

SBTV#13 Business Partners

Guest: Michael Zuckerman

Dennis Zink: In this episode of SCORE Business TV, we're placing the spotlight on having business partners. Whether they're investors or working partners, there's little doubt your life will change when you accept a partner in your business. What are the risks and potential rewards of having a partner? What type of documentation should you have? Stay tuned as we explore the ins and outs of having a business partner.

Dennis Zink: Welcome to SCORE Business TV, sponsored by Wells Fargo. In this series, experts share their opinions with business owners and entrepreneurs on a variety of topics. So let's set the scene today. Either you're in business as a sole owner, or maybe you're planning a new business and you'd like to have one or more partners to help carry the load. Let's explore these issues with an expert.

Dennis Zink: It's my pleasure to introduce Michael Zuckerman. Michael recently retired after practicing law for 54 years in New York. He graduated with a BA in economics from the Wharton school and a JD from Harvard Law School. His expertise is in estate planning, employment, shareholding partnership agreements, succession planning and the purchase and sale of businesses. Michael, welcome to the show.

Michael Z: Thank you.

Dennis Zink: Michael, when you're starting a business and you're taking a partner on, does it matter what type of entity you have?

Michael Z: Yes, it really matters and you should understand that there are a number of different entities that you can choose from. When I started practicing, many years ago, there were only two choices. You could do a partnership or a corporation and there was a tremendous difference between them, well, I'll get into later. After that, the IRS came out and said we could allow a corporation now to be taxed as a partnership and we'll call that an S corporation. So a corporation now took on the trappings of the taxability of a partnership but had the protection of a corporation.

Michael Z: Several years later, they came up with limited liability companies, and they said okay, limited liability company is something that we're going to allow you to do, basically to elect either as to be taxed as a partnership or as a corporation, you make that election, but you get the protection you that you have with a corporation without actually going through the corporation. So today, people can choose between, a limited liability company, or a corporation, which they can elect to have either S corporation and taxed as a partnership, or a straight taxation, or a partnership.

Dennis Zink: Okay.

Michael Z: Now, the laws are different from state to state, so the terms that I'm going to use are the ones I'm familiar with, they might be slightly different, but the concepts are all the same.

Dennis Zink: Michael, what are some of the advantages and disadvantages to each type of entity?

Michael Z: Well, the two main advantages and disadvantages center around liability and taxation. In liability, for example, a partnership, itself, every partner is responsible and liable for all the debts of the partnership and possibly even for debts or obligations of other partners. The one exception to that would be a limited liability company, a limited partnership, where you would have limited partners who would only be investors, but would not have any liability. This is extremely rare, its indicated, and we'll just ignore that for purposes of this discussion.

Michael Z: The other thing is the taxation and in a partnership, the taxation is that the entity is not a taxable entity, it's a pass through entity and every income or expense goes through to the partners, in a percentage they have of the partnership. In a corporation that's taxed as a corporation, the corporation gets taxed, and then whatever it passes out, the taxation is a double taxation on the shareholders.

Michael Z: There are other reasons too. For example, if you're planning on going public or becoming large, you can't be an LLC, you can't be a partnership. What you have to do is be a C corporation so that people can buy stock in the corporation. If any of your partners are foreigners, for example, you can't be an S corporation, you would have to become a limited liability company. So there's a lot of different things. I think when you choose which one you're going to go to, you really got to sit down with your accountant and your attorney and go through all the pros and cons to discuss what's the best for me, not just today but in the long run. And I think that that... because getting into one and out of another can be very expensive tax-wise, so you have to be very careful at the initial formation of the entity.

Dennis Zink: Okay. Well, I believe that... isn't it true that if you have one entity that you're in now... So many of the people watching the show will have an existing business, and maybe they have an S corp, can they change out of that every so many years, or change one time?

Michael Z: I think they can change one time-

Dennis Zink: One time.

Michael Z: ...I think there's a 10-year wait period and you're left with some of the remnants of it. I'm not an accountant and don't know all the ramifications but it's tricky and I don't think you should be-

Dennis Zink: Okay, let's move on then.

Michael Z: Right.

