes get huge contracts based upon past performance. Looking at the athletes, no one can doubt their accomplishments and the forging of Hall of Fame careers. At the time of the new contracts, however, the athletes are approaching forty or so. Their skills have diminished to some degree, and television announcers praise their hearts more than their games.

The athletes are probably still fan favorites and still voted to consecutive All-Star games, if the fans have anything to do with it. But the skills aren't there.

Such contracts that reward past performance are the kind of contracts that can cripple an organization. Take a look at Kobe Bryant and the Lakers. The contract given Kobe was so large that there was no room on the payroll for currently great players who could lead the team to contention.

Too many companies make this mistake, albeit on a far less grand scale than the Lakers. Partnership is seen, and sometimes promoted, as a reward for past loyalty and accomplishment. Although loyalty and accomplishment are certainly part of the calculation, the granting of partnership should only be considered with an eye toward the future.

Severance is for the past.

Lie #3: Partnership Is an Incentive

The existence of an incentive to do anything presumes a question asked and answered: "What is it you are trying to incentivize?"

Is it longevity? Is partnership to be a carrot dangled in front of employees to ensure that they don't up and leave for the competition?

If so, there are other, more immediate, vehicles to achieve this same result. Bonuses and opportunities to learn, explore passions, or develop mastery of a chosen craft, to name just a few.

Is it productivity?

If so, there is no evidence to suggest that promising a reward that will, at best, materialize in five or ten years' time will result in an immediate, day-to-day increase in productivity. In fact, there is a good bit of evidence to the contrary. Although an examination of this evidence is well beyond the scope of this book, I highly recommend Daniel Pink's *Drive*. If you want to know what incentives prick employees' ears, spend a few hours reading what Daniel Pink has to say.

If you take it to heart, your company will never be the same.

Lie #4: Fifty-One Percent Ownership Equals Control

The most pervasive business "lie" that I have ever encountered goes something like this: "As long as I control 51% of the vote, I control the company."

The fact is that I've seen stockholders with a 5% share exercise effective control by blocking important initiatives and forcing their will on the majority. In reality, it's comparatively rare for companies to allow every single decision to be guided by the vote of a simple majority.

In most cases, decisions are divided into two categories: 1) day-to-day decisions and 2) extraordinary actions.

Day-to-day decisions are exactly what they sound like. They tend to involve buying office supplies and signing contracts in the ordinary course of business.

Extraordinary actions, on the other hand, are the make-or-break decisions that determine an organization's fate. Every organization is free to define what does and what does not constitute an extraordinary action. Most often, extraordinary actions include these:

- Admitting another partner
- Buying a company
- Liquidating the organization
- Expanding to another region
- Making a significant commitment, such as signing a long-term lease or making a major capital purchase
- Terminating a partner (if this is at all possible)
- Bringing someone on board whose salary could break the bank

Extraordinary actions often require the vote of a supermajority, which consists of something more than 51%. But there is no hard and fast definition of supermajority. One organization could stipulate that 75% constitutes a supermajority, and another could settle on 87% or even unanimity. Take heed: if ownership consists of four partners who each hold a 25% share, then a supermajority defined as 80% effectively requires unanimity.

Note, too, that the fact that a 49% partner could block major initiatives is not the end of the story. Banks often require consent, if not personal guarantees, from partners holding a significant stake — sometimes defined as more than 10% — in the organization.

An uncooperative minority partner can be a nightmare.

Lie #5: We Agree on All Points

Knowing that you want to grow the company and divide the profits equally and that you agree on the role each partner is to play does not mean that you agree on all points. It means that you agree on significant points.

Partners do not agree on all points until they have a consensus on the answers to significant, destiny-changing questions that should be asked of each partner such as these:

- What can be done over your objection?
- Can you be fired – for anything? Consider felony conviction, embezzlement, child pornography, and so forth.[1]
- What happens when one of you wants to leave?
- What does the departing partner get?
- Does the partner staying behind in the business ***have*** to pay the departing partner?
- Is there such a thing as retirement?
- What if one of you wants to sell and one of you doesn't?
- What if one of you wants to expand and one of you doesn't?
- What if one of you wants to sign a personal guarantee for a loan that the company needs and one of you doesn't?

Clients who come to me saying that they agree on all points do so because they don't know all of the questions to ask.

[1] If the answer is "yes" to any of these extreme cause-for-firing cases, then the answer to the question is "yes" and you have to figure out the hows and the whys of the termination of a partner should something extreme occur.

CHAPTER 2:

The One Enduring Truth: You Will Make That Call

Whenever two or more people combine their efforts or resources to run and grow an organization, a partnership is formed.

Lawyers refer to a "partnership" as a specific form of entity, separate and distinct from a corporation, limited liability company, or sole proprietorship. I understand that distinction, and I've lived it for the entirety of my professional career, but that is not my point here. I am using the word "partnership" here to describe the coming together of resources – whether those resources are time, money, talent, connections, passion, or any combination thereof.[2]

There are a million reasons why people would come together to form a partnership. It doesn't matter whether we're talking about a for-profit company, a school, a non-profit organization, or an institution; the right combination of resources, personalities, and intellect can propel any organization to new heights.

But here's the hard truth about partnerships: people leave.

That's not a "maybe" or a "usually"; it's a definite. People leave. And when they do, you will make that call.

I have no idea how many times I have received that call over the course of my career – 100? 500? All I know is that whenever I serve as counsel to any kind of business that includes a partnership, it's almost inevitable that one day, if I work with the business long enough, the call will come.

Sometimes the call comes from the person leaving. He or she would like a copy of the corporate documents that spell out everyone's rights, roles, and responsibilities. Most often the call comes from those staying with the business. Those are the people who want to come in to see me to talk about where they go from here.

Most of the time, those staying behind are a little bit shell-shocked. Sometimes they feel there has been a betrayal, but usually their concerns are more personal.

They hope that their life's work is not circling the drain. They hope they can keep their kids in private school and keep paying the mortgage and that they don't let down their employees who are depending upon the company to help them keep their own lives in order.

[2] "Thereof" is a lawyer's word. I try not to use many such words because that's not how normal people talk. Throughout this book, I also try not to write like a lawyer – meaning that you won't find even one sentence that consumes half a page, contains more than a dozen commas, or uses too many words like "heretofore." I can't promise, however, that a "thereof" or similar word won't creep in every once in a while.

Whatever the case, the departure of a partner usually represents seismic change.

When that happens, the worst position to be in is one in which you are forced to make important decisions on the fly. There are simply too many plates spinning for a person to make clearheaded calls.

Now, I am fully aware that you might be reading this section thinking, "This won't happen to us." I disagree.

When discussing the twilight of a great athlete's career, sports commentators have remarked that Father Time is both undefeated and untied. That's an indelible truth.

When it comes to partnerships, the indelible truth is that people leave.

The Five Ways Partners Leave

There are five (and only five) ways to leave a partnership:

1. Death
2. Disability
3. Voluntary departure
4. Involuntary termination
5. Retirement

No matter how well formed the partnership, eventually it will end; people do not move through life in lockstep. Sometimes the partners' separation occurs involuntarily, such as through death or a career-ending disability. On other occasions, their parting may be more controlled, such as in the form of a graceful exit. There are, of course, those times when parting becomes hostile, leaving both sides to sort through legal, emotional, and financial issues.

Equally, just because two or more people are in agreement as to certain terms, it cannot be assumed that they possess life circumstances that are similar enough, or that will stay similar enough, to allow them to agree on all terms. One partner may have aging parents for whom the provision of outside care is becoming a priority. Another may have kids expecting to go to college. One may be single. One may be supporting a disabled sibling. Each of these personal needs can and will have a profound effect on whether and how the partnership prepares for change.

In order to understand how to build, sustain, and finish a partnership well, you first have to understand your endgame and your options when it comes to controlling it.

Death

The death of a business partner is rarely expected. When partners are active in a business, there is a sense that the sun will rise the next day on an unchanged partnership. I can assure you that no one in the three stories I share below expected to have to contact me to discuss the issues that were now suddenly and inescapably top of mind. But there they were on the phone.

There is both an art and a science to effectively preparing for the death of a partner, and the stakes are high. After all, a business often represents the most significant investment that a person will make his or her lifetime.

Three of my clients died within the past six months. The circumstances and the fallout were completely dissimilar, but each call I received highlighted the importance of figuring out the end before you begin. Consider the situations.

The Call from Forensix Labs[3]

The first call came in on a Saturday morning. My wife and I were traveling in Oregon, and truth to tell, I did not immediately recognize the number displayed on my cell phone because I had not talked to this particular client in a while. When I answered, a shaken voice at the other end of the line told me that his partner, Steve, had died. Steve and Jim had owned their company 50/50 for over ten years, and Jim now found himself alone, left to run the company and deal with the tragedy of Steve's death.

Unbeknownst to me, Steve had suffered from chronic depression and over the past several years had experienced some substance abuse problems. He held up his work and his life as best he could, but apparently, he found himself unable to continue and had taken his own life the night before.

