10 BIGGEST MISTAKES BUSINESS OWNERS MAKE IN CLOSELY HELD COMPANIES

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1. NOT HAVING A SHAREHOLDERS AGREEMENT

Some "partners" or "shareholders" never enter into a formal, written agreement regarding their relationship to each other and to the Company. While New York law does not require such agreements among owners of "partnerships" and "corporations," the best practice is to have one. The start of the relationship is the best time to address issues such as governance, buy/sell, disability, retirement and death, employment, and the roles and powers of each owner, as well as what percentage of votes is required to take certain actions. Without requiring something different, the "majority rules" concept is the norm. If you don't want a simple majority to rule, then a shareholders' agreement can provide for a super-majority or unanimity for certain actions.

Without a written agreement, statutes will provide default provisions and "fill in the blanks." Such statutory provisions, however, may not be what the owners want. For example, and as discussed below, an owner has no right to employment. So, if the shareholders or partners desire such a right, an agreement to that effect is necessary.

If you have an LLC (Limited Liability Company), however, New York law requires an "Operating Agreement," which is similar to a shareholders' agreement. There are many instances in the New York Limited Liability Company Law where a "default provision" is provided regarding certain aspects of an owner's rights or responsibilities, but the statute permits the owners (called "members") to "provide otherwise."

Using a "cookie cutter" or form agreement among the owners, however, may not provide the protections you want or that you need for a specific company and its owners. Do you need or want a "buy/sell" agreement? Are there acts that you want to require unanimity or a super-majority vote? For example, can two owners fire a third? or mortgage property? or order a capital call? Do you want unanimity to merge, sell some or all assets of the Company or to bring in a new investor or business owner? Do you need non-competition covenants? If you bring in a new owner or investor, should governance change?

Setting forth such governance rules and the responsibilities and options of the owners is important. If you don't, then default provisions will apply regardless of whether you "like" them.

2. NOT HAVING AN EMPLOYMENT AGREEMENT

Without an express agreement that an owner will be employed by the Company and paid a salary, an owner has no right to employment nor a right to receive compensation. Therefore, if the owners of a company have reached an agreement to employ any or all of the owners, it should be in writing. This can be in a separate employment agreement or included in the shareholders' agreement.

Among the terms that should be addressed are:

- How and when can the employee-owner be removed or fired? (*i.e.*, what grounds? only for cause? what constitutes "cause"?) If the owner can be removed, by whom? by what vote? if there is a dispute as to the grounds for removal, is there a dispute resolution clause how are such disputes resolved (*i.e.*, mediation, arbitration, or in court)?
- What bonuses or salaries are to be paid? when? how is a bonus calculated? is there a right to a bonus, or is it discretionary? who makes the decision? what are the metrics?
- What duties and responsibilities will the employee-owner have?
- Should you provide a severance agreement in the event of a termination? Do you need a non-compete or a non-solicitation clause? Do you need a confidentiality agreement?
- If the owner is removed as an employee, does it trigger a buy-out of shares?
- What disability provisions or retirement options do you need?
- Does disability or retirement force a buy-out of shares? if so, on what terms?

If you don't address grounds for firing in an employment agreement, in New York, an owner can be removed for any (non-discriminatory) reason and by a majority vote, or by the President. Is this the result you intend?

Many business owners' disputes arise from perceived inequities concerning payments from the Company. For example, where one of two owners is an employee and therefore receives a salary, the second owner may raise issues concerning whether compensation paid to the other is "reasonable." Since there is no right to declare a dividend, the disgruntled shareholder often argues that the compensation paid to the other owner is above market rate for the services rendered, and, therefore is a disguised, "de facto" dividend, and the excessive compensation is "corporate waste." Another type of dispute arises when a salary is paid to a non-working owner. Having a written agreement concerning employment and compensation may help avoid disputes and expensive litigation.

3. NOT HAVING A BUY-SELL AGREEMENT

A buy-sell agreement sets forth the terms and circumstances under which one business owner may require one or more of the other owners (or the Company) to purchase his interest, and can provide a formula to set the buy-out price.

It is often difficult to find a buyer who wants to purchase an interest (especially a minority interest) in a privately held company. There may be no market for your share. Having a buy-sell agreement may be critical, therefore, because without one it may be impossible to "force" another owner to purchase an interest.

Another reason to have a buy-sell agreement is that it can ensure that your "partner" will not sell the interest to a stranger or anyone else with whom you don't want to be in business with, as you can either restrict ownership or have a right of first refusal.