Dennis Zink: Okay, what about choosing a partner. So let's say that I need an investor, is one possible example. Another one might be someone has expertise that I don't have in an industry that I'm involved with or getting involved with. So what do I do about choosing a partner carefully so I don't have problems down the road?

Michael Z: Well, basically you're entering into a marriage, in a business marriage, and I think you've got to be extremely careful of who you do, and who you bring in with you. In many cases, you're just looking for an investor, and this person is just going to put money in, keeps a hands-off situation, they invest in many similar type deals and give a report once a month or once every three months and they're happy as long as they're making money. But the most common is where you're going to bring in people who you want to help. You're a salesperson, you need someone with finance, you need someone in the production part. So you look for those types of people and very often the ones who are good enough to come in, don't want to come in unless they have an ownership interest.

Michael Z: Now, you've got to be careful about who you bring them in and when. For example, I handled a lot of medical practices and a doctor coming out of residency comes into the practice, you make him a partner the first day that he's there. Well, we've had too many people really get burned on that. I try to go for a 2-year period. A 1-year period, a guy could hide who he really is. We had situations where a doctor came in, he was the best doctor they could imagine, but he could not handle the nurses, he couldn't handle the staff and he had terrible relationships with the patients and after six months they said, "Goodbye. You don't have an ownership interest because you had a 2-year waiting period before you came on." So you've really got to be careful who you do it and how you do it.

Dennis Zink: I know instances where a business owner will want to reward loyal employees by giving them some ownership interest in their organization, whether it's an LLC or a corporation. Is there anything you've seen over the years that's a better way of doing that so that you don't go, "Oh my god, I've given up too much, or this person isn't who I thought he was."

Michael Z: There are a number of ways. One is to do it with a bonus system as employment so that they could get a share of the profits at the time that they're working, but as they leave, you don't have to buy them out. You could give them phantom stock and say, "We'll pretend that you have this stock, and when you do leave, we'll give you some appreciation that's based upon it." Or you could give them an option to be done at some later time, but you've got to be very careful bringing in these people and you might want to do it on a different level. You might not want to bring them as a full shareholder. You might want to bring them in a corporation as a non-voting shareholder or in a non-voting member in an LLC, something like that.

Dennis Zink: Obviously, when you bring in a partner, you don't want to do it on a handshake, that's not really way to run the railroad. So what kind of documentation is necessary?

Michael Z: Well, it's very interesting because people come and they say, "Gee, my partner, we went to grammar school together. We've been together for 50 years, my best friend." "Well,

how much business experience?" "Well, we never did but we talked about it." Or "I've got a family member who's coming in. You know, How could I ask my brother-in-law to do this or do that?" And, I'll give you a perfect example. I had a client who had a very successful business. He had an unmarried daughter who was in the business and suddenly she becomes engaged. They get married, have two children, and he comes to work for the business. He's great in the business.

Michael Z: So my client comes to me and says, "Gee, I want to give 20% of the business to my son-in-law." I said, "Well, why don't you give it to your daughter, cause she's married..." "No, he really wants it himself." I said, "Please, don't do it... yet." He's just been there for a short time. "No, no, I really want to." I said, "Okay then, let's get an agreement with him that if he leaves he has to sell it back and set the price." "No, no. I don't want to embarrass him." I pleaded with him. No, he gave him the 20%, and two years later when they come to divorce court, he comes to me and says, "The divorce is absolutely horrible, they're just hating each other. He's refusing to give up his stock, and I can fire him, but how can I stop him from being a..." And I said, "You can't and you can't stop him from selling it to a competitor, if a competitor wants to come in and own 20%." So he really learned his lesson.

Michael Z: So there's nothing that's safe. You can't do it on a handshake. You've got to tie everything down. And I think further on in our discussion, here, we're going to discuss the various things that should be in either the operating agreement, which is the agreement that you use in an LLC, limited liability company, or the shareholders by-laws and employment agreements that you use in corporations or a partnership agreement that you use in a partnership.

Dennis Zink: Okay, and each side should have their own attorneys, correct?

Michael Z: Well, you might even have as many as an extra attorney. I've seen people who each have their own attorney and then they hire a third attorney who draws the documents and then the other two comment, because there's no way, and I've been doing it for 54 years, that I could be fair to everybody in every point. I can try to be or pretend that I am, but it's called conflict of interest and that's one way to get disbarred.