Steve and Jim ran a very successful business through the operation of their well-oiled partnership. They had a buy-sell agreement that they had pulled off of the internet more than a decade earlier when they started their business. It provided for a valuation that now was completely out of touch with the current value of the company and was silent on key terms such as logistics and terms of payment.

The Call from Old Line Furnace

I helped the principals of Old Line Furnace buy the company in 2006. The company had been in business since the late 1800s and, once my clients completed the closing, was family-owned by father and three sons. The son who served as the president of the company emailed me one afternoon to tell me that his father had passed away.

[3] True story with changed names.

While completing all of the work in the run-up to closing, I had recommended to the family that we sit down and prepare a buy-sell agreement. While they knew it made sense, they decided to put all of their time and effort toward purchasing the business and put off discussion of a buy-sell agreement until after closing. I had no quarrel with this decision as long as they followed through.

Sure enough, we completed the closing and immediately met to begin drafting the buy-sell agreement. We had run through a few drafts when frontline concerns began fully occupying the attention of the principals. I repeatedly told them that they should finalize the agreement, but no amount of prodding produced this result. We moved on to other issues and the agreement sat in the drawer.

Now, with the passing of the family patriarch, 25% of the stock was going to be disbursed in accordance with the father's will, drawn up decades prior to the Old Line Furnace purchase.

The Call from E&E Construction

E&E Construction was owned by two friends who were as close as brothers. They lived near each other, raised their kids together, played softball as teammates, attended the same church, and eventually, formed a company together. They came to see me about five years in, and together we drafted a stockholders' agreement that addressed each of the five ways to leave a partnership.

Edward called me from the hospital where Eric had been taken the night before. Eric, a marathon runner and avid hunter, had suffered what the doctors could only presume had been a massive heart attack, the cause of which was unknown. The cause, however, was the least of Edward's concerns as the loss of his lifelong friend and business partner seemed to be imminent.

Eric died three days after his arrival at the hospital. Police and Edward suspected foul play, though it could never be proven. Regardless, Edward had to put that aside because he had a company to run.

Disability

When I speak of disability in this context, I'm not necessarily describing a condition that would entitle you to a parking space closest to the mall entrance. Disability in a business context is a condition that prevents a person from carrying out the primary functions of his or her specific position.

As an example, it would not make a difference, at least in this context, if I woke up tomorrow and suddenly found that I could no longer walk. Many fine lawyers are wheelchair bound. While I by no means intend to minimize the difficulties associated with such a condition, the loss of function in my legs would be irrelevant to how well I could do my job.

However, were I to be struck with a cognitive deficit or a condition that effectively eliminated my ability to communicate on the level and to the people I'm required to reach in my job, such a condition would be a career-ending disability.

The question here is not whether the company would be able to make adjustments to enable the partner to continue working – make what the lawyers call "reasonable accommodation." The question is whether a physical or mental condition has so limited a person's function that he or she is unable to perform his or her job, even with every practical accommodation.

Similar to death, the onset of a partner's disability can be sudden, crippling, and devastating on both a personal and professional level. A company unprepared is a company at risk.

Voluntary Departure

As I always tell my clients, you never know when one of you may be seized with the irresistible urge to leave your business behind, reap the benefits sown, head down to Florida, and open up a flip-flop shack on the beach. Just reading that sentence sounds enticing, doesn't it?

People change. They age, they fight their battles, and frequently their outlook evolves. People who begin a business with enthusiasm may find that ten years in, they're ready for a change.

Sometimes you can see this change of mindset coming; sometimes you can't.

I had a client who, along with his brother-in-law, was the third generation of a highly successful machinery distribution business. He had been employed full time at the business since he was a teenager. Starting in the warehouse, he had worked his way up to the executive suite.

What he couldn't get past was the fact that his father had died suddenly of a stroke at the age of 54. My client was 52 at the time of our conversation and felt that he was looking down the barrel of a gun. He didn't know what he wanted to do, but one thing he knew for certain: he was not going to die at his desk.

He had begun what became a series of conversations with his partner/brother-in-law about leaving the business in two years. They had no stockholders' agreement, but they did have a high level of respect and goodwill between them. This was absolutely critical because once the roles become set and each partner knows who's leaving and when, extreme disagreements can develop between future buyer and future seller. Here, there was a lot to work out, but the partners at least had the goodwill on which to build wings while they were flying. Many partnerships are neither as solid nor as lucky.

Whenever a partner decides to leave, those remaining behind face a twofold challenge. First, they have to figure out a way to keep the business going by redistributing the work (and relationships) for which the departing partner had primary responsibility. Second, they presumably have to hire someone new to take on all or part of the departing partner's job – while laying out what could be significant cash payments to redeem the outgoing partner's share of the business.

Involuntary Termination

Can you fire your partner? Can she fire you?

Most of the time when I ask this question, the partners look at me, chuckle nervously, and smile. They have no answer. They never thought about it. What's more, had they thought about it, they likely would have dismissed the thought immediately from their minds as it would have been inconceivable.

But let's take a look at an extreme example:

- Let's say the once diligent partner with whom you formed your business was now coming in at 10:00 a.m., leaving at 2:00 p.m., and taking a three-hour lunch.
- Let's further say you found cocaine in her desk or she came in each morning with alcohol on her breath.
- Finally, let's say you also found a series of unauthorized withdrawals from the company's bank account.
- What if she were embezzling? Could you fire her then?

When I ask clients about firing the partner in this example, the answer is almost invariably, "Absolutely." If we were talking about the downloading of child pornography, for example, the answer is always, "Absolutely that person would be fired." Why? Because there is no question that something that egregious, disturbing, and wrong merits immediate dismissal.

So, the answer, whether you had at first believed it or not, is, "Yes, there are some circumstances in which I could fire my partner and she could fire me."

If that's the case, then you have to decide what those circumstances are and what evidence is required. Maybe it's only a felony conviction or maybe it's something less definite such as persistent conduct that does grievous harm to the organization's reputation and prospects.

Whatever the case, the question merits serious consideration because if there is even one circumstance in which involuntary termination becomes a partnership right, it darn well better be addressed at a time when neither partner believes anything like that could possibly happen.

Retirement

There comes a time when each person wants to sit back and savor the fruits of his or her labor. Whether it's leaving outright or simply stepping back a bit, such a change seems inevitable. Even people with the longest of tenures have a tendency to want to slow down after a while.

Some of my peers lump retirement in with voluntary termination. I see the overlap, but I believe retirement stands on its own because it carries with it a built-in dedication to the company that may or may not be present in voluntary termination.

The term "retirement" can be defined however the partners choose. I normally discourage the typical definition of retirement that is based on age. What's age got to do with it? When it comes to an organization, the important things are tenure and contribution. I would rather see retirement defined as voluntary termination after X number of years with the organization. The X can be 10, 20 or any number the partners choose. The important thing is that X is evenhanded.

It doesn't matter whether one partner is 25 and the other is 45 at the start of the partnership. If the partners decide that one has earned retirement after 10 years of work, then good for the 25-year-old. She gets to "retire" at the age of 35. If you make retirement age-based, then it would mean that the ten-year contribution of a 25-year-old in the end is markedly less valuable than the ten-year contribution of a 45-year-old.

If you think that's fair, so be it. It's your organization. Just make sure to plan for your and your partner's retirement from it.

Chapter 3:

Write Your Partnership Story Before It Happens

As I've said, each story begins with a phone call. Each phone call, you now know, ends in one of these five ways:

1. "…so he passed away over the weekend."
2. "…so because of the stroke, he'll be completely unable to work."
3. "…so she's always wanted to move to Florida, and she just decided that now is the time."
4. "…so because of what we uncovered, we have no choice but to fire him."
5. "…there's no doubt she put in her time, and I guess she decided that she wants to kick back and relax."

Now it is your job to write the story ending from here – before it happens. You have to figure out what happens to each character, and when. You have to craft each ending to your satisfaction because you never know which of the five ways your conversation with your lawyer will end.

To be sure, your story could have quite a few variations. On the one hand, you might be considering ending a relatively new partnership because things simply did not work out the way you had intended. On the other hand, you might be envisioning the end of a partnership that had been the very definition of success for a decade or more.

Whatever the case, writing the possible endings to your story now – before an event that precipitates one of your endings occurs – is the key to ensuring that when one of the five partnership-ending events does come to pass, you experience the happiest ending possible.

Case in Point: The Story of Atlas Accounting

There are many sound reasons for the principals of two or more existing businesses to decide to pool their resources and move forward under one banner. Complementary services, a larger geographic footprint, more negotiating power, and genuine respect between the principals are only a few of the foundations I've seen established for a successful merger.

I've also seen quite a few deals fall apart at the conference table, and for good reason. What follows is one such story.

Steve Atlas was an accountant with a solid reputation and a growing firm. He had started his firm eight years ago, guided it through a recession and one failed partnership, and worked to see it really take hold in his area. He felt his clientele of small to midsize businesses could use more services than he could provide, and he turned his attention to a professional acquaintance, Cyrus Kurlander, who had started an IT business some two years prior.

Like Atlas Accounting, Cyrus Kurlander's company, ServIt, worked exclusively with small to midsize businesses and prided itself on both its expertise and responsiveness.

