Business Advisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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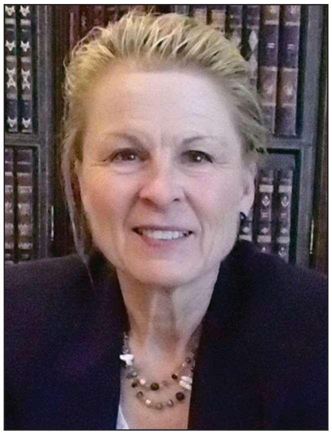

Mary Hanson

About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 30 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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THE TROUBLE WITH CO-OWNERSHIP

by Mary Hanson

Before investing in someone else's business, giving or selling an ownership interest in your business to an employee, bringing an investor into your business, combining your business with another business, or starting a business with another person, consider some of these challenges of co-ownership:

- A co-owner's ideas, objectives, level of competency, and way of doing business are unlikely to be the same as yours. Every person has his or her own personality, management style, decision-making ability, and objectives.
- Income needs, financial obligations, lifestyle, and financial circumstances affect each owner's approach to business. These circumstances will seriously affect a business owner's attitudes toward work, compensation, savings, investment, expenditures, risk, and other important aspects of decision-making in business.
- Each owner's psychological make-up and beliefs about business, money, self-worth, frugality, and generosity affects his or her attitudes toward level of work, level of pay, profit, hiring friends and relatives, having the business pay for personal expenses, and spending company funds on non-business causes.
- Personal circumstances involving health, age, family challenges, ties to geographically inconvenient locations, hobbies, interests, financial opportunities, and other investments can affect an owner's ability to be available and perform as anticipated.

Financial Considerations

- An employee or manager who is given an ownership interest as a performance incentive may not perform as expected. Compensation and bonuses for achieving goals established by the business are usually more effective in producing desired results. An employee or consultant who fails to perform can be replaced; a co-owner remains an owner until the business is sold or dissolved or the co-owner is bought out.
- An investor who promises to fund a business may be unable or unwilling to provide the anticipated funding.
- Distributions of profits to S corporation shareholders must be pro rata according to ownership interest, regardless of effort or involvement in the business. Most small LLCs also require distributions to be pro rata according to ownership percentages.

Management Issues

- A co-owner involved in management can create undesirable liability for the business through poor decision-making. Hiring employees, firing employees, payment of taxes, contract performance, and supervision of employees are potential sources of significant liability for employment lawsuits, tax penalties, and claims for breach of contract.

"Income needs, financial obligations, lifestyle, and financial circumstances affect each owner's approach to business."

- A co-owner acting as an officer of a corporation, manager of an LLC, or a partner in a partnership has "apparent authority" to act on behalf of the business. One misdeed by a co-owner in a position of authority can cause substantial harm to a business without the knowledge of other owners. A manager, officer, or partners with authority may be able to:
  - approve salary increases, inflated expense reimbursement, bonuses or other payments for himself or herself or for other employees;
  - enter into significant agreements with third parties based on personal relationships, kick-backs, or poor judgment;
  - hire unqualified friends or relatives as employees of the business;
  - fail to file tax returns or pay taxes, or file tax returns with false information;
  - fail to respond to claims, complaints, or lawsuits;
  - misappropriate company funds;
  - misrepresentative the financial condition of the business to other owners and investors;
  - obtain loans and subject the assets of the business to liens;
  - allow insurance to lapse or licenses to expire.

Mistakes or malfeasance by co-owners with authority can seriously impair the financial results, growth potential, and value of the business. Being a minority shareholder or silent partner can be a stressful and financially painful experience.

Being a business owner with a minority shareholder or investor can also be painful.

Bringing In A Minority Co-Owner

Consider these drawbacks when contemplating bringing an investor into your business or selling or giving stock to an employee:

- Under California law, a corporation with more than one shareholder must have additional directors, hold formal meetings, provide notice of meetings, vote on issues at meetings, disclose financial results, and observe corporate formalities.
- Every shareholder in a California corporation and every member of a California LLC has a right to inspect the financial "books and records" of the business. Even a very small ownership interest can be a very large pain for a majority owner of a business.
- You should have a written buy-out or shareholder agreement preventing co-owners from transferring their ownership interests, and providing a right to repurchase ownership interests in the event of death, improper attempt to transfer the interest, termination of employment, inability to work, and other events appropriate for the circumstances.
- Termination of a co-ownership situation almost always requires the involvement (amicable or otherwise) of your co-owner. One owner must buy out the other owner or the business must be sold. Even if a buy/sell agreement between the co-owners imposes an obligation to sell back ownership interests in certain circumstances, such agreements rarely contain terms that enable the entity or other owners to buy out a co-

owner without the co-operation of the selling owner.