Dennis Zink: Well, that gets expensive, having all those attorneys.

Michael Z: It does. So what you usually do, is you try to get one lawyer who's really good in that field. Make sure you don't get your divorce lawyer or the guy who handled your real estate deal. Get some guy who's done a thousand of these businesses and you then you sit down and you go through all these points and you come up with what you think you want. Then he draws that document. Then each of your lawyers looks at it from your standpoint, and says, "I'd like a change here or a change there." Yes, it's expensive but it's a lot less expensive than what I call the lawyers' relief act, which is when you don't have an agreement and they come to you absolutely panicked, "We hate each other. How are we going to get out of this?"

Michael Z: In fact, in SCORE today, we have our exit committee, and a number of our people coming to us are in business together and, "How do we get out this? We hate each other. We're struggling. We got this or that. I can do much better without it. How do I get out of it?" Well, what I tell the SCORE mentors today, is exit planning for partnership starts before you go into business, not when you get into trouble.

Dennis Zink: Absolutely. So what kind of written documents do you recommend they have?

Michael Z: Well, for a partnership, you just need a partnership agreement, and you only really need that if you're willing to rely on the state law. Every state has a very strict partnership law that covers almost every situation, but you're not going to like the way they set it up. Obviously, it's not to your advantage, it's to some legislator who decided that this is the way it should be done. So you form a partnership agreement in which you cover all the various aspects. Who's the manager? What your titles are? Who's allowed to do what you got to do? How you divide your profits, and we'll get into all these different things later on.

Dennis Zink: Okay.

Michael Z: But particularly you should have an exit strategy. What happens when we no longer want to or are unable to continue together.

Dennis Zink: Right, and you're on the exit strategy team at SCORE as well.

Michael Z: Yes.

Dennis Zink: Okay, and we do that.

Michael Z: And I would much rather do the planning in advance then do it after the fact when they don't even want to talk to each other.

Dennis Zink: Okay. So you're putting a company together and you need money. So what forms of capital... What if one partner wants to put in more than the other? The other one doesn't the money. How do you equalize some of those issues?

Michael Z: Well there's certain types of capital that you put in. The obvious one is cash. The cash can either come from a person, it can come from borrowing. It can be put in as capital so that it stays in the corporation or it can go in as a loan, in which point you would get it back at some point. If you do it as a loan, chances are you're going to have trouble getting outside financing from anybody else, particularly, unless you subordinate that loan. So most of the time, you're going to go in with cash for capital. But very often people have equipment, they have inventory. They have the business that they had before, they have accounts receivable, they have a client list. They put those... You kind of somehow value those items as well. If an outside investor's coming in, they're going to want you to value, "How much equipment am I putting in and how much cash I put in to equalize it, or are we going to be equal partners or other than equal partners." So that's a big decision that has to be made.

Dennis Zink: So if you made a loan, what kind of an interest rate would be a fair rate?

Michael Z: I think you'd have to choose whatever the common rate is. You could charge a little more than a bank would charge, probably, maybe even a little less. I don't know. I would go to the accountant and say, "Give us a decent rate." If you fix the rate, that's one thing. If you have a floating rate, that's another, but you really have to subordinate it, and one of the biggest problems you have, when you're forming this partnership with capitalizing it. People say, "I've got X number of dollars, I'm going to put it all into the entity." I say, "Well, what are you going to live on for the next six months?" "Oh, I'll just take a salary, and I'll take..." "You mean you're going to put the money in and then take a salary of your own money, take it back?"

Dennis Zink: Pay tax on it.

Michael Z: What you're doing is you're creating an income tax for yourself for using your own money." "Oh, I never thought of that." So I said, "Make sure you keep out enough money so that you're going to be able to live without taking anything out because you're going to need to build your inventory. You're going to have accounts receivable that don't get paid for 30, 60, 90, whatever days. So you got to finance that. Why should you pay income tax on your own money?" "Oh, I never thought of that." So you got to be very careful about things like that.