Steve Atlas felt that his company could take off if he provided not only accounting services but also IT and software support. Atlas Accounting had a longer history than ServIt, was better established, had a more impressive client list, and had greater revenues. Although ServIt was well thought of in the community, it was a new company still working to gain traction.

This was not a merger among equals.

Both Steve and Cyrus obtained professional valuations for their companies and went into the discussions with realistic views of what each organization was worth. In fact, their opinions concerning value, post-merger salaries, ownership, and benefits were very similar and presented no major issues. The problem came when they looked down the road.

What if it didn't work out? Steve had the more established company and wanted to make sure that if push came to shove, he could buy Cyrus out of the business and return to life as he knew it before the merger. He had worked too hard to enter into a business marriage without reserving for himself the possibility of divorce.

Cyrus agreed that it made sense to contemplate separation if things did not work out. His fear, however, was that he did not want Steve to be able to buy him out if things were going too well. In other words, if the newly merged company really took off and the value of the company soared into the tens of millions or beyond, Cyrus, as the minority partner, did not want Steve to be able to kick him to the curb. Not that he thought Steve would do this, but you never really know, do you?

So there you had it: Steve wanted to make sure he had an escape hatch. Cyrus agreed that there should be an escape hatch, but he wanted it double locked and triple barred.

The two could agree on every issue when it came to joining forces. They simply could not agree on how they would separate if worse came to worse.

They shook hands and walked away friends.

The moral of the story?

When it comes to a merger, it is rare that both sides bring exactly the same monetary value to the table. Most often, one has more to lose than the other if things go south. By telling the story of the breakup first, Steve and Cyrus were able to focus their discussions on a very real issue that, if overlooked, could have been disastrous for both of them down the road.

While there are certainly many ways that companies in Steve and Cyrus' situation have resolved this issue, Steve and Cyrus could not find one to their liking. They could have agreed on a new valuation at the time one of them wanted the other to leave to which a hefty bonus could have been added, depending upon the circumstances of the departure. They could have reached an agreement on a limited number of causes that would justify termination in order to protect Cyrus from being asked to leave for no good reason other than the fact that Steve rolled over one morning and decided he no longer wanted a partner. In the end, and after considerable discussion, they simply could not agree on how the endgame would work. The good news is that they found out before they ever went to closing.

This is what I want for you. Whether, like Steve and Cyrus, you are considering merging two existing businesses or you have a business with a partnership in place or you haven't entered into a business partnership yet but are considering doing so, you need write the ending to your partnership story before it happens.

Get in the Right Mindset

In many ways, the thought process behind telling your partnership story before it happens is similar to that of writing a will. No one wants to contemplate his or her own death, but there you are in the lawyer's office deciding who gets the engagement ring and the prized baseball card collection and who is going to raise your kids. As morbid as it is, you think about your own funeral – not the good part where people stand up and say great things about you but the moments afterward; you envision the person who, after your death, becomes the steward of what you hold most precious. Who puts his or her arm around your young son or daughter and leads your child away after the funeral? That person isn't left to chance. As a parent, you give a great amount of thought to choosing the right person and the right environment.

That's the part that breaks your heart – imagining the first moments of a life totally different from the one you had planned.

You have to go through the same exercise in planning for the end of a partnership, even if the organization is going to go on.

Your task is to envision your partnership story the way you would want it to play out. Because only after you know the story you want written can you do all the things you need to do to settle in, take aim, and ensure that you hit the target.

The New Partnership

I've always been fascinated by the conversations that must take place before the signing of every prenuptial agreement. “Sweetheart,” I imagine one saying to the other, “this marriage will, of course, last forever. And I love you to the stars and back. But just in case it doesn’t, I want to make sure that what’s mine stays mine.”

Prenuptial agreements, by definition, are written with the end in mind…and in the most difficult of circumstances. Think about it. You’ve finally found your soulmate. The person you’re about to marry is someone you’ve searched for, for years, if not decades. There’s an excitement (I hope) about the upcoming commitment, and there’s planning for the future. And in the midst of all of this, you still have to contemplate and prepare for the end.

This is exactly the approach you should use for a new partnership. You have to steel yourself for what could be an unpleasant conversation in the whirl of excitement that seems always to surround a new venture. Don’t shrink from it. You’d be doing yourself and your soon-to-be partner a grave disservice if you do. You can’t let the awkwardness and possible tension keep you from doing what’s right.

After all, the experience of running a business is chock full of tough decisions and difficult conversations. What would it say about your readiness to set out on this adventure if you shrink from the very first, and perhaps most important, of those?

The Operating Partnership

This is a different mindset, but the result is the same. The business has been running fine, for years, if not decades. You’ve probably already engaged in some difficult conversations with your partner. Businesses have to adapt, and time brings challenges. If you’ve survived over the years, then you’ve figured out a way to meet those challenges head on. You’ve built value from nothing and can take pride in that.

Your success in lasting to this point brings with it its own mindset to overcome: “We’ve never had a partnership agreement, and we’ve been doing fine so far. If it ain’t broke, don’t fix it.”

As a business attorney, I’ve discussed partnership with people of this mindset many times. I never try to sell people on creating a partnership agreement. That’s a decision they have to come to on their own. I do, however, point out that nothing ever happens…until it does. You’ve never died, but you prepare for it by buying life insurance, writing a will, and maybe even making pre-need funeral arrangements. You may never have been disabled, but you purchase disability insurance.

“If it ain’t broke, don’t fix it” is not the same sentiment as “If it ain’t broke, don’t prepare to fix it.” Too many people confuse the two. Drafting a partnership agreement is all about being prepared for the inevitable. It’s not a look back; it’s a look forward.

Know the Characters

Partnerships are character-driven stories. To be complete, and to serve your interests, each story must account for the needs of everyone who has a stake in the outcome.

The Departing Partner

The driving motivation of the departing partner, or his family, is to reap the fruits of his labor. Whether someone worked for one year or for twenty years to build a business, he expended that effort in order to realize its value someday. This need becomes more acute in the event of a partner's death because the realization of full value becomes a vehicle for providing for the partner's spouse and family.

One of the givens in this situation is that, absent a formula or independent valuation, a departing partner's family will always overestimate the value of the partner's stake in the business. That's because the day-in, day-out effort is personal to the family, and no one wants to believe that the partner worked that hard for something other than a significant, significant sum.

As a result, what the departing partner needs is either the feeling of being justly rewarded or the certainty of a formula that leaves no doubt as to value. Uncertainty, even in the best of relationships, breeds discomfort and often suspicion.

The Remaining Partner

The remaining partner has a decision to make: whether to continue with the organization or to disband.

If she decides to disband, her interests become exactly those of the departing partner. If, however, she decides to continue with the business, she will be forced to address some real challenges.

First, the day-to-day challenges must be met. Just because a climactic event took place in the lives of the organization's principals doesn't mean that phones stop ringing or that customer needs are put on hold. If the departure is immediate, plans to reallocate the departing partner's workload must be put in place by 9:00 a.m. the next morning. Receptionists have to know what to tell callers, appointments must be scheduled, email and voicemail must be forwarded, and people throughout the organization must be told what's going on, lest they fill in the blanks with their own (sometimes wild) speculation.

Second, are the economic considerations. How much is the departing partner's stake in the organization worth? In other words, “What will we have to pay?” This is an important question, and it by no means implies callousness or self-dealing on the part of those remaining with the organization. Even as the remaining partner struggles to do the right thing by the one leaving, she has to know the size of the bill to be paid. As with any financial commitment, she needs to know the material terms:

- Amount of the principal
- Payment terms
- Interest rate (if any)
- Source of funds

Third, the remaining partner must decide on the structure of the organization moving forward. If there’s a hole to be filled, who’s going to fill it? Often, this means that the remaining partner will have to pick up key relationships that have been abruptly dropped. Getting out ahead of any potential problems by scheduling status meetings with key advisors such as bankers, lawyers, accountants, and insurance/bonding people is not something to put off.

In fact, many partners make the mistake of putting off these key meetings until “everything is settled.” The reality is that it will be quite some time before everything is settled, and there is no sin in meeting with consultants, one on one, at least to get the benefit of their thoughts and assure them that the issues left by the absence are in the process of being resolved.

The remaining partner, therefore, needs process.

She needs the certainty of knowing that the organization, and with it her financial life, is not stunned into a damaging and telling silence. There is a comfort in action, slow though it may be. The remaining partner may know that she intends to move forward, and she needs to take the first steps toward proving it.

The Organization

In the run-up to the 2012 presidential election, Republican nominee Mitt Romney famously responded to a protestor who was urging Romney to raise taxes on corporations if elected by saying that “corporations are people.” He was widely ridiculed for this statement, but lawyers knew he was right, at least in the legal sense.

Companies are recognized as entities under the law. They live and they die; they can sue and be sued; and they have rights of ownership and dominion. They also have needs.

In the case of an organization that’s continuing on despite the departure of a partner, the immediate needs, specified here, cannot be ignored:

- *Maintain cash flow.* It is the rare organization that can write a check for a significant part of its own value and continue operations, with sufficient resources, as if nothing had happened.

