



Mary Hanson

About the Business Advisor

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

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

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THE CHALLENGES OF CO-OWNERSHIP

by Mary Hanson

If you (or anyone you know) is considering going into business or starting a new business, there are many issues that need to be considered.

One issue that must be considered is that business is tougher now than it has been in the past. For my views on why business is so much tougher, see my November 2006 article "13 Reasons Not To Run Your Own Business."

Another key issue to address is whether to get into business alone or to have co-owners. Since business is tougher than ever, it is tempting to think that having a partner or co-owner will be beneficial. However, the perceived benefits of having additional funds, additional expertise, and additional manpower by having two or more owners are often outweighed by the disadvantages of co-ownership.

In my experience the benefits of co-ownership are most often not as great as anticipated, and the disadvantages of co-ownership are far greater than one could have imagined prior to operating the business.

Illusory Benefits of Co-Ownership

If additional funds is a key reason for

having one or more co-owners, rather than getting into business alone, make sure (a) the amount of money is meaningful, and (b) the funds are in the business bank account before the other person becomes an owner. Two common problems are that (a) the amount to be contributed to the business by the other person is not enough to make a difference in the business; and (b) promises made regarding contributions of funds are not kept.

If you are giving stock to employees or relatives as an incentive for them to work hard and effectively in the business, you may be disappointed. Giving someone an ownership interest usually does very little to cause him or her to perform. Many individuals simply lack the ability to perform as desired. A better incentive is often giving money, after the fact, to those who actually DID perform.

If the reason for co-ownership is the need for another person's efforts, skills, or sales contacts, this need can often be met in a more effective manner by contracting with that person for his or her services. If the other person cannot perform, he or she can be replaced. If he or she does perform well, there are many ways to compensate for good performance.

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The Challenges of Co-Ownership

Even if the benefits of co-ownership DO materialize, they may be outweighed by the problems and challenges of having a co-owner. Consider the following issues involved in having other owners or investors:

- (1) Each partner or co-owner will have his or her own ideas on management and business decisions. Other owners' ideas are unlikely to be the same as your ideas. Each person's style of management may be very different from yours.
- (2) Sharing decision-making is difficult. Do you really want to share decision-making when it regards your most important asset (the business) and your source of income?
- (3) If you are stuck in an unhappy business relationship, it can be very difficult to get “divorced.” It cannot be ended without some co-operation from your co-owner. The other owner(s) will want to be bought out for a meaningful purchase price.
- (4) If you stay in a bad business relationship your business reputation can be harmed by the activities of your partner or by the management disfunction that results from the difficulties between owners.
- (5) Your co-owner may want to be paid more, or work less, or give a brother-in-law, girlfriend, or someone else a job.
- (6) Your co-owner may want to expand the business when you think it is more appropriate to sell it. There are many variations on this issue. If only one owner is dedicated to expansion, growth, or additional investment, conflicts will arise.
- (7) Your co-owner may turn out NOT to have the management skills, job skills, contacts, funds, work ethic, or other attributes that you anticipated.
- (8) Your co-owner's financial situation is most likely different from yours. When you consider lifestyle, income needs, family situations, financial obligations, and tax circumstances, it is unlikely that you and another co-owner will be a perfect match. Will you both be able to put money into the business, and not take compensation out, when necessary?
- (9) Having a co-owner without having a corporation or other entity exposes you to personal liability for your partner's acts and omissions relating to the business.
- (10) Having more than one shareholder in a corporation

THE CHALLENGES OF CO-OWNERSHIP

means that you will have to hold formal meetings, give notice of meetings, take votes at meetings, and observe all the other corporate formalities with the other shareholders.

- (11) You need to have a shareholder agreement in order to restrict shareholders from selling or transferring their stock to anyone outside the corporation, and to provide a right to buy out the other owner's shares in the event of death, divorce, and failure to contribute to the business.

The Shareholder Agreement

Without a shareholder agreement or some other method of restricting transfer, a shareholder is free to transfer his or her shares of stock just as he or she is free to transfer any other personal property. The key concerns addressed by a shareholder agreement relate to control over the ownership of stock. In a closely held business you do not want to start out in a relationship with one co-owner and later find yourself a co-owner in a business with other individuals, either relatives or heirs of your original partner or third parties who have purchased the other owner's shares of stock.

The most common provisions in a shareholder agreement cover (a) restrictions on any transfer of stock; (b) the mandatory purchase

of shares held by a deceased shareholder; (c) a right of first refusal allowing the corporation or the other shareholders to purchase the stock of a shareholder who has received an offer of purchase from an outsider; and (d) an optional buyout of a shareholder's shares under certain circumstances.

The mandatory purchase in the event of the death of a shareholder is intended to protect the surviving shareholders from ending up as co-owners with the heirs of a deceased shareholder and also protect the heirs of the deceased shareholder from having to negotiate a sale of the shares to the surviving shareholder. Life insurance is often purchased, and should be purchased, if at all possible, in order to make the buyout possible and relatively painless.

A right of first refusal gives the corporation or the other shareholders the right to purchase the stock of a shareholder on the same terms as those offered to the shareholder by a third party before the shareholder can go ahead and sell his or her stock. This enables the corporation and the other shareholders to prevent the transfer of stock to an outsider, while allowing a shareholder to get the benefit of an offer to purchase.

A shareholder agreement also often provides for an option to buy back the stock of a shareholder under certain circumstances, such as:

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FROM THE LAW OFFICE OF MARY HANSON

Publisher's Note

My article mentions the problem of co-owners promising to contribute funds and then failing to do so. This is a problem in ANY contract.

It is important to remember that a contract is just a promise. Some promises simply can't be fulfilled. It is far easier to negotiate an acceptable co-ownership arrangement than to actually keep the promises made. The typical commitments involve contribution of funds, contribution of skills, and commitment to a level of effort. In reality, the sincere co-owner may not have the funds, the skills, or the time to commit to the endeavor.

Many individuals borrow funds to contribute to a business. Later, when the business needs additional funds, the owner does not have additional funds to provide the business. He or she is still paying interest and principal on the funds that were borrowed before and needs to take funds from the business to pay off the loans. You can find yourself with a co-owner who needs to EXTRACT funds from the business at a time when the business most needs to have additional funds contributed.

Mary Hanson
Attorney/Publisher

- (1) the bankruptcy of a shareholder;
- (2) the permanent physical or mental disability of a shareholder whose services are needed by the corporation;
- (3) the failure of a shareholder to perform his or her designated responsibilities, quitting work for the business, or failure to contribute to the business; and
- (4) an attempt by a shareholder to transfer his or her shares without compliance with the shareholder agreement.

The shareholder agreement needs to provide a mechanism for buying shares under the agreement,

including the determination of a purchase price, timing for exercise of any option, and the method of payment for shares.

Planning Ahead

Co-ownership should be carefully considered. It is not merely a matter of trusting your co-owner. If at all possible, go into business alone. Hire the assistance that you need rather than trying to get it from a co-ownership situation. If co-ownership is necessary, have a shareholder agreement and be prepared to buy out or be bought out if running a business with a co-owner turns out to be too difficult.

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