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Beware Partnerships

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Contents

Contents	2
1. Introduction.....	4
2. Purpose.....	5
3. Why Beware of Partnerships?.....	6
4. Business structures.....	8
4.1 Sole Trader	8
4.2 Partnership	8
4.3 Company.....	9
4.4 Trust.....	9
4.5 Joint Venture	10
4.6 Structure Mixes	10
5. The reasons why people go into business with others	12
5.1 By Default.....	12
5.2 More capital.....	13
5.3 To secure key people	14
5.4 To share the risks.....	15
5.5 Economies of scale	15
5.6 Cooperative advantage	16
5.7 As a part of succession or estate planning.....	16
5.8 Summary reasons.....	18
6. Exit Agreements.....	19
6.1 Communication	19
6.2 Types of Agreement	19
6.2 Exit Principles	20
6.2.1 Full discussion.....	20
6.2.2 Expectations	21
6.2.3 Expected partnership life-span.....	21
6.2.4 Reviews	21
6.2.5 Notice periods	21
6.2.6 Process.....	21
6.2.7 Preemptive rights.....	22
6.2.8 Valuations.....	22
6.2.8.1 Annual valuations	22
6.2.8.2 Market price	23
6.2.8.4 Partnership tender	23
6.2.8.4 Shot-gun clause.....	24
6.2.8.5 Drawn lots.....	24
6.2.9 Minimize partnership assets	24
6.2.10 Death.....	25
6.2.11 Compulsory exit.....	25
6.2.12 Disputes	25
6.2.12.1 Mediation	25

6.2.12.2 Arbitration.....	26
6.2.12.3 Court	26
6.2.13 Sunset clauses	26
6.3 Summary exit agreements	27
7. Conclusion	27
8. Acknowledgements.....	28
9. References.....	28

1. Introduction

Beware of partnerships! Some partnerships can be an excellent vehicle for a business and its owners to achieve their goals. However, sometimes they are inappropriate and can be detrimental to the success of the business and its owners. It is essential to those people considering partnerships that the initial optimism and positive feelings they have towards each other do not blind them to the need for rational thought and consideration of the future ramifications of a decision to enter into a partnership.

This paper will set out:

1. Why the reasons many people become partners in business may be invalid.
2. That if, after due consideration, a partnership is still appropriate, why and how an exit strategy should be developed before entering into that partnership.

This subject is of personal interest to me, as my wife and I are in a successful farming business together, and we intend to be involved in business with others in the future. In the past we were also involved in a family farm partnership. While the family farming business was successful, the eventual end and division of the family partnership was difficult. We initially had been advised to “plan how we were going to get out of business together before we went into business together”. However, the agreement we entered in an atmosphere of optimism and good will was very difficult to execute years later under more strained circumstances.

Since then I have often had the opportunity to talk to other people who have been in, or are going into, business with family or friends. It has surprised me that in many of these cases very little consideration has been given to possible alternatives, or how they would eventually exit the partnership.

My experience, and that of others, has indicated that there is a lack of motivation by people considering partnerships to investigate alternatives, and exit plans. This paper is intended to provoke those people to take the time to fully consider the issues.

Please note that I am using the word partnership here in the broadest sense, i.e. to quote the Oxford Dictionary, “ a person associated with others in business of which he shares risks and profits”. The actual legal ownership structure may be a company, a trust or a partnership.

2. Purpose

This paper has been prepared as part of the Kellogg / Primary Industry Rural Leadership Programme, but the information contained is not just for primary producers and would be equally applicable to any other businesses and even non business partnerships such as shared holiday homes or boats.

The target audience is therefore any person considering joining others in business or shared ownership of assets, particularly where there will be a small number of owners (i.e.: 2 to 8 approx.). Businesses with larger numbers of owners still have the same issues to deal with but in general they do not ignore the problems and have systems to ease entry and exit. Publicly traded companies with a stock exchange listing being the easiest system at the other end of the number of owners spectrum.

The purpose of this paper is to provoke anyone considering a partnership to fully review the reasons they are doing so, investigate the alternatives and, if they still decide to go ahead with a partnership, to develop a sound exit strategy.

This paper is not intended to provide answers, or “recipes” for partnerships. That would be impossible, as every situation and person is different. This paper is an “opinion piece” that will hopefully stimulate readers to ask themselves the difficult questions about their own situation, and thereby formulate their own solutions, with their own advisors and lawyers as appropriate.

3. Why Beware of Partnerships?

Why should people beware of entering into a partnership? Because for a variety of reasons all partnerships must end, either because the business itself changes requiring a change in the ownership structure or partners, or the relationship between the partners will change, again requiring a change in the ownership structure or partners.

Examples of business changes:

- The business is very successful beyond original expectations and:
 - One or more of the partners decides to retire on his share of the profits and capital gain.
 - An offer is made to buy all, or part, of the business by a third party.
- The nature of the business changes:
 - The skills of one or more of the working partners are no longer as useful.
 - The changed business situation no longer fits in with the partner's own personal objectives in his role/responsibilities as working partner.
 - The changed business no longer meets an investing partners objectives in terms of risk or diversity.
- The business is not successful and is losing money and value:
 - One or more partners decides to cut his losses and exit the partnership before his situation deteriorates more.
 - The business goes into receivership and is wound up.