- *Attend to morale*. Generally speaking, employees have a lot riding on the health of the organization. They have their own mortgage payments, vacation plans, and retirement hopes to consider. As a result, when something rocks the boat, they tend to feel it immediately. At a time when the organization is already experiencing some instability, the worst thing would be for valuable employees to jump ship as well.
- *Assess the damage*. Partners often assume that they know what the other is doing, but often their assumptions are wrong. To assess the damage properly, direct reports need to provide input. Every file, order, contract, and project for which the departing partner played any role of real responsibility needs to be evaluated. Lists of the departing partner's critical relationships and job functions should be compiled. Exactly what the organization will be missing once the partner leaves the premises, or now that he or she has left, needs to be spelled out.
- *Plug the holes*. Even if the remaining partner temporarily can pick up the slack by working 60- to 80-hour weeks, that's not a long-term plan. An interim replacement should be assigned immediately. Think about it; that's what professional sports teams do when a coach leaves in the middle of a season.

Once the organization's immediate needs are met, a search for a permanent replacement should be started. As you well know, replacements for high-level employees and members of the management team can't be found on every street corner. A recruitment plan will have to be put into place and executed. Social media and outreach must also be addressed. It is the rare organization that does not maintain an online presence, let alone communicate via email. People tend to "touch" the organization electronically ten times for every one actual conversation or in-person visit. The organization must take a fresh look at, and make adjustments to, online bios, LinkedIn, and the administration of social media sites, especially if the departing principal had a hand in maintaining the voice of the organization online.

The organization needs continuity along with very visible evidence that its need for continuity is going to be met. What the organization needs, therefore, is not only good planning but also immediate execution.

The Customers

Customers are the first ones out of a shaky boat. Although they may care about your business, they care more about theirs. For that reason, customers are often first to search for safer ground in the event of trouble.

If the reason for the partner's departure is a tragedy, such as death or disability, customers are likely to cut the organization some slack at first, but that depends entirely on their deadlines. Neither you nor your organization is their first priority.

Customers need to know that they are going to be taken care of just as well as before. They need to be shown that the organization remains just as capable and responsive. Any uncertainty concerning who to call or who is in charge of the account must be immediately addressed.

Understand the Trigger Events

Now that you know the mindset you should employ and the characters you need to keep track of when writing your partnership story, it's time to get down to the plot.

Each partnership ending story starts with one occurrence, the "trigger event," that sets everything in motion. In each instance, the needs of all characters must be met in order to craft the best outcome – even when the story begins in tragedy.

Trigger Event: Death and Disability

More than any other trigger event, death or disability places the competing interests of the stakeholders in sharp relief.

The deceased or disabled partner's family is, predictably, devastated – and the lives of each member inalterably changed.

In the case of disability, the family probably is left wondering how they're going to pay for whatever continuing care will be necessary, particularly in the wake of the partner's loss of income. Unlike what happens in the event of a partner's death, the onset of a life-changing disability is not often accompanied by receipt of proceeds from a large insurance policy. The family of a suddenly disabled person often finds itself critically short of cash.

The family dealing with the death of a loved one and breadwinner may find itself less financially stressed because of the presence of insurance. Nevertheless, the loss of income still may remain a critical concern, particularly depending upon the life stages of dependents (kids going off to college, spouse nearing retirement, etc.).

In each case, it's likely that the family will be ignorant of, and therefore overestimate, the presumed value of the partner's holding in the company. As I said previously, sometimes the overestimation comes from witnessing firsthand the effort devoted to building the business. Sometimes, the overestimation arises from personal need (i.e., "His share *has* to be worth that much. It just has to."). I am not making a character judgment here. Even people of absolute integrity have sometimes been known to get stars in their eyes when doing mental calculations of the value of a company that a loved one has spent the better part of a lifetime building. It will be the job of the remaining partner to deal with that.

Once the emotional shock has worn off, the remaining partner faces critical economic issues. How is he going to ensure that the company continues, the work of the departed partner doesn't fall through the cracks, the departed partner's family receives what they are entitled to receive, the company hires an adequate replacement, and the organization still has enough capital to move forward safely?

These are huge issues, made more complicated still by the emotional overtones. It is inevitable that when a partner dies or becomes disabled, the remaining partner thinks, "There but for the grace of God go I." Although there are exceptions, to be sure, in the vast majority of instances I've seen remaining partners measure their actions against the standard of what they would want the others to do for their families. At the same time, however, they have a business to run, and organizations often do not have the cash on hand to write a check for a substantial part of their value while hiring a high-level replacement and continuing operations.

The money is only one of the questions to be addressed. The other comes in the form of equity. By "equity" I mean the departing partner's ownership interest in the organization, if any.

No one wants to suddenly find himself partners with someone's spouse (let alone ex-spouse), children, or best friend without that person(s) having undergone a thorough vetting process. This is perhaps the number one fear of a surviving partner – that he or she will involuntarily be thrust into partnership with someone unknown.

Therefore, the critical outcomes to this partnership story are as follows:

1. The organization pays out fair value to the family
2. The organization preserves enough value to reset and move forward
3. The departing partner and/or his family receive everything to which they are entitled
4. No part of the company's ownership is thrown into question

Where death and disability of a partner are concerned, that's your endgame – so write the death and disability story to make sure those outcomes are possible.

Trigger Event: Voluntary Termination (a.k.a. Walking Away)

There's an old saying that, I believe, captures the guidelines for how partners should behave in their partnership in a nutshell: "Your right to swing your fist ends where my nose begins." In the context of partnership, it means that a partner is always free to leave the company, but that decision should not place the other partner or the organization at risk. Your job is to write the story that shows how this kind of departure would work.

Imagine that your partner, someone beside whom you worked day in and day out to build the company, walked into your office on Tuesday afternoon and told you that she was hitting the road by Wednesday morning. In shock, you wander down to her office to find that the pictures have been taken from the walls and that she has boxed up her personal effects. It's almost like a death, but there is also the very real, even if subconscious, possibility of resentment. Very likely, the following questions run through your mind:

- What am I going to do?
- What is the company going to do?
- What am I going to tell the employees? The customers?
- How much money do I owe her?
- What is she entitled to?
- How will I replace her?

If the answers to each of these questions have one thing in common, it's that they would be better given sufficient time to prepare. Accordingly, your first priority in writing the end of the voluntary termination story is to make sufficient notice mandatory.

To be sure, you can't hold someone hostage. No one is going to be handcuffed to her desk. Your partner can walk out the door at any moment of her choosing. If you write your partnership story properly, however, she would know that walking out the door without providing sufficient notice is extremely adverse to her own interest.

Trust in God, but Lock Your Car

Almost every time I mention the "what if someone quits without notice" scenario to clients, they smile knowingly and tell me that neither one of them would leave the other in a lurch. I recognize that. Although cynical, I certainly understand that pulling up stakes on a moment's notice is not something people of good character do to their partners who are depending on them. Life, however, has a way of interfering with even the best of intentions.

Recently, a client called me with a problem. He was a day late; I had already ready about it in the newspaper. His son had taken a weapon to school and committed a violent action, hurting a number of people. My client had far more important things to attend to than the running of a company, and he was as good as gone the instant he heard from the police.

That's an extreme, but things happen. You can trust the other person all you want, and for good reason. But at night, lock your car.

The first thing you know you will need if your partner actually decides to leave is time. What you really want, though, is for your partner to realize, on her own, that she has every reason to stay.

This means that partners should have to pay a price to leave early – "early" having been defined by the principals of the company in their agreement. Partners can leave early, but it will cost them.

As we will discuss later, the easiest and most common solution is to make sure that the partnership agreement contains a penalty for early departure. For example, the partner leaving early will be bought out, but she will receive only a fraction of the value of her holding in the organization and that fraction will be received over a long-term payout, rather than all at once.

Trigger Event: Retirement

Retirement is a voluntary termination after a certain period. Partners together may decide that although an early departure justifies a discounted purchase price, ten years spent building the company is long enough to merit a buyout at 100% of the value. And that figure could be anything – 10 years, 20 years, 9 ½ years. There's no hard and fast rule. Retirement can be set at any point, with the best guideline being that point at which the partners collectively believe a full buyout is warranted in light of time served.

It's worth discussing that some people get hung up on the word "retirement." I'm not using the term to imply that the retiring partner must ride off into the sunset, never to work again. It's simply a shorthand term to distinguish a departure that takes place after a partner has devoted his or her fair share of time to building the company from a departure that fits the partners' definition of an early departure.

My recommendation for defining retirement is that it not be tied to age. Remember my example of a company co-owned by a 45-year-old and a 25-year-old? If they established the age of retirement at 65, the younger partner would have to devote 40 years to achieve the buyout earned by the older partner in half that time.

Retirement is about fairness, not about age or lifestyle. So, write the retirement story to be fair to all partners. Think about the time, possibly far into the future, when one of your number walks into your office and tells you he's tired and wants to scale back. He tells you that he knows his share of the company is worth $1,500,000 and he's looking forward to using that money to set up his flip-flop shack on a beach somewhere. How will you feel?