- Without an agreement that requires a co-owner to sell back his or her interest, an employee owning an interest in the business may remain an owner and make demands for meetings, information, and financial records after leaving the employment of the company.
- A co-owner who is no longer contributing to a growing business gets a free ride from the efforts of others. As the business grows in value the purchase price for buying out the co-owner's interest goes higher and higher.
- A minority shareholder whose vote is needed to approve certain transactions or whose signature is required by lenders in order to obtain a loan or line of credit can impair the growth of a corporation by refusing to co-operate.

Investing In Someone Else's Business

- It can be impossible to sell an ownership interest in a company you do not control. You may be unable to attract a buyer willing to purchase a percentage ownership interest and step into your unhappy or unrewarding situation.
- If one key person controls the business, you may have few options for replacing that individual, limiting the key person's authority, or causing him or her to change his or her unacceptable business practices.
- Contracts intended to mandate proper behavior or prohibit certain actions can't assure that things will be done or not done. A contract doesn't force a party to a contract to perform. A contract gives you a written record of your agreement and the right to pursue a party for breach of the contract.

What Can You Do?

What can a co-owner do to prevent problems or change unacceptable behavior in a co-owned business? Legal action may only increase an investor's losses and may not be helpful in resolving the problems to be addressed. Business agreements and state and federal laws typically address fraud, self-dealing, and conflicts of interest. Many types of management failure are outside the scope of laws protecting investors and minority owners.

- Own a controlling interest and have agreements in place that confirm your control of the business. Have solid enforceable contracts covering your investment, your loans, and your veto powers. Make sure entity agreements clearly provide for removal of managers and directors under specified circumstances and establish rights to buy out a co-owner upon the occurrence of specified events.
- Stay involved. Be involved enough to know what is being done – or not done. Communicate with other co-owners. Attend meetings and stay in touch with key people in the business. Upon receipt of information indicating a problem with a co-owner, let the person know that you are aware of it and do not approve of his or her actions. Let other owners know of events and circumstances affecting the business.
- When problems relate to breach of contract, violation of law, or poor

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Publisher's Note

In the clearest cases of management malfeasance, state law may provide judicial methods of removal of corporate directors and LLC managers, even if the entity documents are silent on the subject of removal. Legal action is typically costly, but removing a co-owner early on in order to end a bad management situation may avoid even greater expenditure on taxes, penalties, judgments, settlement agreements, and attorneys' fees if the bad management creates liability.

Criminal wrong-doing requires immediate action. The business should promptly determine the course of action to take when a co-owner embezzles or otherwise commits a crime against the business. The commission of criminal acts on behalf of the business – creating criminal liability for the business – presents even greater challenges for a business. Stopping any criminal behavior promptly is key.

Have a detailed agreement between you and other owners before you get into a co-ownership situation. If you can't reach a reasonable agreement on co-ownership that protects you from bad management, consider taking a completely different approach to that business opportunity or "just say 'No'" to that opportunity.

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management practices, take steps to educate or inform the offending co-owner on the issues. In particular, bring to his or her attention the liability, penalties, and additional expenses that may be incurred if corrective action is not taken.

- Make sure the company has good accounting practices and effective internal controls. Good accounting practices improve the accuracy of the financial information and performance gauges of the company. Internal controls that establish protective procedures relating to bank accounts, signature authority, and approval of payments make improper financial activity less likely.

- Communicate early in the course of events as soon as problems are noted. It is easier to prevent bad behavior than to stop it. Use communication wisely and effectively. Only put in writing communication that you would like other parties to see or that could later help you with evidence of events, actions, or communications.

- Avoid creating documents that could make your business look guilty of wrong-doing.

- Check your agreements and legal rights. Corporate bylaws, LLC operating agreements, and other co-ownership agreements may provide a right to remove a problem manager or director. Boards of directors always have the power to remove officers. Buy/sell agreements may establish a right to buy out a co-owner for taking an action that triggers a buyout option. BA