The Punxsutawney Phil problem —

Drafting a business structure that makes owner disputes a little less painful

*By Michael J. Dayton**

This month brings to us the most hallowed of holidays: Groundhog Day — a day so steeped in tradition and of national importance that my iPhone has deemed it worthy of being placed on my calendar. It's a day when the world's smallest weatherman, Punxsutawney Phil, emerges from his burrow (a temporary home; apparently he lives with his wife Phyllis in the town library most of the year) and predicts whether we will have six more weeks of winter.

But this article is not a biography of Phil or an account of his day. (For a complete and certainly accurate summary of the historical origins of Groundhog Day and its similarities to pagan prognostication festivals, please consult the appropriate Wikipedia page.) This article is about what I do on Groundhog Day.

For me, Groundhog Day is a day to find Bill Murray's movie somewhere on cable and a day, more soberly, to ruminate on the most frequently recurring issue seen by the business lawyer — the irreconcilable dispute between or among owners of a company.

For those of you who have not seen the movie Groundhog Day, Bill Murray's character, Phil (like the groundhog Phil) is a despicably self-centered weatherman who is required to relive Groundhog Day over and over and over until he discovers the meaning of life and finds happiness, and wins the girl by doing good for others. A classic man versus himself tale.

The complex, time-consuming, confrontational and expensive process of unraveling a company or buying out an owner because of an irreconcilable owner dispute is the business lawyer's Groundhog Day. This type of dispute has many recurring forms: sibling owners of a family farm in an LLC; close friends who had a great idea and started a business; partners whose individual financial situation has diverged since start-up, to name a few. The dispute often involves people who were very close to each other at start-up and, for this reason, they never conceived of such a dispute. Unfortunately, when a rift between owners has formed that is significant enough for one of the owners to consult an attorney, the company will probably not be able to succeed unless one (or all) of the owners leaves the company. Fortunately, by properly advising your client from the outset and carefully drafting the organizational documents for the company you can help save your client time and money if, and when, the irreconcilable owner dispute arises.

When a client comes in to form a multi-owner entity, it is tempting to simply pull a form off of the shelf, change the names, and circulate the governing documents for signature. However, unlike *Legal Zoom*, we lawyers have the ability to think and to prepare for contingencies and ownership disputes based on the specific facts and circumstances for the company. So we should do so.

Before discussing the types of provisions that may help in the event of an owner dispute, I should point out a few matters that are outside the scope of this article. First, as alluded to above, an initial problem in these matters is convincing the potential owners of a to-be-formed business that there is even an issue to be resolved and that they should pay you money to resolve it. And this assumes that the potential owners have come to you to form the business in the first place. I am sure each of you has your own analogies and horror stories that will help the potential owners see reason, but I recommend showing National Lampoon's Christmas Vacation to your client or equating the business to a marriage.

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Once you have convinced the potential owners that ownership disputes are a serious and frequently recurring problem, and assuming they even want to go into business anymore, there are a few initial decisions to be made **[a further discussion of which I hope to include in forthcoming articles]**. Ethically, you will need to decide carefully who your client is — the to-be-formed company, one owner, or, if permissible, all of the owners.

You should also help your client choose the type of entity to be formed. You may need to assist the client with due diligence on available names for the entity. And you should analyze the formation transaction for other issues, such as securities law compliance.

To help alleviate the pain of owner disputes in any multi-owner entity, I would discuss with the client, at a minimum, the following: 1) governance and voting requirements, 2) share/interest transfer restrictions, 3) purchase price and payment requirements, 4) drag-along and tag-along rights, 5) put and call rights, and 6) deadlock and mandatory buy-sell provisions. The foregoing is certainly not a comprehensive list; other provisions should also be addressed with your client and in the governing documents, depending on the facts and circumstances for the company and for purposes outside of the scope of this article. And, of course, what provisions you decide to include and how you address these issues will be determined ultimately by an analysis of the client's expectations for the company and his/her position (financial, leverage, etc.) vis-à-vis the other owners.

Voting Requirements. The most common response I hear to the question "how will you manage your company?" is "we will make all decisions together." Although unanimous voting may be impractical, for a two-member LLC or a two-shareholder corporation it is often appropriate (at least for major, as opposed to day-to-day, decisions). In such cases, the mandatory buy-sell and deadlock provisions, discussed below, may be more helpful.

However, for an entity with more than two owners, the unanimous-voting answer is likely based on a failure to consider all of the issues that might arise during the life of the company. A simple majority voting requirement may be enough for most issues. But organic changes to the business (conversion, re-domestication, dissolution) and the sale of substantially all of the assets of the business are common actions that may require a supermajority or unanimous vote.