Sad, of course. Maybe a little bit lost. Those feelings are natural. But would you also feel that he's earned it – that a full buyout is fair? Or would you feel that he's taking advantage? Let's say that your partner has already put 40 years into the business. You'd think retirement was fair, wouldn't you? You may hate to see him go, but the rational part of you – the unemotional part – would whisper that he earned it.

But what if he's only put in three years? What would that rational, unemotional part say then? I'm guessing, of course, but I think it would be saying, "He can go, but there's no way he's getting his full share. We got into this thing for a lot longer than three years." What's more, I'm betting that that part of your brain wouldn't be whispering. I'm betting it would be expressing a full-throat yell.

Find the point at which each of you would know that a full buyout was earned, rather than extorted. That's the point at which voluntary termination becomes retirement.

Trigger Event: Involuntary Termination

The decision to fire a partner is nothing if not a slow burn. Most of the time, the first call I get is from a member of the management team, in confidence, asking whether a partner can be fired at all. To be sure, there is a difference between employment and ownership. That distinction, however, can be relatively insignificant if no documentation is put in place to answer the question.

Even if a partner can be fired, it typically takes a long time for the rest of the management team to decide to act. The more extreme examples, such as the following ones, lead to the easiest decisions:

- Conviction of a felony
- Loss of vital certification (such as debarment from government contracts)
- Embezzlement from the company
- Taking business "on the side" that should have come to the company
- Extended, unexplained, and unjustified absences
- Fraud

If a partner can be fired, then the events that give rise to termination are such that the offending partner would not deserve a 100% buyout. After all, would you want to pay someone full value for his stock even after you'd just found out he had embezzled hundreds of thousands of dollars from the company? Chances are, probably not.

The exercise of writing the involuntary termination story is when you really have to think about that call to your lawyer. What are those events that would cause you to see no other option than to kick someone out of the club?

Imagine the conversation. After the pleasantries, once you get down to business, you finally unload: *"Either she goes or I go!"* you practically yell at your attorney.

So worked up are you that you barely hear his response: "Tell me why."

That's when you do it. You start wherever you deem the beginning to be and you leave no detail out. Your story builds to the conclusion with which you opened the conversation…only this time you state it more calmly: "Either she goes or I go. I have no other choice."

Now comes the hard part. Think about the events or circumstances that would lead up to that conclusion. We discussed some of the easy ones – embezzlement, felony convictions, and the like. But what about the gray areas, such as these?

- What if you're working 80 hours a week and your partner is barely putting in 30? Is that enough to kick someone out?
- What happens if you're bringing in the lion's share of the business, and for whatever reason, your partner just keeps striking out? He's a great guy, but for some reason incredibly ineffective.
- What if, several years in, you just can't stand to be in the same room with him? Perhaps a civil word hasn't passed between the two of you in years.
- What if you need money to expand, or even just to sustain operations, and your partner refuses to put money in or sign a guarantee to enable you to obtain a larger line of credit? Can one of you be fired for having a different risk tolerance?
- What happens if the employees all hate him? The two of you are, to quote Forrest Gump, like "peas and carrots," but people just don't stay. Worse, every single one of them cites your partner as the reason he can no longer remain with the company. Would there come a time when enough is enough?

Sometimes, maybe even most of the time, partners agree that they'll just have to trust each other to work out differences or to know when the time has come to part ways. There's nothing wrong with that answer – as long as each partner has written the story of that phone call.

If you can act out every word of that frustrated, anguished "get me out of this" call to your lawyer and you're still willing to enter into an agreement that protects you from only a few, if any, of those circumstances, then get out your pen and sign. I can't tell you that would be a mistake. The only thing that would qualify as a mistake is if you didn't play out the entire phone call in advance – many, many times.

Now that you understand the potential plotlines of the partnership story, let's discuss how a partnership agreement should work.

PART II: AIM

CHAPTER 4:

How Your Partnership Agreement Should Work

Regardless of the trigger event, the critical components of a partnership agreement are these:

- Whether sale is mandatory
- Valuation
- Purchase price
- How purchase price is going to be paid
- Timing
- Disputes

Let's look more closely at each component.

Should Sale Be Mandatory?

Although companies may make different decisions based upon individual circumstances, I almost always recommend a mandatory sale in the event of the death or disability of a partner. It is the rare organization indeed whose members do not mind having a stranger take up the reigns as a new partner by virtue of a deceased partner's will or power of attorney. Absent a compelling reason to the contrary, that's my recommendation – make an immediate transfer mandatory.

Valuation

Once you have decided that a transfer is going to take place, you must tackle the issue of valuation. After all, how can you buy something if you don't know the price? There are any number of ways approach this, and it is beyond the scope of this book to list all of them, let alone go into detail about each method. I will, however, touch upon them with broad brushstrokes.

Agreed Value

When the subject comes up, a lot of clients tell me that the partners will simply get together every year and agree on a value for the company. If, for example, they decide the company is worth $4,000,000, then that means that the purchase price for a 25% interest would be $1,000,000. Simple math – no muss, no fuss.

It sounds simple, right? The problem is that it usually doesn't work.

Despite the best of intentions, the partners never actually meet to discuss value. Sure, they may get together the first time, and maybe even the second, but that's where it stops. This can be a problem for a growing company.

Take, for example, a case in which partners decide at the outset to value their company at $1,000,000. Time goes by, and they become absorbed with front-burner concerns while the buy-sell agreement lies in a drawer. Then, when a trigger event occurs 14 years down the road, the binding agreement that the partners signed holds the company's value at $1,000,000 – even though it's now worth $12,000,000 at a minimum. This means that a 25% partner who actually would have been due the tidy sum of $3,000,000 instead would be paid $250,000 for his share of the company.

If partners are insistent upon using this method, I always insist they have a backup plan. The agreement must provide that if the partners failed to establish a stipulated value within 12 months prior to the trigger event, the previously agreed number would be thrown out and a second valuation method would be employed.

Formula

Using a formula, established with the help of an accountant or other valuation professional, is a very common valuation method.

The formula can be anything you want it to be. You can decide that the company will be valued at three times the average earnings over the prior six years, a multiple of EBIDTA[4], a function of accounts receivable, or anything else you and your consultants deem appropriate.

The benefit of this approach is that the company's value can be determined at any time based upon the most recent numbers. The challenge, of course, is to make sure that the formula does not become subject to dramatic fluctuations based upon temporary conditions.

Let's take the case of American Roofing Corporation (ARC).

ARC was a $10,000,000-a-year company. Year in and year out, ARC's gross annual revenue hovered around the $10,000,000 mark. Then 20 years after its founding, two huge hurricanes hit Florida within one week of each other. The U.S. government, through FEMA, began giving out huge contracts to any roofing company with feet on the ground in the affected area. In the space of one month, ARC signed four $10,000,000 contracts and began hiring every carbon-based life-form in the tristate area.

If ARC had a formula that did not take into account wild fluctuations but instead focused solely on the numbers at the time of the trigger event, then any partner wishing to jump ship (or unfortunate enough not to be given a choice) would realize an artificially inflated value for his or her stock.

[4] Earnings before interest, depreciation, taxes, and amortization.

As long as the formula takes into account possible fluctuations, stands the test of time, and when tested with real numbers actually yields a value commensurate with the partners' current expectations, using a formula may very well be the way to go.

Texas Buyout

When my two sons were younger and they found themselves fighting over the last piece of cake or the last slice of pizza, my wife and I told them that one of them could cut the piece into two, but the other one would get to choose which piece he took. I can't take credit for that as an original solution, but I can tell you that it worked. Whoever was making the cut took pains to ensure it was right down the middle because he never knew which side he was going to get.

Some companies apply the same protocol to their buy-sell agreements. If the partners decide that they simply no longer can work together but cannot reach agreement as to who will buy the other one out, then the partners resort to what has become known as a "Texas Buyout."

In this scenario, the initiating partner proposes a purchase price to the other. The receiving partner gets to decide whether he is going to be the buyer or the seller at that price.

In theory, it sounds fair. What's more, it has that exciting game show quality to it. The problem is that it rarely works out well in the real world because the partners playing the game are not always on the same economic footing. Consider the following example.

Recently, the principals of a health benefits company came to me asking about incorporating this scenario into their buy-sell agreement. The problem that I could see developing down the road arose from each partner's lifestyle. One was in his early thirties, unmarried with no children. The other was in his mid-forties, married with a hefty mortgage and two kids in private school. Which one do you think would be more likely to have available cash down the road?

Considering the end of the story first, I could easily see a scenario in which one of the partners decided to invoke the Texas Buyout. Let's say that the value of the company at that time had grown to $5,000,000 so that in a vacuum, the fair price for a 50% share absent any discounts would be $2,500,000. The younger partner, single and unencumbered, was much more likely to have greater resources. He and his partner were making identical salaries. The younger partner, however, could put most of his salary away, while the older partner's lifestyle made him lucky to save 5% of his.

Five years down the road, the younger partner would have much more cash and borrowing capacity than the older partner. As a consequence, if he wanted to, the younger partner could offer a purchase price significantly lower than the true value of the older partner's 50% share and basically dare him to match it through the Texas

Buyout. The younger partner would know that the older partner could not possibly amass the resources to be the buyer and therefore instead would wind up selling at a huge discount.