Examples of changes in the relationships between partners:

- A partner decides to leave the partnership to pursue a better opportunity for himself elsewhere, be it a better job, investment or lifestyle.
- A partner retires because of health problems, or worse yet, dies.
- Partners' personalities and relationships change over time so that what was initially a harmonious and constructive group becomes the opposite.

There are as many examples of change as there are business and people, and the only certainty in life is change. These changes will eventually cause all partnerships to end if only because one of the partners dies. Partners must therefore prepare themselves to deal with these changes with a robust agreement dealing with foreseeable changes and allowing all partners to exit the partnerships as harmoniously as possible.

When a partnership is created, it is a result of a harmonious and unanimous decision by those partners. However, when a partnership ends it is likely to be less harmonious and probably not unanimous, and by its very nature tense and difficult. While it is difficult to agree to exit strategies when every partner is happy and comfortable with each other, it is practically impossible to do so when partners no longer feel that way.

The best time to draw up good exit agreements is at the start of the partnership. This will not be easy but is in itself a good test of the partners' relationship. If it cannot be

achieved at that point in the partnership it probably will never be successful. Some partnerships have in fact put such an agreement aside in the “too hard basket”. This is a serious mistake. Partnerships do end and they need to deal with this. Whatever the cost in time and effort it takes to write this agreement at the start of a partnership, it will be considerably less than the cost of agreeing to everything at the end of the partnership. These agreements need to be regularly reviewed, and as much as is possible take into account all foreseeable circumstances, ensuring a timely and fair exit of any partners who decide to do so.

Perhaps an analogy about exit agreements is that the success of Apollo 11 was not just about landing men on the moon, but in landing men on the moon and getting them home again to earth safe and well! Exit strategies should ensure that all partners “land safe and well” at the end of their partnership.

To quote C.D. Jackson, *“Great ideas need landing gear as well as wings.”*

Readers considering entering into a partnership should have asked themselves these questions:

- What are their expectations of such an arrangement?
- Will entering such an arrangement really help them achieve their personal goals?
- When do they plan to exit the business/partnership?
- How do they envisage this happening?
- What events or changes would alter their answers to the above questions?

4. Business Structures

The choice of business structure for your business is one of the most significant decisions business owners make. It should definitely be made in consultation with your financial advisor, accountant, and solicitor. There are pros and cons for each structure depending on the type of business, the goals of owner/s, tax, estate planning, and security issues.

An excellent reference about business structures in New Zealand is *The Law of Business Organizations* –published in Auckland 1999. A brief outline of the main options follows but readers should consult their own legal advisors for details and advice on business structures.

The five main types of structures available are:

- Sole Trader
- Partnership
- Company
- Trust
- Joint Venture
- Mixes of some of the above.

4.1 Sole Trader

A sole trader is the simplest business structure and means that, in going into business as a sole trader, the individual is the trading entity. You receive the profits from the business, and must bear all of the risks and any of the ensuing financial losses that go with the business. Sole traders can trade under any name as long as it does not resemble an existing business name. Although there are no registration formalities, sole traders must comply with relevant business and tax legislation. The structure is simple and low cost to administer. The business of a sole trader inevitably ends with the death of the owner.

4.2 Partnership

A partnership is similar to a sole trader except that it involves two or more people. A partnership is not a separate legal entity and as with a sole trader there are no formalities to set up a partnership. However, it is usual for a partnership agreement to be prepared setting out the operating rules and terms of the partnership; depending on the people involved and nature of the business this can require considerable effort and expense. The partnership can have a name but it cannot be registered. Each partner is the agent for the others and can bind the partnership in obligation with third parties. Partnership assets and liabilities are owned jointly by the partners. Each of the partners is responsible for the losses and shares the profits of the partnership. One partner could have to bear the entire debts of the business if the other partners were unable to do so. Unless otherwise

stated in the partnership agreement, a partnership ends, and the assets/liabilities are split equally, when any partner dies.

4.3 Company

Companies are the most common form of business structure. One or more individuals can form a company by filing documentation, including a reserved name, at the Companies Office. A company is a separate legal entity from its owners (shareholders). Companies are governed firstly by the *Companies Act 1993*, and then by the rules of their constitution. In smaller companies it is often desirable to alter or minimize procedural requirements by shareholder agreements, which require unanimous written consent by all shareholders. Companies are managed by directors who may or may not be shareholders. The assets, and any liabilities to third parties, are borne by the company. Because the company is a separate legal entity it can continue after the death of one or more of its shareholders. The major advantages of a company are:

- Limited liability of the shareholders
- Recognition of the company as a separate legal entity
- Separation of ownership from control
- Continuation despite any deaths of shareholders
- Transferability of shares to existing or new shareholders

4.4 Trust

A trust is an obligation binding one person, or persons (the trustee/s), to deal with property for the benefit of others (the beneficiaries). The trust is created by the settlor transferring assets to the trustee. A trust can be created while the settlor is alive (an *inter vivos* trust) or may be created under the terms of the settlor's will (a *testamentary* trust). Having created the trust the settlor has no further control over the trust property. It is no longer the settlor's property. The terms of the trust cannot be changed by the settlor once the trust is created. The settlor exercises indirect control over the trust by the ability to appoint compliant trustees, and can be a trustee himself, but must always deal with the trust property according to the terms of the trust.