In some circumstances owners may want to require supermajority voting for any host of business decisions, such as incurring debt above a certain threshold, hiring or firing employees, entering into transactions with affiliated parties or changing the purpose of the business. Discussing and drafting these provisions from the outset will set owner expectations and hopefully avoid disputes when these issues arise.

Transfer Restrictions. Almost all owners of a closely held start-up intend to only have their initial partners be in the business with them. However, generally, ownership interests in an entity are freely transferable (both voluntarily by sale or involuntarily by, for example, death) unless transfer restrictions are included in the entity's governing documents.

A complete prohibition on the transfer of interests may be desired among the owners, but may be impractical (what happens when one of the owners dies?) and is frowned upon by courts. As such, transfer restrictions are frequently subject to rights of refusal, first in the company and second in the remaining owners' pro rata based on their ownership interests.

Restrictions on transfer may have certain permitted transfers carved out, such as transfers to lineal descendants in a family farm LLC. Properly addressing transfer restrictions will help to protect your client's expectations for the company and will provide a set of procedures to follow if a transfer event occurs that you will not find in the applicable organizational statutes.

Purchase Price and Payment. Part and parcel with transfer restrictions are purchase price and payment terms. If the company and the remaining owners will have rights of refusal, the terms of such rights must be clear. For voluntary transfers, the proposed price to be paid by the third-party purchaser is often used as the purchase price for the company's and remaining owners' rights of refusal, though purchase price deductions can be used to deter voluntary transfers.

For involuntary transfers, a certificate of agreed value backed up by an appraisal is a common method, but a formulaic approach can be useful for companies with a sufficient operating history. Deductions for certain "bad" involuntary transfer events (e.g., breach of a subscription agreement or operating agreement, termination of employment for cause or placing a lien on an ownership interest) can also be used. Payment terms should balance the owners' need and desire for liquidity against the company's or remaining owners' ability to cash flow the purchase. Key-man insurance should be considered to provide the company with the necessary liquidity to redeem an owner's interest on death.

The nice part about negotiating these provisions, is that in almost all cases each owner does not know whether he or she will be on the purchasing or the selling end of the transaction, which is a good atmosphere for compromise.

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Drag-along and Tag-along Rights. The previously discussed provisions are helpful to set owner expectations and to provide procedures where there are no statutory defaults, but none of these provisions provides an exit strategy to an owner. Properly drafted exit strategies, if they mirror owner expectations, can be wonderful in an owner dispute. Like transfer restrictions, you will not find a satisfactory exit strategy in an organizational statute.

Two potential exit strategies, which dovetail with voting requirements, are drag-along and tag-along rights. Because an ownership interest is the personal property of the owner, absent an agreement to the contrary, an owner cannot be forced to sell his ownership interest. This situation may prevent the other owners of an entity from effectively selling the company to an interested third party.

In certain circumstances it may be appropriate for the owners who desire to sell to be able to "drag" the obstinate owner along so that he is required to sell his ownership interests to the third party purchaser. In such cases, drag-along provisions should be included. The converse of the "drag along" is the "tag along" – the right of an owner to tag along with other owners when a third party purchaser may be attempting to buy only a majority of the ownership interests in a company. If a drag-along right is included in governing documents, a tag-along right is often included as well.

Put and Call Rights. Put and call rights provide exit strategies that may be appropriate in certain circumstances. A "put right" is an owner's right to have his/her ownership interest redeemed by the company (or purchased by the other owners) upon the occurrence of a certain date or triggering event. The converse, a "call right," is the right of the company (or the other owners) to purchase an owner's interest based upon the occurrence of a certain date or triggering event. These provisions are most commonly utilized when a preferred investor is involved in a transaction, but can be used in other cases as well.

Mandatory Buy-Sell and Deadlock Provisions. Finally, what is the cheap, convenient exit strategy for an entity owned and controlled 50:50 by two owners? There is one, though it is not for every owner, nor the faint of heart.

The mandatory buy-sell, or "wild west shootout" as I like to call it, works like this: at any time one owner (Owner A) can hand the other owner (Owner B) a piece of paper with a number on it. The number is the price at which Owner B can buy out Owner A or be bought out by Owner A; who does the buying is up to Owner B, but he/she must choose.

You may require deadlock on a major issue as a triggering event for the mandatory buy-sell process, though requiring deadlock may just be adding something else for the two owners to dispute. Do be wary of using such a provision, however, as it will give the owner with greater personal wealth an advantage over the lower-wealth owner.

So, the next time a client comes into your office to form a multi-owner entity, tell her or him some horror stories, avoid the forms and do some good by advising him/her on the issues discussed in this article. Maybe that good deed will be sufficient to avoid the business lawyer's Groundhog Day.

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