I realize, certainly, that most people would have more scruples than to pay less than a fair price by taking advantage of the other's economic situation. But, as I've said many times, particularly in my book *Fire, Aim…Ready for Contracts*, the goal of a good agreement is not merely to effectuate the best but also to protect against the worst. If partners decide that they want to incorporate the Texas Buyout into their agreement, I recommend that they do so with certain limitations. For example, we build in a provision that establishes a floor on the purchase price that is tied to a percentage of an appraised value or the result of a formula. That way, partners can use the mechanism of the Texas Buyout to adjust the purchase price but still ensure that a disparity in economic conditions will not leave one partner facing the prospect of realizing something far less than the true value of his or her share.

Appraisal

Sometimes partners choose not to include a value in the agreement but rather to leave the question of valuation to qualified professionals when the need arises.

There are many reasons for this decision. Sometimes a company's growth path is uncertain, and the partners are no surer of a formula that can stand the test of time than they are of an agreed-upon value.

Whatever the reason, it is a perfectly valid decision to provide that a valuation professional, with appropriate credentials and experience in the company's industry, be engaged to perform an appraisal and issue a report.

Subject to a dispute (discussed below), the valuation report will be used to determine the purchase price of the company as well as the share being sold.

The primary drawback to this method is the cost. Depending upon the size of the company, its geographic footprint, and its industry, an appraisal may cost $10,000 or more. Many companies are reluctant to spend that kind of money, especially when dealing with the turmoil of a partner's exit. If the company does decide to go forward with an appraisal, then the following points should be considered when drafting the agreement.

Valuing the Effected Partner's Share

It is important to understand the distinction between a valuation of the company as a whole and a valuation of the effected partner's interests. One might think that it is a simple math problem. A $4,000,000 company would yield a $1,000,000 for each 25% interest. To be sure, the principals can decide that that's the way it would work, but that's not always the case.

Discounts

This is yet another key decision that partners must make in determining the valuation of an effected partner's share. Do discounts apply or is the value to be determined by straight percentage? If the principals intend that no discounts should be taken or that only one of these discounts should be considered a contributing factor, they should state their intentions plainly in the agreement.

Minority Discounts

Discounts routinely are applied to the particular partnership interests that comprise less than the percentage required to exercise control over the company.

For example, let's say that every decision in a certain company can be determined by majority vote. No matter how adamantly a 49% partner (a partner with a "minority share," any amount less than half the company) disagrees with the decision, his concerns can always be overridden by the partner holding 51% (the partner with the "majority share").

Of course, a majority share is more valuable than a minority interest, and often by a lot more than the two percent difference between them. The owner of a majority interest can make decisions. The owner of a minority interest cannot.

As a result, many appraisers would apply a "minority discount" reflecting the lack of control.

If we take the example of the $4,000,000 company divided into 25% interest, then it may be that each interest, taken individually, would be valued not at $1,000,000 but rather at $900,000 once the minority discount is put into effect. That's because the value of owning 25% is reduced due to the possibility that an existing partner could outvote you if she wanted to. People perceive, correctly, that it's riskier to own 25% or even 49% of a company than it is to own 51%.

Imagine, for example, that you owned 49% of a company and that you were looking for that last 2% that would put you over the top. If you acquired just 2% more, you'd be able to call all of the shots. How much would you pay for that 2% in a company worth, say, $1,000,000? Would the price tag be limited to just .02 x $1,000,000 or $20,000? Probably not. Depending on the company, some people might pay $50,000 or even $100,000 for that last 2%.

So, as you can see, all percentages are not created equal. Sometimes, a 10% share is worth exactly one tenth of the overall value of the company. Sometimes it's worth more than that. Often, it's worth less. When it's worth less, the reduction in value is called a "minority discount."

If applied, minority discounts can run anywhere from 5% to 50%, depending upon the company's industry and the perceived disadvantage inherent in owning a minority share.

Lack of Marketability Discounts

Another discount that may be applied to the valuation of an effected partner's interest is known as the "discount for lack of marketability."

Certainly, no discount of this nature would be applied to the stock of a company on the stock exchange such as Apple® or Disney®, as the stock of publicly traded companies is bought and sold continuously. However, typically there is not much of a market of ready buyers for the stock of a privately held company, such as ABC Landscaping. Just as with a commodity like a house or a car, the price often has to be discounted when there are fewer buyers. This is what's known as the discount for lack of marketability.

Similar to the minority discount explained above, this discount could run anywhere from minimal to substantial, depending upon the industry.

Disputes

Most agreements that provide for the performance of an appraisal at the time a trigger event occurs also provide a method for disputing that appraisal if one side or the other thinks the appraisal is way off base. Typically, the objecting party may hire, at his or her own expense, another qualified valuation expert to go through the same exercise.

Agreements often provide that if the two results are within a certain percentage of each other, then the appraisal commissioned by the company will be deemed to control. They also may provide that if there is a larger than acceptable disparity between the two, then one of these conditions be met:

1. The two appraisals be averaged
2. The two appraisers appoint a third appraiser to conduct what then would be a conclusive appraisal

Purchase Price

Value is not the same as price (leave it to lawyers – and economists – to complicate things). The price of a partner's interest is determined, in large part, by the reason for the partner's departure.

Let's take an example of a partner who is being shown the door because he was convicted of embezzling money from the company. The remaining partner would not want to pay him the full value of his partnership share just to hurry his departure. It is perfectly justifiable to write a partnership agreement that specifies that the purchase price for a partner who leaves involuntarily (meaning fired for cause) will be only 50% of what would otherwise be the value of that partner's share.

Here's the way purchase price typically breaks down within each trigger event scenario:

Trigger Event	% of Valuation that Is Deemed the Purchase Price	Rationale
Death	100%	In the event that a partner dies, his or her beneficiaries normally receive 100% of the value of the partner's interests because everyone would want the same for his or her family.
Disability	100%	Sometimes – even more than in the case of a death – the disabled partner's family needs the money. Because again, everyone in that person's shoes would want the same, companies typically provide that the purchase price equals 100% of the value of the disabled partner's interest.
Voluntary Departure	60% to 90%	When a partner decides to leave, he or she should receive a purchase price commensurate with the value of his or her interest. A discount should be taken, however, and this discount should provide an incentive for each partner to stay. Additionally, no one wants to provide individual partners with an incentive to time their exit to sync with the securing of one big contract. Many companies use a sliding scale to increase the percentage received by the departing partner, making it in line with the number of years a partner remains at the company.
Involuntary Termination	40% to 75%	It is usually understood that even someone fired for cause should receive an amount of money reflecting his or her contributions to the company. A heavy discount should be taken by the departing partner, however, to reflect the very limited circumstances that would result in a termination for cause.

Retirement	100%	This is the top level of a payout for a voluntary departure. Prior to any departure, the partners together decide what amount of time is "long enough" to justify a 100% purchase price.

Note that the comments and values reflected above are based on my experience working with countless small to midsize businesses across a wide variety of industries. They do not, by a long shot, represent the only answers to these questions, but they should provide a guideline for how a lot of other companies address these issues.

Payment

Once a purchase price has been determined, partners must decide how it is to be paid.

It is the rare company that can write a check for a significant piece of its value. A company with a $1,000,000 value will be hard pressed to write a check for $250,000 on a moment's notice. Few companies carry that kind of cash. As a result, a payment method should be assigned to each type of departure.

Where retirement, voluntary termination, and involuntary termination are concerned, the partnership agreement typically will provide for a long-term payout, anywhere from five to twenty years, through monthly or quarterly payments. It is important that the agreement contain very specific instructions regarding the frequency of payments, the interest rate (if any), and what happens if the payments are not made on time. Frequently, a template for the promissory note that will be used to document the payout is attached to the agreement in order to remove all doubt as to the language and terms that will be used.

In the event of a death, payment often can be made much more quickly if the company has secured what is known as "key man insurance" on the life of each partner. Then, the partnership agreement could provide that the entirety of the insurance proceeds up to the value of the deceased partner's interest would be used to buy that partner's stock as soon as the proceeds become available. Any remaining balance would be paid over time.

There are also key man disability policies, though they are far less common. If the company secures this type of policy, then the same payout formula would apply – the proceeds would be paid immediately up to the amount of the purchase price, and any balance would be paid over time. If there is no insurance policy with which the bulk or entirety of the purchase price could be paid immediately, then often companies provide that payment be rendered on a shorter term than those for other departures.

Timing

The partnership agreement should provide guidance as to when each of the necessary steps will be executed. Typically, companies would like the issue of stock ownership to be resolved no later than 6 months from the trigger event. This means that if an appraisal is to be secured, the appraiser should be appointed within a certain period of time – often 30 to 60 days. In any case, a timeline drafted into the agreement will assure all sides that vital issues will be addressed in a timely fashion.

CHAPTER 5:

Why Reaching an Agreement Will Take Longer than You Think

Every partnership discussion has deal breakers. Even for people who feel that they have fully vetted the issues and are convinced that they've reached agreement on all material points, there are deal breakers. The potential partners just don't know all of the issues they should have discussed before walking into their lawyer's office.