Those entitled to benefit from the trust (the beneficiaries) can include the settlor, any person or group, and even unborn children. They have no control over the trust assets but receive the benefit of these assets. Different beneficiaries may have different rights according to the terms of the trust document. Income beneficiaries receive income derived from trust assets during the operation of the trust, while residuary beneficiaries receive legal title to the trust assets at the conclusion of the trust. A trust cannot continue indefinitely like a company and by law must disburse the trust assets to the residuary beneficiaries within 80 years of creation.

In a trust the beneficiaries have beneficial ownership of the trust assets while the trustees exercise control over the business. The trustees are personally liable for the debts of the business unless this liability is excluded by contract.

4.5 Joint Venture

While the term joint venture is commonly used in business it has no strict legal definition and is basically a collective undertaking. It is a popular term in the USA where companies cannot join together in partnership. Joint ventures are commonly seen in construction projects, property developments, research projects, franchises, share-milking agreements etc.

Joint ventures can take the form of a company, a partnership, or a “true” joint venture. Companies and partnerships are outlined above. A “true” joint venture is a convenient legal label to describe a joint venture which is not a partnership.

To be a partnership a business must have three component parts:

- carry on a business
- require joint management decisions
- be run with a view to profit

A “true” joint venture will fail to satisfy one of these three prerequisites, usually the requirement for joint management decisions. For example in a share-milking agreement joint management decisions are not required; one party provides the land and the other the cows and labour. They have pooled their assets in a business activity under a contractual agreement, but they are not in a partnership.

4.6 Structure Mixes

Quite often the goals of the owners and the nature of the business will not be satisfied by any one structure. It is also quite common for the owners of a business to change its structure over time as it grows. It may have a small beginning as a sole trader, expand into a partnership, and later be incorporated into a company, which may even ultimately become a publicly listed company.

A mix of structures can in some situations have tax benefits as well. For example: to maximize the tax loss advantages of qualifying companies, a large group of investors, in a commercial forest venture, may form a partnership of qualifying companies. There are various combinations of ownership structures designed to minimize tax liability, and for protection against a return of estate duty or possible imposition of an asset/wealth tax.

Owners may wish to separate different aspects of their business and assets for security. Partners may safeguard their personal assets in a family trust to avoid the unlimited liability problems that go with partnerships. Owners may also wish to separate the

operating or riskier part of their business in a company or partnership, from the non-operating or low risk parts. For example: a retail shop and the commercial building it is in, or a livestock farming business and the land it is on. In both cases this can be done using a contract agreement or lease.

It is important to note too that arrangements like this may be used to separate the roles and different levels of involvement of individuals in the total business. For example, a group of investors and a farmer are in business together, but the investors have a shareholding in a company owning the farm land, while the farmer leases that farm from the investors' company. Going into business with other people does not mean that one simple partnership or company is by itself the best structure to allow the partnership to operate and succeed. Different structures linked by contractual agreements to reflect the different expectations of the people involved are a valuable means of avoiding some of the pitfalls of going into business with other people be they family friends or strangers.

Note: The above brief outline of business structures is by no means complete and does not contain all the details that should be considered before going into business. The readers' own professional advisors should provide them with all the information about this, as well as less common structures like co-operatives, incorporated societies, charitable trusts, tax issues, etc, as applicable to their own situation.

5. The Reasons Why People Go Into Partnerships

There is a whole range of reasons, both good and bad, as to why people go into business with others. But any business with more than one owner is going to involve greater complexity, and encounter additional difficulties operating successfully, as compared to a sole trader. The more people the more opinions, and the harder it will be to resolve problems. Some of the relevant quotes I have come across concerning the subject are:

- “They say that a second marriage is a triumph of hope over experience. Business partnerships are much the same.” Martin Hawes.
- “People entering into a partnership, like an engaged couple, are starry-eyed and imagining a rosy future. Being generally optimistic people, we try not to pour too much cold water on their ideas, although usually we feel bound to point out that their chances of long term success are not great.” Martin Hawes.
- “Often the partners start as good friends and end up in bitter disputes, in some cases leading not only to the loss of the friendship but also to the parties being mortal enemies. My advice to people concerning partnerships in business is simple: Don’t do it if you can possibly avoid it!” Peter Thorpe.

So given this type of advice, why do people go into business together? The main reasons are:

- By default.
- Introduce more capital.
- Gain added expertise, or keep key people.
- Share the risks.
- Share and thereby minimize expenses - economies of scale.
- To share management and problems with others.
- As a part of succession or estate planning

Let’s examine the validity of these reasons:

5.1 By Default

People sometimes end up sharing the ownership of a business with others by default; that is more as a result of circumstances, or a desire to avoid tax, rather than as a conscious and well thought out decision.

Examples of partnership decisions that are sometimes made by default are:

- Married couples in their own business
- Families where children join their parents in the family business

- Because other people, either peers or people in similar work, are in partnerships, others assume that if they are going to work in that industry they will be in partnerships too.