Similarly, if an owner dies, is disabled, or retires, a buy-sell agreement should set forth what rights the other owners have. Do you want to be in business with a widow or widower or other heir? If you are disabled or want to retire, do you want to be able to extricate yourself from the company and monetize your investment? Do you want to force the disabled partner to leave? If so, on what terms? Will these payments cripple the Company and leave you without a source of income?

A buy-sell agreement should not only set a price (or a formula for setting a price), but also should answer the question of who can own the shares after a death, define "disability" and when and on what terms a partner can (or must) retire. The agreement can also name a person to perform the appraisal or valuation, and set forth the method to calculate the buy-out price or appraisal.

There may be no statutory right to force a buy-out of an owner's interest, so these are important matters to consider. Remember, if shareholders have trouble addressing these issues at the start of the relationship, imagine how difficult it will be to reach an agreement if the relationship has gone sour.

4. NOT REQUIRING SUPER-MAJORITY VOTING (OR UNANIMITY) TO MAKE CERTAIN DECISIONS

Without a written agreement to the contrary, majority vote rules in almost all circumstances by statute. The owners of a business should give consideration as to what issues should require more than a majority vote to approve certain actions. The following issues are often ones that the owners agree will require super-majority (*i.e.,* more than 51%) of shareholder votes (or unanimity):

- hiring a relative
- firing one of the owners (as an employee)
- buying or merging with another company
- selling certain assets
- mortgaging or pledging certain assets
- selling all or substantially all of the assets (which under New York law applicable to corporations requires a 2/3 vote)
- engaging in a transaction of a certain size
- adding owners
- a sale outside the ordinary course of business
- moving a principal place of business
- setting compensation of owners or relatives
- changing the nature of the business

Requiring a super-majority (such as 2/3 vote) or unanimity in order to take certain enumerated actions may prevent a situation where some of the owners "gang up" and may "abuse" or "oppress" another owner. Alternatively, a super-majority or unanimity requirement may give extensive "veto power" to a relatively small shareholder and can cause paralysis and missed opportunities. Governance decisions are extremely important and must be thoroughly thought out.

5. NOT ADDRESSING DISSOLUTION OF AN LLC IN THE OPERATING AGREEMENT

When members of a New York LLC do not address in their Operating Agreement under what circumstances the LLC can dissolve, the default provision is found the statute. The statute, however, provides extremely limited grounds for dissolving an LLC: "**[the Court] may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement."**

Thus, in New York, dissolution by the court may not be an available remedy, even when there are substantial losses, the owners are not getting along or have different visions for the company or disagree over strategy or business decisions, or there has been "oppressive" conduct.

The statutory framework for an LLC is different than for a corporation or an "old-fashioned" partnership. With a real partnership, a partner may withdraw at any time, and for any – or no – reason. With a corporation, there are statutory grounds for a shareholder (who owns at least 20% of the voting shares) to seek dissolution of the corporation and, in certain circumstances, any or all of the <u>other</u> shareholders (or the corporation) can <u>elect</u> to buy-out the dissenting shareholder's interests. These grounds include oppressive conduct, waste of corporate assets and fraudulent conduct. 50% owners of a corporation also can seek dissolution where there is a deadlock. Not so, however, with an LLC.

In New York, the death, retirement, resignation, expulsion, bankruptcy or dissolution of a member of an LLC does not result in the dissolution of the LLC, nor does it permit the withdrawal of the member – unless the operating agreement provides to the contrary or a majority of the members vote to dissolve within 180 days of the event.

Therefore, this topic is one that the parties should address in their Operating Agreement so that they can agree on the terms of dissolution and consider what remedies the owners will have.

6. NOT ADDRESSING "WITHDRAWAL" OF A MEMBER FROM THE LLC

In a New York LLC, a member cannot withdraw from the company unless the operating agreement provides for such. It is important to consider at the outset whether retirement, disability or death should result in a withdrawal, and if so, what the terms of withdrawal are: Is there a buy-out? How is the interest valued? What are the terms for a purchase? Who can acquire it? Can the interest be sold to a non-member? If a member cannot or does not work at the company, may he still own shares?

7. ADDING A NEW "PARTNER" WITHOUT REVIEWING THE "OLD" AGREEMENTS

When a LLC is formed and the two LLC owners have equal ownership stakes, the 50/50 ownership interests ensure that the parties must agree in order to take action. The concept of "majority rule" obviously does not apply where there are two equal owners. Unanimity is required.