Dennis Zink: Let's talk about personal guarantees. So you have leases, you have contracts. What do you guarantee? What are you expected to guarantee? If you have anything with the bank, I'm sure you're going to guarantee it. Why don't you comment on that.

Michael Z: Well, the dream when you go in is that, "I don't have to guarantee anything." And then the money guy comes in and says, "I'm going to give you this money, but I'm not going to guarantee anything." So now the question is to convince your landlord, because you got a 5-year lease or whatever, 10 year lease, on a business that has no history at all. You go to the banker, as you said, no history at all. How much money are you going to have? I'm going to have your personal guarantee and you've got to have the assets behind it. So some guy's putting everything he has into this entity. He really doesn't have the personal guarantee and he's going to rely on the other person and if you're that person giving the guarantee and you're not really the one running the business, you've got to think twice. That's really tough.

Dennis Zink: Guarantees really aren't a problem as long as everything goes well. It's when they don't go well when you have a problem, so-

Michael Z: Exactly.

Dennis Zink: ...all the partners would have to sign on the guarantee, correct?

Michael Z: Well, that's the ideal, but all the partners are not equal and what you try to do on the guarantee is to say, "We'll sign the guarantee but we're only responsible for our

proportionate share. I'm not going to be responsible for 100% because this clown is not going to be able to come up with a nickel and then I'm going to cover the whole thing."

Dennis Zink: Well, that's where I was going with the question. So, but let's say that exactly that happens. So something comes up, things aren't going well. It goes south and one person says, "Okay, you know, we owe \$50,000. Here's my 25," and he looks to the other fellow and he says, "Well, I don't have the 25 and..." You know, isn't the first person that did the 25 still liable?

Michael Z: You have to read the guarantee. If it says, "I'm only responsible for my proportionate share." The answer's yes. If it says, "I unconditionally guarantee..." the answer is, you're responsible. And then what we do then is cross indemnities, in which we say, "Okay, if you have to pay my share, I'll agree to pay you back." But that's only as good as the paper it's written on.

Dennis Zink: Absolutely. So what about salaries and draws? So, two partners... I'm keeping it simple with two, it could be three or more. Two partners in a business and they say, "Okay. The business is making some money, let's take money out. How should we take it out, as a draw, as a salary, as a bonus?" What are the other options and what's good and bad about the options?

Michael Z: Well, I think that you've got to look at the needs of the entity first. How much monies you're going to need? You can't take out more than it has because that's the sure way to bankrupt the business. So you've got to work it backwards. What we did, particularly with professional practices. I handled a lot of doctors, dentists, and they're on a cash basis. So whatever came in or went out on the last day of the fiscal year was in that year. If it was the next day, then it would be picked up in the following year. So they had to sit down about a month in advance, figure out how much was coming in and then they would figure out bonuses and whatever, and in order to get to that position they had a small draw. Each month or each week or whatever it was, they would take out, about, it was clearly less than they were entitled to, and then they'd settle up maybe every month, every quarter. Quarterly was the good way to do it, or semi-annually, and then they would have to live on that until they got to the end to see how they were going to divide it.

Michael Z: The key here, though, is how people decide how much they're going to get. Now, I'll give you a perfect example. I had a professional practice with four doctors, and they decided that they would all share equally. Now this turned out to be a disaster because doctor number three decided that, "Why should I work Wednesday and Friday afternoons when I can earn the same amount and take off and do what I want to do?" So suddenly, he's off two, three days a week and getting equal amount. So they came to me, "What do we do?" I said, "Well, we got to put in a formula." The formula was based upon what you've actually produced. It doesn't have to be 100% of what you produced because that's not fair either. I've got other people working for us, I might have a dentist hygienist. I might have some kind of a nurse practitioner. So we got to figure out how we're going to share these things.

Michael Z: And that was one of the biggest things setting up these partnerships, was to sit down with the accountant and get the experience that other people in similar businesses had. Do a real good calculation of cashflow. What you're going to need in the business. What you're need individually and see if those are going to work out.

Dennis Zink: I'm going to give you an example of what I did. You tell me if this is a good example or not, or was a good method. What I said-

Michael Z: Am I representing you or your partner?