Good decisions are always made after examining all the options and choosing the best.

Readers going into business with others should ask themselves these questions:

- How will the business and business structure help me to achieve my personal goals?
- What other options are there that might achieve the same or better result?
- Is my decision based on my own thinking or is it being made as a result of pressures from others, be they family, peers or professional/industry traditions?
- Am I making a decision with my head (i.e. rationally), or with my heart (i.e. emotionally)?

5.2 Increase Capital

Partners and shareholders are often taken into businesses because the person with the original proposal or business perceives the cost of taking in partners as lower than the cost of paying interest. Usually if a business is really sound and profitable this is a fallacy, as in the long run the share of profits going to the new partner/shareholder and the eventual increase in value of their share in the business will exceed that of the interest cost.

If a business satisfies its bank's lending criteria, that is the best place for it to look for more capital. If a business is sound, it should easily produce a cash return or appreciation in value that on average well exceeds interest charged by a bank. If its own bank will not lend the capital because it is outside their lending/risk criteria, but the business owners are confident their business can create profits greater than the interest cost, they should talk to other banks and lending institutions.

Before one takes in a partner/s to raise capital, one should ask:

- If your business does not produce profits equal to or greater than the amount you have to pay in interest, is it really a worthwhile business?
- Why would anyone else consider putting capital into your business if the return is less than bank interest?
- Why would you consider sharing ownership of your business, if returns are greater than bank interest, when eventually you will have to buy that person's share of the business when they leave, probably at a higher value and after paying them a share of the profits all the way along?
- If even one bank you approach rejects your proposal, then review it carefully. What is it that they are seeing that you have missed in your enthusiasm for the project?

Situations where taking in shareholders or partners for the extra capital they bring may however be valid when:

- The returns from the business, although possibly extremely good, are also perceived to be very risky by all lenders. This could be because of the nature of the business e.g.: a new industry, or because the person with the business proposal has insufficient experience to gain the confidence of lenders.
- The business is capital intensive or large scale, and while profitable it cannot itself borrow without a higher equity percentage. So just to start the business investor equity is required. Examples are large scale farms and forestry investment.

5.3 Secure Key People

Key people to a business are sometimes taken into a business as partners to secure their expertise. This sounds like a good idea especially if the person setting up the business lacks expertise and skills in a particular area. The hope of the partners being that if the key person is a partner in their firm, they will be less likely to leave. The usual reason for people to leave a job is to pursue a better opportunity elsewhere; be it remuneration, responsibility or freedom. Unless their new position as a partner addresses whatever the key person is looking for, it will not secure them, and it will reduce the authority of the current owner/s and further complicate the business.

Locking a key person into a business may secure their beneficial skills but it will also secure any negative aspects they have as “baggage”. No one person is good in every aspect of their personality or skills.

Alternatives that could be considered to secure key people as partners are:

- Better employment conditions from the key employee’s perspective, i.e.: work hours, responsibility and remuneration.
- Help the key person set up their own business and then contract it to your business.
- Train other people in the business in the same skills so that no one person holds a key position.
- Review the plan: are the potential profits from going into business with a key person worth the risks of the business hinging on that one person, especially if something were to happen to him/her.

5.4 Share the Risks

Partners are sometimes taken in to share the risks involved with a business. The venture capital industry is based on this. Obviously if any business is very risky decisions need to be made as to whether it is worth entering anyway.

Valuing risk and risk management techniques is a whole business subject in its own right. However, when considering partners the subject can be refined to a few key issues:

- The value of the risk
- The probability of partial or full business failure
- Will taking in partners reduce or increase the probability and amount of risk

Rather than taking in partners perhaps the risks of the business could be minimized by:

- Starting the business on a smaller scale.
- Grow and develop the business a little more slowly.
- Investigate and research the business further, identifying key risk areas, monitoring these carefully, and develop contingency plans.
- Make use of mentors and/or consultants to help identify and minimize risks.

Before taking in partners to minimize risk one could ask these questions:

- What is the amount or value of the risk you actually face; for example, if the business goes bankrupt will you lose everything?
- Will you lose any less if you take in partners, or will it just take a little longer to go bankrupt, and you still lose everything?
- Depending on the nature of the business you may in fact be making it a riskier venture having partners involved, e.g. will the process of discussing and agreeing to decisions between partners cause any important decisions to be made too late for good business?
- Will having more owners increase the number of bad decisions being made?
- Are you comfortable with sharing in the cost of bad decisions your partners make as well as your own?
- The process is as much the issue as the people a poor process can result in bad decisions irrespective of the calibre of the partners.

5.5 Economies of Scale

The larger the business the smaller the fixed overheads of a business are as a percentage of costs and revenue. Larger businesses can seek greater discounts on volume purchases and sometimes higher premiums on volume sales.

The key issue of forming a partnership to benefit from economies of scale is that the extra profits derived from larger scale are still significantly greater than the costs of forming, running and eventually dissolving the partnership.

Some economies of scale can be achieved without the need to form a partnership; for example farmers can coordinate together and seek better prices for their stock by marketing similar stock together; likewise they can increase their purchasing power by seeking quotes for supplies together.