What follows is a discussion of the issues that, in my experience, leave most current or would-be partners hemming and hawing.

What Can Be Done over Your Objection?

Lawyers typically open the partnership discussion using words like "voting rights," "governance," and "control." In plain English, the question being posed to each partner is this: What can be done over your objection?

Extraordinary Actions Versus Ordinary Course Decisions

Typically, a company's decisions can be divided into two categories:

1. Decisions in the ordinary course of business
2. Decisions on extraordinary actions

Decisions in the ordinary course of business include things that fall into the more mundane – buying office supplies, signing contracts, bidding on projects that are typical for the business in both size and scope, deciding normal raises and promotions, and choosing where to hold the company's annual holiday dinner.

Extraordinary actions, on the other hand, include those that for most businesses would require a full partnership vote, as well as those that are specific to the nature and size of the particular business being discussed. Actions typically deemed extraordinary include these:

- Liquidating the company
- Merging the company
- Expanding to another state or country
- Bringing on another partner
- Firing a partner (if possible)
- Taking the company public
- Filing for bankruptcy
- Creating a subsidiary
- Changing the company's tax status

Few would dispute that the decisions listed above, and others like them, are "extraordinary" and would merit full consideration by the partners.

Other decisions are not as clear-cut and depend heavily upon the size of the business, each partner's appetite for risk, and the group's trust in the judgment and discretion of the partner placed in charge of the company's day-to-day affairs. Such decisions on the fence may be these:

- *Committing more than a certain amount to a new employee's salary.* The partners may be happy to designate the hiring of a $30,000-per-year receptionist an ordinary decision, but committing six figures to the next business development rock star may require discussion of a more global nature.

- *Signing a contract above a certain amount.* Every contract carries risk. Take, for example, a company that signs $20,000 contracts day in and day out. For that company, the execution of another $20,000 contract is something that occurs in the ordinary course. A $200,000 contract, however, merits discussion and could be categorized as "extraordinary." For some companies, that threshold is a million dollars or ten million dollars. For others, commitments in excess of $10,000 require a full vote.

- *Signing a lease, even without personal guarantees.* Commercial leases tend to be three- to five-year commitments at a minimum. The typical lease requires that all amounts due through the end of the lease are paid in the event of a default. This means a company better think long and hard before opening itself up to hundreds of thousands or millions of dollars in liability.

- *Transferring an ownership share.* Some companies allow partners absolute freedom in transferring part of their ownership share to family members, to a trust established for estate planning purposes, or even to third parties, provided that the third party meets certain requirements. Most commonly, companies maintain very tight control of ownership. In their partnership agreement, partners should specify when permission from the entire partnership is required and when it's not.

- *Making a capital purchase.* For construction companies, a major purchase might be a backhoe or different large piece of yellow metal. For other companies, it could be a truck, a printing press, or a parking lot. Whatever the case, partners often determine a threshold limit beyond which a perspective purchase must be discussed.

- *Amending the agreement.* It is not only a foolish oversight but also legal malpractice for an attorney representing a minority partner if a fully negotiated agreement that provides protections to various minority partners is drafted in such a way that it could be fully revised at the whim of the majority. Amending the agreement to alter the rights and responsibilities of the partners typically requires a very high percentage of the partners' approval, if not absolute unanimity.

What Is a Majority?

A distinction between decisions made in the ordinary course and those made regarding extraordinary actions answers only part of the question, "What can be done over your objection?" This distinction addresses what the "managing partner" can do without seeking a vote or bringing the issue to the other partners.

The next question to be answered is, "How does an extraordinary action get approved?"

For example, if the company can make any decision, including those pertaining to extraordinary actions, with an affirmative vote of over 50%, then when a 49% partner asks, "What can be done over my objection?" the answer is, "Everything."

Most companies do not operate this way. In fact, most minority shareholders insist that some safeguards be put in place so that the answer to the question is not "everything."

A company may decide that decisions in the ordinary course require only an affirmative vote of more than 50% of the ownership but that approval of extraordinary actions require an affirmative vote of 75%, a "supermajority."

The math is important. If ownership of a company is divided 51%/49% between two partners, then a supermajority of 75% effectively requires unanimous approval. If, however, a company has ten partners each with an equal 10% ownership share, then a supermajority requiring 75% approval means that the action in question can be taken over the objection of two partners.

Companies can designate a supermajority to be whatever they want it to be, 87%, 75%, 53%, or any other percentage. It doesn't matter. Care must be taken, however, to walk the line between protecting the rights of minority shareholders on the one hand and risking tyranny of the minority on the other.

If, for example, a company agreed that extraordinary actions would require unanimous approval, and one partner held 98% of the ownership while another held 2%, the partner holding 2% would effectively control the destiny of the company for all extraordinary actions. Nothing of a significant nature could be done without her approval.

As I shared previously, in terms of the law, my right to swing my fist ends where your nose begins.

Law, like every agreement, is a question of balance. Each party to an agreement may have the right to swing his or her fist, but that right is not unlimited. The right to swing one's fist ends at the point where it impacts the safety of another.

For example, a company may give a managing partner discretion to change various banking arrangements. If, however, the partners had been required to execute personal guarantees, the managing partner should not be able to increase the credit limits (thereby increasing the exposure of each partner) without obtaining the approval of each partner.

Even where personal guarantees are not present, partners who devote a significant amount of time and money to the company or who depend on the company to maintain their lifestyle should be given a role in approving potentially company-breaking decisions.

Can You Be Fired?

Previously, we established that a partner can, indeed, be fired, so let's explore further where this line is drawn.

If the answer to the question, "Can a partner be fired for habitually coming in late, leaving early, and taking three-hour lunches?" is "yes," then you can drill down still further into what each partner expects of the other in terms of productivity, effort, and results.

Sometimes, perhaps even most of the time, a partner only can be fired over something egregious and not because of a real or perceived lack of productivity. Sometimes the partners want to drill down to specific quotas. Whatever the case, the question of whether a partner can be kicked out of the company is important and must be addressed.

Do You Have to Sell Your Shares Back If You Leave the Company?

Most of the time, the answer is yes.

Except in the case of a publicly traded company, or one that is trending in that direction, most people do not like the thought of sending a percentage of their profit to someone no longer working to build the business. Usually, as long as they are to receive fair value for their share when they sell, the partners agree that employment and ownership go hand in hand.

Nevertheless, when you find someone opposed to this notion, his or her opinion is usually firmly entrenched. Often it's an older partner who looks at the continuing stream of income as necessary or desirable in retirement. It is crucial that this issue be addressed and put to bed before an agreement can be signed.

Even if a departing partner is allowed to keep an ownership share, say in retirement, the company should strongly consider converting the stock to a non-voting class. The retiring partner may be interested in, due, and worthy of a continuing income stream but would hardly be knowledgeable enough about the company's affairs to cast a vote on important decisions.

Can You Be Forced to Meet a Cash Call?

There are many reasons a company could need more cash: expansion, cash flow shortage, mobilization for a large project, or simply weathering tough times. The first place to look, especially if borrowing power is at a minimum, would be to the partners' personal assets. What happens then?

One company I worked with knew that one of the partners, a 60% owner, was more expansion minded than the other. Further, they knew that the company would have to spend an additional $2,000,000 in order to expand with any hope of gaining a foothold in a new territory.

The 40% partner was more conservative. She didn't want to expand and felt that the company was providing both partners with a nice income and had good prospects as it currently stood.

This was a situation in which reasonable people could and did disagree. Expansion is not an initiative to be taken lightly, and both partners had considered the factors carefully and arrived at different conclusions.

They agreed to move forward only if they could find a funding solution that respected both partners' perspectives. What's more, they knew that their solution would have to satisfy the bank's conditions for lending the money.

You see, as a practical matter, most banks would insist upon personal guarantees from the stockholders and possibly their spouses. That condition may not be met if someone holding a 40% interest in the company doesn't want to sign on the dotted line. In that situation, another solution would have to be reached.

In this case, if the 60% partner put up personal collateral so that he was the only one signing, he wanted to make sure that he was commensurately rewarded once the expansion began paying off. However, the 40% partner did not want to sign a personal guarantee and did not want her share in the company to be diluted. Further, she didn't want to risk losing the company or tapping its cash reserves in the event that the expansion did not go as planned.

The partners were able to resolve the funding issue by using a subsidiary with a different ownership structure for the expansion and working out a few other issues with a new bank.

This example demonstrates why the cash call issue must be addressed in the stockholders' agreement. Who would want to be mandated to post a personal guarantee or put up additional cash without consent?

Can Your Ownership Share Be Diluted?

Let's once again take the example of a 60/40 partnership. In this example, the company has issued 100 shares, divided proportionately. The question is whether the 60% partner, on his own, could vote to have the company issue another 100 shares to be divided among two additional partners.

There are many reasons a company would want to do this – primarily to attract cash. If the 60% partner is able to do this on his own, without the approval of the minority partner, it would mean that the 40% partner's share would be diluted without her consent from 40% to 20% as she now would own 40 shares out of 200.