Dennis Zink: Well, it was in the agreement. It said that no one will draw any money or distributions to partners until a ratio of two times the amount of expenses. The money had to be in the bank. So if our expenses every month was 50,000, no one got a dime until we had at least 100,000 in the bank. Over that amount then we'd start doing distributions. Does-

Michael Z: I think it's a great idea if it could work.

Dennis Zink: It did work.

Michael Z: The problem is whether the people could afford to live without getting anything out of the business.

Dennis Zink: Yeah. Well, in this instance it worked. It was-

Michael Z: Yeah, but if you got two people starting a brand new business, they're in their 20s and they're trying to do things and they got kids in school, whatever. They might not be able to handle that. But yeah, that's the type of thing that you really got to think about.

Dennis Zink: And that's really how profits are distributed is what we covered. Is there anything else that we should look at in relation-

Michael Z: Well, you take a corporation's only gets taxed on its income. Up until last year the corporate tax was quite high. Now, it's quite a bit lower, but when it was high, they would sit down and try to take out the day before the year ended as much money as they could to make sure there was no profit. So they'd rather pay the tax personally than not. In fact, a couple of them would not go to the mailbox to get last week to make sure that they didn't get any checks in so they could take them to the following year.

Dennis Zink: Yeah. Okay, what about additional capital. When additional... the more money-

Michael Z: That's a huge area because... I'll tell you an interesting story. I represented, when I first started practicing, years ago, people who owned a lot of land out in the area where the mines and they had a lot of mining rights there. So they would go to the big publicly held corporations and say, "Listen, I will give you the right to go on this land and mine and I get 95% and you get 5% after you've got back your expenses." "Fine." So they dig around and dig around, they come back and say, "We need more capital. You got 95% of it, we'll give 5%." "No, I can't do that." "Okay, we'll put in all of it." "Well, now you've got

50% and we've got 50%." And two more draws later, he had 5% and they had 95, when they finally... believe it or not, they found gold, right?

Michael Z: So, here... you've got to plan ahead for the additional capital. And if you can't put in your share, you've got to be prepared to take a less of a percentage in the business or sell out. And that's another reason for an exit strategy. "I need more capital. I can't afford to put it in." "Fine, then I'll buy you out and I'll put it in."

Dennis Zink: Right, or the percentages can change.

Michael Z: Exactly.

Dennis Zink: Yeah. So what about proper expense allocation for business expenses. What's considered proper and what isn't?

Michael Z: Well, again, you sit down with your accountant, but I want to have a Lamborghini and you want to have a Ford, right? And I'm x number of years old and I want to put so much in my pension plan and you're much younger and you don't have to put as much in to end up with the same thing. I need two secretaries and you need one. You got to sit down and decide... I've run partnership agreements, with doctors, particularly, where four or five pages long cited each expense and how it was to be allocated because I don't want to pay for your... because you have two nurses and I only have one, why should I have to pay for that. And your nurse has been with us for 20 years, so she's getting the highest salary. Mine has just come in and getting absolutely low.

Michael Z: How do we balance those things? The problem becomes some things like rent. You've got two offices, you're in one with a small little office we pay \$100 a month. I'm in the big main office, they pay \$1,000 a month. Do we each share equally? So you've got to go through a lot of the danger expenses. How about my medicine, my medical coverage? How about my disability insurance? How about my life insurance? We'll get to these later but... my retirement plan. I don't need a retirement plan, my spouse has a very good retirement plan, I don't really need it. I do. So you have to allocate these and very often you'll take expenses that one wants and one doesn't want and you add them in as part of their salary. So that's part of the draw. If you want medical insurance, but my spouse has their own and I don't need it. Fine, but your salary, then, will be reduced by the amount of your premiums that we're paying.

Dennis Zink: Okay, so here's question number two. I did something similar to that where I said, "Okay, we want different things. I'm a little older than you are." And so we looked at the amount of dollars and then we made an adjustment for any differentials. So I would... Mine was 10,000 and yours was 12, so we adjusted for the two.

Michael Z: Right.

Dennis Zink: Does that make sense?