5.6 Cooperative Advantage

Some partnerships are formed because the partners hope there will be synergy, or cooperative advantage, created by going into business together. It allows them to have contemporaries to bounce ideas off, and share problems with, and to pool their intellectual and physical resources. While this is a commendable concept it does not require the people involved to be in a business partnership together to work. This is about forming a team of people to run a business, and for the same reasons as in section 5.3, about securing key people; the team can work as well as employees without having to be partners. Being a good employer and providing an environment that encourages staff to reach their potential and then rewarding them appropriately is better business than taking them in as partners.

Other alternatives would be:

- The involvement of outside consultants or a mentor. Third parties like these may be expensive at the time but they bring impartiality and a lack of vested interest to helping you solve any difficulties.
- Industry groups like farm discussion groups are also excellent for this sort of thing, as are organizations like Federated Farmers, Employers Federation, Institute of Management, etc. No one group is going to be able to deal with all the problems that arise and outside consultants may still be required, quite possibly to first deal with the partners disputing the solution to the problem!

5.7 Succession or Estate Planning

Most parents with a successful business have a desire to assist their children financially and quite often both parents and children are keen to work together in the family business. Trusts, companies etc. are used as vehicles to assist with the transfer of some or all of the assets from parents to children, and to avoid as much as possible any potential future duties/taxes on the transfer. However in doing so the parents are effectively taking in some or all of their children as partners with all the advantages and disadvantages that go with that. For this to be successful the family involved should go through the same process of considering how their succession plan, which may or may not involve joint ownership or partnership, achieves their individual goals.

Just because a family grew up together does not mean that they (or the children's spouses) will automatically work well together in business. In some cases the opposite may well occur. One of the great strengths of families is the ability to pass on wisdom and assets from one generation to the next. The order in which this is done is obviously important - assets without the necessary wisdom are a recipe for disaster. The other key component, in one generation of a family helping the next, is that the second generation is allowed the freedom to use the assets passed on to them to achieve their own goals. At some stage parents have to relinquish control on those assets they have decided to give to their children.

It is a sad situation to see families pass assets on to the next generation that lock children into businesses or shared ownership of assets when doing so restricts the children from achieving their potential and/or allowing the children to meet their own goals. Ideally if parents are going to help their children they should do so in such a way that the children have the skills and abilities to build on whatever they receive and are independent of each other. If they subsequently decide to join any of their siblings in business, that decision should be the child's, not one imposed by their parents.

5.8 Summary Reasons

A partnership, company, trust or a mixture of these structures can be very good and useful vehicles for businesses and their owners. But, as the above sections 5.1 to 5.7 explain, not all the reasons for entering into such arrangements are necessarily valid.

If one, after considering all these points, is still confident that the best or only way to be in the business concerned is to share that business's ownership with others, then consider the following check list:

- Is everyone clear on what their own goals and objectives are?
- Have you adequately analyzed all the reasons why shared business ownership is absolutely necessary?
- Are you thinking this through with your *head* or your *heart*?
- What are the alternatives, and what is the *logic* behind not using them?
- Will you be comfortable *sharing control* of the business with others and of course the *compromises* that will inevitably require?
- Will you be comfortable *sharing profits, and the equity gain*, with the other partners, even though that would exceed what the business would pay in interest to a lender?
- Are your goals and expectations for the business the same as the other people you will be sharing ownership with?
- Have these goals and expectations been communicated with each other?
- Do you have an agreement on all the details involved with running the partnership/company and a sound business plan for the actual business venture?
- Do you have an agreement between the owners on how they will handle partners leaving that is fair and equitable to all involved?
- Importantly: Have you had good third party advice from your professional business advisors, consultants, mentor and peers? Please do not consider this wasted time or money. It is very likely that if you do not spend it now, before you get into some sort of business with others, you will end up spending considerably more on similar consultants and lawyers (or worse still court costs) when the partnership ends.

6. Exit Agreements

6.1 Communication

For a partnership to work and fulfill the owners' goals, in addition to having the appropriate structure and good agreements, the key to the successful running and exit of the partnership is excellent communication between the owners. Partners need to be open and honest communicators with each other without any hidden agendas. The effort required to achieve this will vary with the types of businesses, the structure and the level of involvement of the owners. In general, to ensure excellent communication any group of owners should:

- Appoint a chairman
- Appoint a secretary
- Appoint a managing partner if appropriate
- Have regular meetings - weekly, monthly, or quarterly depending on the situation
- Minute all meetings and decisions and distribute to all owners
- Update owners on the business, minimum monthly
- Involve a third party as facilitator

6.2 Types of Agreement

Agreements between the owners of any enterprise will vary in format depending on their particular business structures.

- Every business should have a comprehensive business plan.
- Partnerships should have a partnership agreement.
- Companies will have a constitution, and should have a comprehensive shareholders agreement.
- Trusts will have a trust deed and may have a memorandum of wishes.
- Joint ventures should have a written contract.
- Contracts between the business and some, or all, of the owners depending on their roles, i.e.: employment contracts, and supply contracts etc.
- Every business should have a record of meeting minutes and any decisions made by owners.

