The Closely-Held Business: Key Issues Owners Should Have In Writing

By: David F. Hanley, Esq.[1]
Angelo & Banta, P.A.

Whenever two or more friends, family members, or other individuals come together to form a closely-held business entity, whether to start a new business, invest in South Florida real estate, or some other purpose, the parties should execute a binding legal agreement amongst themselves and the Company to address a variety of issues relating to the ownership and control of the Company. The agreement should be discussed and executed when commencing the business relationship, because many individuals tend to overlook or downplay the real possibility of potential conflicts and problems that may arise in the future. While not exhaustive, this article will attempt to discuss some key provisions that the author feels should be considered for inclusion in such agreements. Readers are advised to consult with an attorney to determine whether the provisions discussed below might be appropriate to their individual situation.

Capital Contributions, Ownership Interest and Control

The Agreement should clearly document each owner's (hereinafter generally referred to as "Owner")[2] respective interest in the entity (hereinafter generally referred to as "Company")[3]. For S corporations[4], this is relatively simple as profits and losses must be split in accordance with the stock ownership of the Company. For limited liability companies, which provide great flexibility, the agreement (hereinafter generally referred to as "Agreement")[5] should carefully outline each Owner's initial capital contribution to the Company, his or her relative ownership interests and share of profits and losses, and the order of preference or priority in making distributions. In the event a limited liability company requires additional capital, the Agreement should also provide what each Owner is required to contribute and when. Including a contingent requirement of additional capital contributions is common in a limited liability company Agreement and helps to ensure the Company's financial security and assure its continuance.

The Agreement should also contain specific provisions addressing who will manage, operate, and control the Company. For instance, in an S corporation, the board of directors and officers usually run the business, while in a limited liability company, managers or the managing members typically control the operations. In either case, the Agreement often provides that major business decisions, such as the decisions to acquire a new business, sell substantially all the assets of the Company, or to enter into loan agreements, will require a majority or a supermajority (i.e., something more than 51%) of the Owners to approve before such action may be taken.

Restrictions on the Transfer of Ownership Interest

A provision restricting the transfer of an Owner's interest (hereinafter referred to as "Interest")[6] in the Company is necessary to eliminate the possibility of the Owner transferring his or her Interest to an outsider. In a typical Agreement, the provision restricting the transfer of an Owner's Interest may require the consent of all other Owners of the business prior to the proposed transferee being recognized as a substituted Owner, as the new proposed Owner may not have the necessary skill to be involved in the business or may not be compatible with the existing Owners. Such provisions often additionally provide the Company and/or the other Owners with a right of first refusal allowing the Company and/or other Owners to purchase the individual's Interest at the same price and on the same terms and conditions as those offered to the outside party. These provisions give the Company the opportunity to restrict ownership and retain control of the business, and give the current Owners the opportunity to increase their percentage of ownership interest in the Company.

Buyout Provision for Deceased Owner

It is not unusual for disputes to arise upon the death of an Owner, which could be prevented by including a buyout provision in the Agreement. When an Owner dies, his Interest normally passes to the beneficiaries of his estate. An individual receiving an ownership interest in this manner may decide to keep the Interest and become involved in Company's business affairs, keep the Interest but remain uninvolved in the business, or transfer the Interest to a third party. Often the remaining Owners will not want to be co-owners with the spouse or child of a deceased Owner since he or she may not have the skills, knowledge or desire necessary to become actively involved in the business, or may lack the necessary personal compatibility. Additionally, since closely-held Companies generally do not pay dividends, an individual holding onto the deceased Owner's interest will not usually receive any regular income stream from the investment.

If the beneficiary desires to sell the deceased Owner's Interest and keep the proceeds, there may not be a market for the Interest, or the remaining owners may not want outside third parties to become new owners of the Company. Including a mandatory buyout provision in the Agreement can resolve these situations by requiring the Company, or individual owners, to buy back the Interest of a deceased owner at a pre-determined fair price. The provision should further provide the means by which the Company will fund the buyout such as by purchasing life insurance on the deceased Owner.

Buyout Provision in the Event of Retirement, Disability, Bankruptcy, Dissolution of Marriage or Failure to Perform

Parties entering into a new business venture should include a provision in the Agreement that allows the Company and/or its Owners the option of purchasing the Interest of an Owner who fails to adequately perform at a required level, who engages in business directly in competition with the Company, or who will no longer be able to meaningfully participate in the operation of the business. Some of the circumstances under which this last option may arise include the retirement of an Owner, the disability of an Owner, an Owner declaring bankruptcy, or in the event of a dissolution of marriage of an Owner. The Agreement should outline the circumstances which will generate the option and the method by which the buyout may be accomplished.