Typically, the issuance of new shares and the addition of new partners fit within the extraordinary actions we talked about earlier. But even so, everyone contemplating entry into a partnership should determine whether the percentage of the company he starts out with can be decreased without his consent.

Should Your Agreement Contain Restrictive Covenants?

"Restrictive covenant" is a legal term that's easily explained by the following statements:

- A "covenant" is a promise concerning future performance
- A "restrictive covenant," therefore, is a promise that restricts someone's future activities

Employers often try to protect their interests by placing restrictive covenants in employment agreements. True to their name, restrictive covenants prohibit employees from taking certain actions or engaging in certain activities during or subsequent to employment.

Partners also frequently are asked to sign restrictive covenants. The reasoning is simple.

Imagine a situation in which your partner has given notice. According to the buy-sell agreement, your partner will earn a handsome payout. The last thing you want is for that money to be used to fund the start-up of a competitor.

Of course, as I've said previously, the sword cuts both ways.

Just as the remaining partner would want to make sure that the departing partner does not set up a competitor, the departing partner may not want any restrictions on her future activities. She may reason that she put in her time and earned her money. What she does after departure is no one's business but her own.

There are three types of restrictive covenants commonly used (or at least considered) in partnership agreements:

1. Confidentiality
2. Non-competition
3. Non-solicitation

A detailed discussion of each type of restrictive covenant is beyond the scope of this book but is covered more completely in my book, *Ready, Aim…Fire: People*. For the purpose of this discussion, you should be aware of the following definitions and distinctions.

Confidentiality

A confidentiality provision is typically the least objectionable of the three restrictive covenants.

It provides that a departing partner must keep company information confidential. She would not be able to disclose it to other people or use it in the formation of her own business. The term "confidential information" would have to be defined to cover the particular type of information the partnership would not want to see fall into the public domain.

Partners typically do not object to the inclusion of confidentiality provisions in partnership agreements because they make sense and they carry very little risk. They also, for the most part, have no real teeth.

If you sued somebody for breaching a confidentiality provision, your damages would be hard to prove. Even if you knew for a fact (and could prove beyond a reasonable doubt) that a former partner had disclosed your company's proprietary information, you might find it difficult to answer a judge's "so what?" question. What damages resulted from the breach? Can you prove a cause and effect relationship between your company's loss and the ex-partner's disclosure?

For this reason, most companies view confidentiality provisions more as a deterrent than as the basis for future litigation.

Non-Competition

Unlike a confidentiality provision, the insertion of a covenant restricting competition is often the subject of heated exchange.

A non-competition agreement provides that a departing partner would not be able to undertake any role in an organization that competes with any aspect of the company's business for a certain period of time and within a reasonable geographic footprint. The reason that this often inspires intense emotion is that the effect of non-competition agreements can be significant.

Imagine a plumbing company in which the principals spent most of their professional careers in the plumbing field. A partner leaves after 20 years because he wants to move on from the business, but he is not yet ready to ride off into the sunset. He envisions that he might want to step back and take on a different role at another company. Consider that he has spent his entire professional life in the plumbing industry. If despite having worked for decades to build his company, he has to abide by a non-competition agreement that makes it so he has move out of state to take even a small, part-time consulting position in the only trade he knows, then you can see why he might be a little upset.

At the same time, it's logical to assume that after decades in the business, the departing partner has built strong relationships with his company's key customers and vendors. There is no way that the remaining partner would want to pay him to leave and take those relationships to another organization. He can't, the reasoning goes, have his cake and eat it to. He can't receive his payout and then receive an income for injuring the cash flow of the company that is providing it.

People tend to dig their heels in regarding their position on this, and often, the agreement discussion hinges upon the definition of the word "competition" and the dimensions of the geographic footprint. Both limitations have to be reasonable, as does the duration of the restriction, but different people tend to have vastly different ideas as to what actually constitutes "reasonable."

Non-Solicitation

Whereas non-competition agreements are a shotgun, non-solicitation agreements are a laser.

A non-competition agreement provides that "within whatever territory we name, you can't set up any business that would take any money for doing anything that competes with our company." A non-solicitation agreement, on the other hand, allows the departing partner to set up a competitive business right next door as long as he doesn't take or solicit any of the company's employees, customers, or active prospects.

Just as with non-competition agreements, the scope of non-solicitation agreements is fertile ground for negotiation. Suffice it to say that there are many possible options, provided that the partners at least agree to the establishment of some type of post-termination restriction.

What Do You Want the Future to Look Like?

There is no better time to envision the ending of your story first than when considering whether or not restrictive covenants should be included in your partnership agreement.

Partners should decide, together, what exactly they need to protect in order to ensure that the business can keep running long after someone leaves. Are all customer relationships vital or does the business depend on one-time transactions or purchases determined solely by price?

If the business depends upon the maintenance of ten key relationships, for example, then each of those relationships is vital. If, however, the business is a discount store that competes only on price, customers' relationship with the partners is much less important than the following associated with the company's brand.

Using Restrictive Covenants to Cut Down on Competition – The Story of Rough Cut Lumber

Rough Cut Lumber supplied wood and related products to consumers and contractors throughout the mid-Atlantic area. It was owned equally by two partners. Jane ran the back office. She was responsible for everything from HR to taxes and kept the operation running smoothly. Jim's role was business development. He cultivated relationships with contractors and retail outlets throughout a very large territory.

Jane did not mind the prospect of a restrictive covenant. She didn't have to compete with the company as she could ply her trade in any industry. Jim, however, was extremely concerned that if he left the company he would not be able to earn a living. He had spent most of his professional life building relationships in the construction industry. Should he leave the company, he did not want to have to move his family to the Midwest (or beyond) in order to work, and he could not envision switching to another industry after all these years. He had no intention of trying to undermine his company, even after departure, but he didn't want to put his future at risk.

Despite being very close friends, Jane and Jim had to spend a great deal of time crafting restrictive covenants that protected the company but did not overreach to the point that either partner would have been unduly hamstrung after departure. Finally, they were able to agree on a limited term, an even more limited geographic footprint, and a volume-based definition of exactly which customers and relationships would be off limits in the event that the provision ever came into play.

PART III: READY

CONCLUSION:

Putting It All Together – What You Need to Know Before Walking into Your Lawyer's Office

Whenever clients ask me to draft a partnership agreement, I offer them two payment options.

Clients can pay me by the billable hour or they can pay a flat price. Frankly, I prefer the flat price option, not because I make more money (I actually make less) but because when there's a set price in exchange for a deliverable, no one has to watch the clock. It doesn't matter if it takes 12 meetings and 48 phone calls to arrive at a final product, the price never changes.

In theory, clients also prefer the flat price model. I would venture to say that if you ask people how they feel about billable hours, ten out of ten hate them. Everyone knows the flaws of the billable-hour model.

As the saying goes, when you pay for time, you get time. Anyone working under the billable-hour model profits more through inefficiency. What's more, it's predicated on the false assumption that a product requiring six hours of work is twice as valuable as a product that requires only three.

So, if everyone can agree on the evils of the billable hour, then why is it that when presented with the payment options for drafting a partnership agreement, the overwhelming majority of clients choose the billable hour option?

The reason is that clients routinely overestimate their preparation and underestimate the amount of work the lawyer will have to do to fill in the gaps.

When I propose a price for drafting a partnership agreement, I know that we will require anywhere from three to five drafts and several meetings in order to arrive at an agreement that will serve the principals for decades to come. Most clients, however, have a different idea. In keeping with Lie #5 discussed at the outset of this book, most clients truly believe that they've reached agreement on all points. If that were true, a price that assumes multiple drafts and several meetings would be overkill. After all, if the lawyer has drafted partnership agreements before and has been given a very clear roadmap as to the decision of the principals on all issues, wouldn't it be a matter of just revising an existing template and hitting "print"?

"No, we'll take the billable hour plan," says the client, speaking on behalf of the partnership, "because this won't take you that long to do."

Never in my career have I found the clients to be right on this point. Never.

I have worked with well over a thousand companies, and to this day, I have not found one set of partners that has truly examined all partnership issues with the end in mind before coming to see me.

You're about to buck that trend.

If you have reviewed this book in detail, not only with an eye toward discussing the issues it raises with your existing or soon-to-be partners but also, and more importantly, with an eye trained to fully envision and craft the story of each possible scenario, then you are poised to save yourself thousands of dollars.

All you need to do is two things:

First, tell the lawyer how each of the five departures (death, disability, voluntary withdrawal, involuntary termination, and retirement) would play out from the moment it occurred to its conclusion. Explain to him or her, in each instance, how the company's value is determined, what the purchase price will be, and how the payout will be paid.

Second, get consensus from the principals on the issues listed in the chapter titled, "Why Reaching an Agreement Will Take Longer than You Think."

Then, when you arrive at your first consultation with your lawyer with these two tasks completed, you can either negotiate your price or choose the billable hour option.

You will have fired the perfect shot. Not only will you hit the target of being able to craft an agreement that acts, when called upon, exactly in the way you envision, but also you will save yourself thousands of dollars in legal fees and untold hours of time.

In other words, you will have created a partnership that is truly…*ready*.