Irrespective of the type of agreement or agreements they need to cover three principal areas:

- How the organization will run.
- How to deal with partners/shareholders joining or leaving the organization.
- How to deal with disputes.

Any agreement between the owners should address these areas. It is vital that these issues are discussed, agreed to, and signed off by all owners. Obviously the agreement should be clear, concise, within the law and in plain English.

Good agreements add value to the business and the partners' share of that business. They provide the framework for good management and smooth operation of the business. Exit agreements provide security for the partners and avoid them feeling trapped with the aggravation that may cause. Exit agreements also ensure that each partner's share is fully valued because, if an old partner can readily exit, so could a new partner, and therefore a new partner will be more comfortable buying that share. Likewise if a partner can readily exit a partnership it is better collateral for any borrowing.

6.2 Exit Principles

"Plan to get out before you get in" is the usual and excellent advice about partnerships. However, the reality is that drawing up an agreement to ensure that will happen harmoniously is extremely difficult. Every group of owners and every business is different and the appropriate agreement will therefore be unique to that situation. But there are some basic principles and tips to consider.

6.2.1 Full Discussion

The end of the partnership needs to have been comprehensively discussed between the partners. If one or more of the potential partners does not accept that the partnership will eventually end, and that how that ending should be dealt with is a vital issue, that person should not be included in any partnership. In order to formulate a robust exit agreement partners could "brainstorm" possible reasons that would cause them to want to leave the partnership. These may include:

- The partnership has met the partner's goals
- A partner perceives the partnership as not being able to meet his expectations because of poorer than expected business conditions
- A partner wishes to retire from the partnership because his own goals have changed
- A partner is forced to leave for reasons of health, finances etc.
- A partner dies
- The partnership includes a spouse and that relationship ends
- If the partnership involves a managing partner and he has to leave for whatever reason one or more of the remaining partners may also decide to leave
- An offer is made on the entire business or a partner's share of it
- Personality conflicts between partners
- Disputes between partners
- Poorer business conditions over an extended period of time leading to the enterprise failing
- Sudden disaster causing business failure

Note that in the event of business failure partners need to consider how they will deal with any potential financial liability they may be bound to.

6.2.2 Expectations

All the partners need to detail for themselves, and each other, what they expect from the partnership, i.e. contribution, roles, dividends, work (if applicable) and time frames for these. To be successful, partners need to have common goals for the business and any differences preferably complementary rather than divergent. A qualified and experienced third party facilitator would help ensure this process works, especially in family situations where emotions and assumptions could affect the result.

6.2.3 Expected Partnership Life Span

There will be an expected partnership life span, or time frame that emerges from the discussions about partners' expectations, when either the business by its very nature will finish, or the partners can no longer be sure they will want to be involved. This expected partnership life span might be 1 year or 10 years but, whatever that period is, that is the time frame to base the agreement on as a probable wind-up date.

6.2.4 Reviews

Partners should formally discuss and review their partnership position and expectations with each other annually. This will either confirm their position, or initiate changes either in their position or, if all partners agree, in the business direction. Again involving a qualified facilitator in meetings like this can ease the process. Partnership agreements should be considered as "living documents" that are altered as the nature of the business and, circumstances of the partners change.

6.2.5 Notice Periods

The length of notice in the process of an exit agreement should be as short as possible; there is no point in delaying the process once someone has decided to leave. All the parties are better off dealing with the issue and then getting on with their lives and business. Ideally the time from a partner informing his partners of his decision to leave, and final settlement, should be no greater than 2-3 months depending on the nature of the business.

6.2.6 Process

Every exit agreement should have a defined process, detailing what happens and when, and the number of days for each step. The process should be as simple and as timely as possible, and ideally would be able to be outlined in a flow chart. The more decisions that are already in the agreement the better the actual process will work, especially if communication is tense and difficult between partners, or worse if one or more of the partners has died. The fewer decisions required at the time of exit the less the process

can be sabotaged by deliberate delays by unhappy partners, or accidental procrastination.

6.2.7 Preemptive Rights

Preemptive rights are the right of remaining partners to buy any exiting partner's share. The usual situation is that any exiting partner must offer his share to all his other partners in proportion to their current ownership. If one decides not to take up that offer the rest can take up proportionally more. If none exercise their preemptive rights, the share can then be offered to third parties. A variation to this is where the exiting partner's share is offered to one partner before the other partners. This could be applicable for example where the partner having the preferential right originally owned the business himself and then took in partners. This preferential right would allow him to again eventually own the business himself if all the partners were to leave.

While the simplest agreement would not have preemptive rights, it would be in the best interests of all partners to ensure the remaining partners have the opportunity to buy any exiting partner's share before a third party. The partners know each other and they know the business.

Some agreements require that a third party be approved by the existing partners before he can acquire the exiting partner's share. While this can avoid future problems between the new partner and the remaining partners, it can also create complications, and delay the settlement process. The reasons why a third party should be excluded need to be realistic and detailed in the partners' exit agreement.

6.2.8 Valuations

Establishing the fair value of a partner's share in a business can be extremely difficult. Difficult because it is only a portion of a business, the full public market is not involved when the sale is to other partners, and possibly because of the nature of the assets, e.g. goodwill, or liabilities e.g. lease commitments.