- Michael Z: That makes sense and another thing that makes sense is, we'll allocate to a car x number of dollars a year. If you want to spend more than that, that's your business. If you want to spend less, that's your business. I know you want to get these professional journals, I don't need them. We'll figure that out and you can do those things on a... I want to go to professional meetings. Okay, there's one around the corner. You can take the trolley over there for 15 cents. No, I'm going to Hawaii where I can spend the week enjoying a full... it's the best conference. Fine, I'll allocate X number of dollars for that. So that's the way we work that.
- Dennis Zink: I'm going with the Hawaii fellow too. Let's look at management and control, okay? So, who decides what? You have two partners, they are equal, in terms of... And that's... let's go back one step. They're equal. Should they be equal? Should they be 50-50 or 51-49? What are the... What's your comment on that?
- Michael Z: Well, if you can convince one to be a minority, that's fine, but if they're putting in equal amounts and spending equal time, then they going to have to work out the management between them. I've done that in a number of ways. One is, I actually alternated each year. January 1st, you become the president, next January 1st, you become the president. That's one way. I don't recommend it, but it works, if it works. The second way is, you have a committee, and you're allocated, say you're in sales, so you can deal with anything in sales, inventory and that kind of stuff. The other guy's production, he deals with that and anything else they have to jointly agree on, or they have a third member as a committee.
- Michael Z: I had one company, it was third generation. The grandfather had formed the company, did a great job. Left it to his two sons who were phenomenal. They ran it so well. One was the inside guy, the other one was the sales guy, finance guy. The production guy was great. They get older, they bring their two sons into the business. These kids couldn't decide on whether this was black or this was white. What we did was... and I hesitated to do it, but every Monday morning for breakfast, I met with the two of them, with two other people. One was an accountant and one was an expert in their business. And we sat down and we said, "You get together all the problems that you can't decide between yourselves, and we'll discuss it and we'll settle it." And we did, and last year they sold the business.
- Dennis Zink: You just took away my question number three, which was... you kind of covered there, so I'll pass on that. But it really just had to do with area of expertise, so you have the sales expertise and I have the general business running expertise. So if it's a sales related question, you make that decision, otherwise I make the decision, that kind of a thing.
- Michael Z: Well, the places you run into though is hiring and firing. We had the thing in our law firm, where one person had a secretary who was absolutely the best secretary you could imagine. And the fellow, we rotated managing partners for a while and the one guy that was managing partner at this time had something against the other guy. He fires his secretary. He absolutely screamed bloody murder. He said, "The secretary, you can't do that to me." Finally they reversed but it could be a disaster. You can... If you get into an area that you don't know what you're doing and you do it, that's where problems arise.

Dennis Zink: Okay.

Michael Z: But you always set down in your agreement. If you have by-laws, for example, a corporation has by-laws. Those by-laws will provide how this happens. The operating agreement for an LLC will so provide and so will the partnership. The problem is that, for outsiders, if you have a title. If you're a member of an LLC, or a president or vice president of a corporation, you are given apparent authority to bind the corporation. So you could go out and make it a position that everyone else is opposed to, but you could be bound by that because you've given the person that you're dealing with, the apparent authority that this person can do that. So you've got to be very careful giving titles and authorizing what people can do.

Dennis Zink: Absolutely. If someone's an officer of the company...

Michael Z: Exactly.

Dennis Zink: ...they can get you in trouble.

Michael Z: Yeah.

Dennis Zink: So let's talk about-

Michael Z: I won't give you a raise, I'll give you a title.

Dennis Zink: There you go. That's right. Let's talk about some health issues. So let's talk about disability and death. One partner's disabled, should you insure for that? What do you do when that happens and you didn't expect it?

Michael Z: Well, there's several kinds of disability. So you've got to deal with that. You have temporary disability and you've got permanent disability, or total disability or partial disability. And you've almost got to deal separately with them. Now, you can only afford disability buyout service if you're a very successful company. It's quite expensive. You have to have an agreement that covers it and they will only pay 80% of the buyout pay over a number of years, so that you can't get a lump sum payout on something like that. It's quite expensive and you have to follow all their definitions. You have to be exactly defined as it is. So forget the disability buyout unless you're really successful and have a good business.