However, when a third owner is added, and the Operating Agreement is not changed, suddenly majority rule applies and "two against one" can allow for one of the owners to be frozen out of decisions – and possibly even fired or otherwise oppressed by the majority. Thus, it is important to spell out how the company will be governed so that the minority owner is not oppressed.

The same rule applies for shareholders in a corporation (although there is <u>no</u> statutory requirement that the parties enter into a written shareholders' agreement, such is advisable). At the time that another shareholder is being added, it is therefore important to consider whether or how governance should change. Do you need or want unanimity for certain decisions? Should an owner be fired only for "cause" (and define "cause" very precisely)?

Not having such protections will allow for a minority member to find him himself on the "outside" looking in, with few remedies.

8. NOT PROTECTING BANK ACCOUNTS

Is only one "partner" named as a signatory on the bank account? Is a second signature needed to permit withdrawals (or payments) over a certain amount?

Being "on the bank account" (*i.e.*, having signature authority), can ensure that you get information from the bank and can protect against dishonest or improper conduct.

9. NOT HAVING COUNSEL REVIEW DOCUMENTS

Some business owners either take an "old" agreement and re-use it for a new business, or cobble together many different "form" agreements to create a new one. Or, in today's new electronic age, take agreements off the internet, regardless of whether it comports with New York law or is appropriate for the needs of the parties. This may save fees in the near-term, but may be expensive mistakes. Before drafting your own document, the owners should consider whether having a lawyer prepare and review agreements would help to make sure that they not only comply with a state's law, but also address the concerns and needs of the specific business and its owners. Also, if one lawyer is the "scribe" for the parties, you should consider whether you need your own counsel to review drafts and provide you with independent counsel.

10. NOT INCLUDING AN AGREEMENT TO MEDIATE OR ARBITRATE DISPUTES.

Litigation among business owners is not only expensive, but it is time-consuming and a major distraction from the business. It can dilute the value of the Company, too, as vendors or customers may flee, hearing (correctly or not) that the business is going to dissolve because of dispute among the owners. Including in your contract an agreement to mediate and/or arbitrate your disputes may be the best way to either resolve disputes early or to less expensively.

A "mediator" is a neutral who helps the parties settle their disputes. A trained mediator can help the parties find common ground and facilitate discussion. The mediator helps to find consensus and creative ways – often business solutions – to put an end to disagreement. Not only can a mediator be brought in as problems arise, but the parties' agreements can include a provision that *requires* mediation *before* a suit (or arbitration) is instituted. This, too, can be an important cost-saving measure.

An *arbitrator* can be used to help resolve external disputes – just like a judge does – but the arbitration is usually a less expensive means of resolving the disagreement. An arbitration is also confidential – so that vendors and customers - and competitors - will not know that there is disagreement. An arbitrator is a neutral who makes decisions that are binding on the parties.

Arbitration can be used in a creative way to determine internal disputes whether caused by a deadlock among business owners about important business issues (such as about "what to do next") The arbitrator can be used to break the deadlock.

Let's suppose the family-owned business is a real estate holding company and the owners have a deadlock as to what to do with a particular piece of property. Group A wants to sell the property and Group B wants to develop the property. A stalemate such as this can cause paralysis, hurt the investment, and, unfortunately, lead to litigation and liquidation.

Unlike a mediator (who doesn't decide anything, but rather, helps the parties to find the common ground to resolve the dispute themselves), an arbitrator is "the decider." An arbitrator is a neutral who can hold a meeting (such as a board of directors or shareholder meeting), and have each "side" present his or her position. In my example above, Group A would present their case as to why the property should be sold, what the ramifications of such sale would be, what the proceeds are, the tax consequences, and how the proceeds would be distributed, or what capital would be re-invested. Group B would present their model of developing the property, the costs entailed, how the project would be funded, and what the cash flow would be following the completion of the project. The arbitrator would then cast the deciding vote, and, thus, "decide" the parties' dispute. The arbitrator could also decide other legal issues presented.

In this way, an "alternative dispute resolution" technique (here, arbitration), would assist the parties in creating a fast-track resolution of the dispute, with cost savings *and,* because each group of investors had a chance to present their viewpoint, the relationships among the shareholders will be salvaged.

Saving relationships through these fast-paced dispute resolution techniques is extremely important. Preventing "toxicity" is a goal of mediation and arbitration.

CONCLUSION

There is no such thing as "one size fits all" when it comes to the documents used to organize a new business and govern its affairs and the relationship of the owners, successors and heirs. To make sure that your agreement meets your needs and the Company's requirements, hire competent counsel and have your "old" agreements reviewed periodically to make sure that they stay apace of changes in the law.

Best of luck!

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