A Premarital Agreement for Your Business

By Raymond P. Kolak

Before two people with money get married, it's a good idea to sign a premarital agreement. A premarital agreement says what happens when the couple splits up – who gets the house, the car, and the brokerage accounts, and whether either spouse will have to pay alimony to the other after the divorce. A premarital agreement is a good idea because a divorce between two people with money is like the breakup of a business partnership in that the main concern is who gets the assets and the earning power of the business. If premarital agreements are a good idea, then pre-partner agreements are an even better idea. You should have one in place before you form any business with another person.

Why? Let's suppose you start a printing business with your friend from college. You know printing, have been the plant manager for printers, and will handle operations. Your friend has been involved in industrial sales for years, and will handle sales. The business is started on a handshake, and you file the minimum one-page Articles of Incorporation to start your new corporation, on your own. No pre-partner agreement is signed, and no stock certificates are even issued, though there is agreement between the two of you that each owns 50% of the business. If you started your business this informally, don't feel embarrassed to admit it, since many people do just this.

After years of struggle, the printing business finally attains some success, and each of you begin to see a return on your investment of cash and sweat equity. Then something happens. It could be that one of you has to leave the state, and cease an active role in the business, or becomes seriously ill, or even dies. Perhaps the success of the business has masked a personality conflict, and one of the partners must leave to avoid the tension. In any case, the fundamental character of the partnership has changed. One of the two founders is no longer working full time at the business. Most beginning businesses do not do well with inactive shareholders. There is just not enough earnings to both attract a management employee to replace the withdrawing shareholder, and to pay the withdrawing shareholder enough to support his or her family.

So the partner still active in the business decides to buy the other's stock. How is this to be accomplished? Well, without a pre-partner agreement, there are basically no rules. The inactive partner doesn't have to take a fair price, doesn't have to take a exorbitant price, and in fact doesn't have to sell at all. On the other side, if the inactive shareholder is a spouse without business acumen who merely inherited the stock, the spouse can't force the active shareholder to buy the stock back. Everything depends on the good faith of the parties at the time this happens. I believe that most people act in good faith, and things generally will work out. At the same time, the synergy that kept you and your college friend working at the common cause of the company is gone, and agreement between two parties who will separate afterwards is always harder.

If you and your friend cannot reach any agreement, the laws of most states may provide some remedies. Although the corporation laws differ from state to state, take the corporation laws of my home state, Illinois. Under certain circumstances, you can apply to the Circuit Court for a court order requiring that the company buy back your shares at fair value, or that the company dissolve and give you half of its assets in a liquidating dividend. Those circumstances are tough to prove, however. You must show that your board of directors or shareholders are deadlocked, and that irreparable injury to the company will occur, or that business can no longer be conducted to the general advantage of the shareholders. Alternatively, you may win if you can show that the active shareholder is acting illegally, oppressively, or fraudulently, or that the company's assets are being misapplied or wasted.

These cases are tough to win, because courts hate to intervene in the conduct of private businesses. If the company is still operating with the active shareholder at the helm, then there may be no "irreparable injury" to point to. Moreover, this remedy does not come automatically. You get it only by paying a lawyer to draw up and prosecute a lawsuit, which could take months or even years to be concluded, at great expense to you and the other side. There is a better way.

A pre-partner agreement (often called a buy/sell agreement) is an agreement between the owners of a business on what happens to the stock if certain triggering events occur. I'm using the terms partner and shareholder interchangeably here, since pre-partner agreements can be done for any business entity, whether it be a corporation, limited liability company, general partnership, limited partnership, or limited liability partnership. There are four traditional triggering events: death, disability, leaving employment, and desire to sell or transfer the stock. These triggering events need careful definitions. Disability for how long? In whose judgment? Will voluntarily quitting employment only be covered, or is involuntary firing by the company also covered? Once an event happens, it triggers an option or an obligation to buy the stock.

The decision on whether the triggering event will give a party an option to buy the stock, or create a binding obligation to buy the stock, is an important one. For example, if a company has an option, and cash is low, the company may decide not to exercise the option to keep the business in operation. The option/mandatory purchase decision may change, depending on the triggering event. If the company has key person life insurance, then it will get life insurance proceeds at death, and a mandatory purchase at death makes sense.

The price at which the stock will change hands should be spelled out in the pre-partner agreement. There are zillions of ways to treat this. The agreement may specify a fixed price, or a formula price tied to book value, earnings, or sales. The purchaser might have to match the price offered by a third party, if the triggering event was a desire to sell to the third party. The price could be set by the board of directors each year. Or the price could be established by appraisal. This decision has important estate tax ramifications, so caution is needed.

Who will buy? The company is usually the one with the money, and most states have lifted restrictions on how and when a corporation can repurchase its own stock. There are important tax advantages if the remaining shareholder is the purchaser. Some pre-partner agreements make the corporation the primary purchaser, or if it does not act, then the remaining shareholders can.

Finally, terms of sale. The sale does not have to be for all cash. The purchaser (company or remaining shareholder) can give a note, with interest, for all or part of the purchase price.

So many difficult decisions. You want to stop reading now, and skip over to something a little less intimidating. Don't. Your attorney will be able to provide guidance on each of these issues. In most cases, after meeting with a client, a particular format jumps out. It takes some discussion and soul-searching, but you make much more difficult decisions every day in operating your business.

Premarital agreements and pre-partner agreements share another characteristic. They can make people at the beginning of a relationship uncomfortable. We're in love, we're getting married, and you want me to sign a document about our divorce? We have the trust to start a business together, and you want to question that trust by setting up all these rules about buying each other out? True in both cases. But do it anyway.

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