Dennis Zink: Let's say... go back a step. So when the money comes into the entity. Person dies and the money comes to the entity and they're going to buy the spouse, the shares for the other spouse.

Michael Z: Right.

Dennis Zink: There's no taxable gain to the entity, correct?

Michael Z: Correct. Life insurance is received tax-free.

- Dennis Zink: Right, right. Right, right. I just wanted to state-
- Michael Z: And there's no taxable gain-
- Dennis Zink: I'm an insurance agent, I wanted to make sure that was stated.
- Michael Z: And there's no taxable gain to the spouse, because the spouse took a step up in basis which would be equal to the sale price.
- Dennis Zink: Right. Mike, what do you do when one partner wants out? They've said, "I've had enough. I want out?"
- Michael Z: Well, again, the agreement should have provision, but the alternatives to that are, number one, well the other partner can buy them out and that could be over a period of time, with a note or whatever, based upon future profits or something like that. If that's not acceptable, you can allow them to sell to another party, if you agree to that other party, or third, you can both agree to sell and we have what's very often called a drag along tag along. And that's something that really should put in, if one partner wants to sell and they have come up with a decent bona fide offer that's reasonable from an outside party and they decide they want to sell, the other person then has to sell their share, if they don't want to buy the other share at the same price.
- Dennis Zink: So they get the option.
- Michael Z: They get the option first to buy out and that's... You could even take a discount off the other price and they only have to buy their share, or they have to both sell to that third party.
- Dennis Zink: Okay. So what if one partner wants the other partner out?
- Michael Z: Now you've got a whole different situation, because that's very sticky. But again, the provisions can say... Say if you have three partners, if one wants one of them out, you've got a difficult situation. If two of the three want the third one out, then you can certainly provide that a majority can always ask someone to leave. And then you've got to set forth the conditions of that. The price, how it's paid, and things like that.
- Dennis Zink: So in the initial partnership documents, should you delineate who you can and cannot sell to?
- Michael Z: Yes.
- Dennis Zink: Okay, so it's very, very important.
- Michael Z: Very important.
- Dennis Zink: Let's talk about-

Michael Z: Most partners don't want to be partners with my kids or your kids or your spouse or your brother-in-law and so they'll provide for it. Others, if it's something, just a pure passive investment like real estate, owning buildings, really doesn't matter, so it would fit the situation, in that case.

Dennis Zink: Okay. Mike, let's talk about covenants not to compete. Let's talk about it from two perspectives, while the ownership continues and then after it's terminated.

Michael Z: The best place to put the covenant is at the time that you create the company, before you do anything. It should be in the initial agreements. And the reason for that is, I don't know the law in every state, but in New York, unless there's consideration for the covenant, it won't be enforced. It has to be reasonable, has to be over a reasonable time, a reasonable place and it has to be for consideration. So that, the consideration is entered in to the agreement and the relationship altogether. If you've already entered into that relationship and you say, "Oh, by the way, I forgot a covenant not to compete." Go ahead and draw it, but I doubt whether the courts will enforce it. To go to the court and have it enforced is expensive anyway. So, again, it's a matter of who says, she says, or whatever.

Dennis Zink: And I've done that, so I know a little about that. But a lot of that has to do with the variables of time and geography, distance.

Michael Z: Exactly.

Dennis Zink: So you want, maybe it's 25 miles from the courthouse and maybe it's for two years, and once you get beyond a certain amount of years they'd say-

Michael Z: Exactly.

Dennis Zink: Well, it's not necessarily reasonable. But in that covenant, wouldn't you say you would do to what a court would reasonably consider-

Michael Z: You set your limits and you say, "By the way, if any court finds that this is too extended or too great a period of times then we'll do what the court says is reasonable."

Dennis Zink: Right, you'd back it down. And what about-

Michael Z: Courts don't like to set that if they don't have to, so you're smart to keep it, you don't say, "All right, I'll do it forever, for the whole world, but if the court cuts it down to three blocks in Sarasota, we'll go with that." Court's not going to do that, they'd say it's overreaching in the first place.

Dennis Zink: All right. So we're in business together, we're partners, and I say, "Michael, I've got another opportunity here that I'd like to get involved with, or that I am getting involved with and I guess I couldn't possibly continue to give my best efforts," though I wouldn't tell you that, "Because I'm going to be distracted." How does that go over?