6.2.8.1 Annual Valuations

Much of the difficulty involved with establishing a valuation can be avoided if the business is valued by a professional third party acceptable to all partners annually, or even more frequently, depending on the business. While this may appear expensive, if the business had a full valuation initially as part of the process of determining partners' contributions and bank financing, providing the valuer is fully informed of any relevant changes, it should be reasonably inexpensive to update that valuation annually. Besides making it easier to value a partner's share, this allows the owners to know how successful their investment is in terms of return on capital and capital growth. Should a partner decide to leave in the middle of the year the valuer who has been used annually could easily advise on any relevant valuation change.

6.2.8.2 Market Price

The only true value of a business, or a partner's share of it, is what the public market is prepared to pay. If a partner cannot sell his share to another partner or a third party at a price agreeable to both parties, irrespective of what a valuer may advise, in a reasonable time frame (see above section on notice), the partners' agreement should then require that the business as a whole be sold publicly and the proceeds distributed to the partners. The exit agreement should also cover the method of public sale and the time frames involved. This type of agreement is good because:

- It establishes the true market value of the business.
- Having such a final solution hanging over the heads of the partners encourages them to negotiate a fair price within a previously specified time frame.
- It is relatively simple and avoids all the time, stress and expense of getting separate valuations, arbitration, lawyers, courts and so on.
- Those partners wishing to continue in the business can still do so together, or individually, by bidding for the business in the market place.
- It makes any partner's share more valuable because its easy to sell and obtain full value.

Other valuation options that could be used include:

- Using an annual valuation as the non-negotiable price for the following 12 months. This would be easy to make the process quick but if the business or market is rapidly changing it may not be equitable, or
- Limiting the ability of partners to only be able to give notice of their decision to exit within a short period after the annual valuation is completed. This avoids the problem immediately above but does make the partnership more restrictive and therefore less attractive.

6.2.8.4 Partnership Tender

A method for a two-person 50:50 partnership to value and dissolve the partnership is for each party to tender for the other partner's share. Their agreement would allow for both partners, after reasonable notice, to submit a tender for the other partner's share of the business to each other, or through a facilitator. The highest tender then buys the other at his price and settles after a period specified in the agreement. The partner now owning all the business can either carry on running it himself or sell it on the open market. A variation on this is that the settlement price is the average of the two tenders paid by the higher tendering partner. This tender approach could possibly be adapted for partnerships involving more than 2 people. It has advantages of being quick and simple but does require the partners have access to good valuation advice on the business.

6.2.8.4 Shot-gun, or Russian Roulette Clause

The shot-gun or Russian roulette clause can be used as an alternative method of dissolving and valuing a two-person 50:50 partnership. If partner “A” decides to end the partnership and wants to buy his partner “B”, out their exit agreement would require partner A to submit a purchase offer to partner B. Partner B then has the option of either accepting that offer and selling or reversing their roles and buying partner A out at partner A’s offer price. Partner A has no choice but to accept. Again, reasonably quick and simple, and would encourage both partners to keep up to date with their business’s value.

6.2.8.5 Drawn Lots

Where a business allows itself to be divided into a number of equal and still viable parts, equal to the number of partners, a partnership can be dissolved by each partner receiving a part by drawing lots or some other random method. Their exit agreement would require the division into parts to be either agreed to initially, or for a mediated method of deciding on the division and valuation (probably supplementing different parts with cash/debt to establish exactly equal value). Once the partners had agreed that all parts were equal, they then draw their part by some random method. This method ensures equality and could be relatively simple if the business is easy to divide. However if the business was difficult to subdivide, it could be equally difficult to conclude the dissolution of the partnership. Therefore the division would be best decided before forming the partnership, because it will be very much more difficult to conclude a division at the time of dissolution. Logically then, this raises the question that, if the partners can decide how to subdivide the business before entering into partnership, perhaps it may be better for each partner to own a part of the business individually from the outset. They could then contract to each other, as appropriate for the business, as an alternative to being tied into a partnership.

6.2.9 Minimize Partnership Assets

The fewer actual assets the partnership has the easier they are to deal with when the partnership ends. For example a retail business run by partners could lease its premises, even if those premises are owned by one of the partners. Likewise in a farming situation two neighbouring farmers could lease their farms to a partnership they form, rather than having to sell their farms to their partnership. In both cases, if the partnerships were to end, the assets of the partnerships would be inventory and minor plant for the retailer, and stock and plant for the farmers; these assets being readily counted, valued, divided up or sold.

A variation on this that allows both partners to own all the assets would be for a different ownership structure for different types of assets. Using the example of a retail business again, the partners in this business form a company (company A), to run the shop whose assets are inventory and minor plant only. The actual shop building is leased by company A from another company (company B). The same people own both companies A and B, but each company has its own exit agreement. This allows some flexibility and allows

for situations where a partner, who wishes to retire from working in the shop, could exit company A under whatever process agreed upon, but still retain his investment in company B, which only owns the building. The same would apply to the farming example; one farmer could retire from the partnership without having to sell his farm.