Method for Buyout

The method by which a buyout is to be effectuated should be included in the Agreement to provide fair pricing and an orderly transfer of the departing Owner's Interest. The buyout method provision should create a procedure by which a transferring Owner is to give notice of the transfer and initiate any right of first refusal. It should also set out deadlines for the exercise of options and specify a pricing formula, or fixed price, and payment terms for a mandatory buyout or optional buyout. Without a pricing formula to determine the fair price of a departing Owner's Interest, disputes may arise between the Company and the Owner or the estate of the departing Owner. A properly crafted pricing mechanism can go along way toward ensuring a smooth and fair buyout of the Owner.

Depending on the type of business, there are numerous ways of determining the price of an Owner's Interest, including:

1. Appraisal from an outside source at the time of the buyout;
2. Yearly valuation of the Interest, set by the Owners of the Company on an annual basis;
3. Percentage of gross income;
4. Book value, determined by deducting the Company's liabilities from assets and dividing the figure by the number of outstanding Owner's Interests; and
5. A formula based on a multiple of earnings, which multiplies the Company's last year of earnings by a fixed number, and divides the figure by the number of outstanding Owner's Interests.

Mandatory Buy/Sell Provision

When two or more Owners each own fifty percent (50%) of a Company, a mandatory "buy/sell" provision can be very useful, particularly in the event of a deadlock or other situation where the parties cannot agree and the business of the Company is impacted. Such a provision allows one Owner to give the other Owner a buyout offer at any time. The recipient of the offer must either accept the offer and be bought out, or conversely, purchase the Interest of the first Owner on the same terms and conditions as the first Owner's offer.

By its nature, this arrangement should result in a price and terms that are considered fair by both parties, since the Owner initially making the offer may be forced to sell on the terms and conditions of the initial offer he makes. Including such a provision in the Agreement can provide the Owners with a mechanism with which the Owners can terminate an unhappy business relationship with a buyout that is fair.

Restrictive Covenants

The Owners of the Company should consider including provisions in the Agreement that protect the trade secrets, confidential and proprietary information, and customer and client relationships of the Company. The Agreement should require the Owners to hold such information in confidence, protect it from disclosure, and not use it for personal gain. The Agreement should also require other persons, such as employees and contractors, to protect such information.

An Owner whose Interest is purchased by the Company or other Owners should also be prevented from competing with the Company. Florida law generally recognizes the validity of restrictive covenants[7] depending on their terms. The best time to deal with these issues is at the beginning of the business relationship, not when an Owner is leaving, perhaps with plans to compete with the Company.

Conclusion

It is difficult for many small business owners to imagine the need to have a formal agreement setting forth specific rights, obligations and restrictions relating to a new company, particularly when ownership is limited to relatives or close friends. Unfortunately, these business owners are unaware and ignoring the risk of conflict and uncertainty which may arise when an Owner wishes to sell his interest, dies, retires, becomes disabled, gets divorced, declares bankruptcy, competes with the business, or other circumstances. Smart Owners will want to have a written Agreement that addresses these circumstances upon commencement of the Company in order to avoid any confusion or disputes which may arise in the future. A written Agreement is the surest way to protect the Owners' interests and ensure the orderly flow of business.

 This article is for general information purposes. The article does not constitute or contain legal advice. This article should not be considered as a legal opinion by the author or by the firm of Angelo & Banta, P.A., or as a substitute for legal counsel. The author would like to thank law student Jennifer V. Ortega for her assistance with this article.

[2] The owner may be a stockholder in a corporation, a member of a limited liability company, or a partner of a partnership.

[3] Closely-held businesses are typically organized as S corporations, limited liability companies or partnerships. This article does not address, among other issues, the differences between these three, and other, business entities. These subjects may be covered in a future article.

[4] An S corporation is a corporation that has elected to be treated under Chapter S of the Internal Revenue Code of 1986, as amended, which provides for a single level of taxation at the shareholder level. It is common for closely-held corporations to elect to be treated as S corporations.

[5] If the closely-held business entity is a corporation, the agreement will be called a "Shareholder's Agreement." If the business entity is organized as a limited liability company, the agreement will be called an "Operating Agreement." If the business entity is organized as a partnership, the agreement will be called a "Partnership Agreement."

[6] If the closely-held business entity is a corporation, the ownership interest will be stock. If the business enity is organized as a limited liability company, the ownership interest will be a membership interest. If the business enity is organized as a partnership, the ownership interest will be called a partnership interest.

[7] See Florida Statutes §542.335.