Michael Z: Well, if you were only a cash investor, that's not a problem. That's probably allowed in the original agreement, as long as it's not a competitor that's going to come in and actually compete with you. But I think that that situation is such that... then you'd have to get permission, in any such event, to go out and do that and probably take a reduction in your percentage because if you're devoting less time to the organization, obviously there should be something there. A way around that, and I've seen it happen, is if you're truly happy with your partners, you say, "I've got another deal. Why don't we go into this together?" And then there's no question about it, you'll both be doing that. If they say, "No, I don't want you in my other deal," or "No, I don't want to come in on your other deal," then you've got to deal with it, but I think... I don't think they should be allowed to do it without any discussion.

Dennis Zink: Okay.

Michael Z: It has to be upon agreement.

Dennis Zink: And finally, let's talk about the exiting process, which you've alluded to several times. As far as cashing out and exit strategies, just general comments on that.

Michael Z: Yeah, in the buy-sell agreement, you've got to have all these things covered. Death, disability, I want to leave, you want to leave. I don't want to be your partner anymore, or you're such a bad person, or you get convicted of a felony, or you're accused of whatever, or you want to go into politics. Any number of things could cause it, and you really should list all these different things. You're never going to get every possibility.

Dennis Zink: Right.

Michael Z: And no agreement is ever going to cover every possibility, but at least you try to get 90% and provide some other way to deal with it. The biggest question you're going to have is valuation, and valuation is really sticky and I think you've got to deal with how you're going to deal with it right at the start. Some ways that people deal with it, they say, "Okay, this business is worth X number of dollars, this is what we're putting in. We're going to stick with this number for a year, two years, and every period of time we'll come back and revisit it." And guess what?

Dennis Zink: They don't do it.

Michael Z: They never do it.

Dennis Zink: I know, I've-

Michael Z: I've had them for 50 years and I call them and say, "We're supposed to re-do it." "Oh, we're too busy, we're having a whole bunch of fun. No one's leaving. We'll do it next year."

- Dennis Zink: You know what? I did it on a 3x5 index card. Honestly, and every year we'd come out and we'd look and we'd change the number and we would initial it. But let me ask you one final question-
- Michael Z: Now there's a formula and the accountant will work out a formula. Very often the business that you're in has a formula. X number of times gross, x number of times net, or what have you. Or assets plus something, and you just do that for them, and every year the accountant, when they do your tax return and your annual statement, come up with a new number and you agree to be bound by it.
- Dennis Zink: My final question is, in your opinion, in your experience, what percentage of partnerships fail?
- Michael Z: Can we add marriages to that? Because this is nothing but a business marriage.
- Dennis Zink: No, just keep it to business.
- Michael Z: That's hard, I don't think I can-
- Dennis Zink: Give me a range.
- Michael Z: I would say, you know it depends on the relationships and what have you, but it could be as high as 50% fail. If they're a restaurant business, going to fail anyway, but...
- Dennis Zink: Oh. Mike, do you have any additional thoughts as the show comes to a close?
- Michael Z: I think the best advice that I can give is what we've talked about for the last period of time is so complex and so comprehensive that we can't expect people to have gotten the message. If they're going to get into a relationship, partnership, get yourself some good, competent advice, right from the start, and go with it. It's going to cost you a little more at the beginning, but in the end it'll save you not only headaches, but all kinds of money, and that's my best advice. Again, talk to your SCORE people. I think that's a huge advantage because we're training them to be sure that these things happen and I think that that's very important.
- Dennis Zink: Mike, thanks for being my guest today on SCORE Business TV, you've incredibly enlightened our audience on a very common topic that happens with a lot of SCORE clients are involved with partnerships. If you'd like more information about today's show or you'd like to inquire about having your own SCORE mentor, please reach out to us at 800-634-0245 or on our website at www.score.org. I'd like to thank Mike Zuckerman for appearing as my guest on SCORE Business TV. I'd also like to thank our sponsor, Wells Fargo. Please tune in for our next episode. Until then, this is Dennis Zink, thank you and have a great day.