Minimizing the type and amount of assets in any partnership, by either retaining ownership individually or having different ownership structures for different types of assets, linked by contracts or leases, will greatly simplify the exit process.

6.2.10 Death

When developing exit agreements the partners should imagine how the exit agreement would work if they were dead, and their estate's executor, or their spouse, had to work through the exit process. This is a good approach to take because sudden death of one or more of the partners is always a possibility. If the exit agreement will work well in that situation, it will be working well because there is little or no need for discussion or decision making by the partners. Therefore if the partners were all alive and well, but having difficulty communicating, the process will still happen as originally intended. Formulating the exit process and agreement on the basis of a partner/s being dead will tend to result in a process where all the important decisions are made in the agreement and not deferred until actual notice, or death of a partner. One option for an exit agreement is that it could require the remaining partners to compulsorily purchase a deceased partner's share (see below). This could be combined with partners insuring each others lives to help finance the purchase.

6.2.11 Compulsory Exit

As part of the exit agreement it may be appropriate to be able to force a partner to leave the partnership if necessary, and/or for the remaining partners to compulsorily acquire the exiting partner's share. In drawing up their exit agreement those involved should consider what changes they would tolerate in their fellow partners, be they mental /physical health, criminal record and so on. It will depend on the partner's role and the nature of the business as to what is appropriate. Great care needs to be taken to ensure that no legal liability can be incurred by putting this into practice and that every aspect of the decision needs to be transparent and equitable. Some reasons an agreement may require a partner to sell his interests to the other partners could be: failure to meet financial obligations to partnership, insolvency, conviction for fraud or embezzlement, insanity or death.

6.2.12 Disputes

All agreements need a dispute resolution process. The options are mediation or arbitration; if both of these fail that leaves the courts and the legal system.

6.2.12.1 Mediation

Mediation should be the first option for settling a dispute between partners. This is the best value method of resolving differences. It involves employing a third party agreeable to both parties who discusses the dispute with the parties and attempts to arrive at a compromise. The mediator cannot make a binding ruling on the parties, he can only try to facilitate the parties coming to an agreement. Success will depend on the knowledge and skills of the mediator, and the attitude of the parties. If a partnership employs a facilitator for their normal meetings or other aspects of their business he may be the first to involve. However if the dispute is not in the facilitator's area of expertise the partners should not hesitate to employ another mediator with the appropriate knowledge and experience. Mediation can be excellent when the parties are looking for a reasonable conclusion, without undue cost.

6.2.12.2 Arbitration

Arbitration involves the parties in dispute appointing an acceptable third party to act as arbitrator. Both parties put their case to the arbitrator who makes a ruling binding on the parties. It is like court but the parties appoint the arbitrator, and the process will usually require considerable legal expense and the associated costs and time. While it may be appropriate to include arbitration in the exit agreement, it should not be able to be used until all attempts at mediation have first been tried. It is worth noting that many agreements give the arbitrator, in the case of a fundamental dispute, the ability to require liquidation of the business.

6.2.12.3 Court

This is even more expensive and time consuming than arbitration and is not recommended as a method of dispute resolution until all other avenues have been exhausted.

6.2.13 Sunset Clauses

Some agreements have what is known as a sunset clause, where the partners agree not to leave the partnership for a specified period, usually to allow the business to go through a development phase. While this allows partners to focus on the development of the business without distraction, the downside is that they are locked into the partnership for whatever period they agree to which is contrary to the spirit and intention of any exit agreement. The shorter this period is the better.

6.3 Summary - Exit Agreements

Partnerships in whatever structure they take can be an excellent method for the owners to achieve their personal goals. However before opting for a partnership arrangement the individuals concerned need to consider how they will exit the arrangement. The partners need to then formulate an exit agreement that allows for as many contingencies as possible before finally entering the partnership. A good exit agreement will outline a simple, equitable and short process that will allow partners to exit without unnecessary disruption to the business or the partners. Key points to consider are:

- Expected partnership lifetime
- Minimize the assets owned by the partnership
- Formulate the exit process on the assumption that one or more of the partners may be dead, and incorporate all major decisions into the agreement
- Use a professional facilitator
- Mediation is the first option for disputes
- Annual reviews of all aspects of partnership, including the exit agreement and asset values

7. Conclusion

This paper was written to provoke the reader into thinking through the decisions they are, or should be, making when considering entering a partnership. Depending on the situation, going into a business with other people is a little like getting married. While marriage is usually a well thought through decision, and involves a period of courtship and engagement, entering partnerships is often not. Joining a partnership is a big decision and it deserves full consideration. It is not a decision that should be made in the heat of the moment, when all those involved are optimistic and feeling good about each other. It is a business decision requiring rational thought which could have a large financial impact on the partners. The impact will hopefully be profitable but it could also be a decision that ends in bankruptcy.

There are alternatives to sharing ownership of any business with other people that should be considered before deciding to go with a partnership. But if some form of shared ownership is the best alternative, work out how that arrangement will end so that all concerned can hopefully eventually exit, having achieved their goals.

A partnership is only a means to an end, not an end in itself. It is a vehicle for the partners to get from where they are now, in terms of their plans and goals, to where they want to be in the future.

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