Everything
You Need to
Know About
Business
Partnerships

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You'd be astounded at the number of clients I meet with who literally know nothing about their partner's background, their approach to business, and their vision for the partnership. They rush into the relationship so quickly that they don't even gather this fundamental knowledge about their partner.

Here are some issues to consider before you ink any partnership deal:

- Obviously, only go into business with those you trust. Vet everyone in your business dealings, whether it be a contractor, a tenant, etc. This could mean conducting background checks and calling personal references. This is especially true with your business partner(s) and is by far the most important way to protect yourself when entering a partnership.
- Address potential issues before they become issues. Talk about worst-case scenarios. If your partner isn't willing to do so, for whatever reason, you have the wrong partner.
- Read and understand your partnership documents ***before*** you sign them. A good attorney can help you identify possible issues and present solutions, but ultimately you and your business partner(s) need to take ownership of the agreement and share a thorough understanding of how it will govern your business.
- Consider getting separate counsel if using the same attorney as your partner(s) is presenting concerns.
- If you live in a community property state, have every business partner's spouse sign the partnership/operating agreement and any amendments. The spouse presumably has an ownership interest in the business, and you want them to agree to the provisions of the partnership/operating agreement. This is especially important regarding the method of valuing the business when buying out a partner in the event of a divorce.

Setting Up the Partnership

Creating the partnership agreement and setting up the proper entity/structure for the partnership are the two most important steps in the partnership process. Understanding the mechanics of how your business will be managed is the key to designing your partnership agreement and documenting the terms. While the list of items to consider in a solid partnership agreement is indefinable—every partnership is different—I've narrowed it down to my top ten:

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1. Partner roles in signing and authorizations. Have a very clear understanding of what the managers or officers of the business are authorized to do on behalf of the company.

2. Duties and responsibilities of each partner. There should be a description of each partner's responsibilities and duties so each partner knows what to expect from the other. Furthermore, there should be predetermined consequences for partners not completing their duties.

3. Contributions of capital. What amount of time, money, and assets is each partner contributing to the partnership? This includes the initial contributions as well as additional contributions that may be necessary to continue operating the business in the future.

4. Rights to distributions, profits, compensation, and losses. Any right of the partners to receive discretionary or mandatory distributions, which includes a return of any or all of their contributions, needs to be clearly and specifically set forth in the partnership agreement.

5. Unanimous vote requirements. Which events or decisions will require a unanimous vote of the business partners? It's crucial that you and your business partners decide the procedure together from the outset.

6. Dissolution or exit strategy. The partnership agreement should indicate the events upon which the partnership is to be dissolved and its affairs wound up. It's possible the business concept and model don't lend themselves to answering this question. But, for example, in a real estate deal, it's important to have a timeline and possible triggering events that will lead to either selling the property or buying out one of the partners if they don't want to stick around for the long haul.

7. A buy-sell provision or separate buy-sell agreement. This type of agreement addresses major changes in the partnership arrangement. For example, what if one partner voluntarily or involuntarily leaves the partnership? How are they bought out? What happens if you want to sell your ownership interest—should your business partner have a right to buy it before you sell it to a third party? What if your business partner dies? Or gets divorced? Or files for bankruptcy? Or just wants to retire?

8. Expulsion provision. Carefully consider this provision, which is a double-edged sword. The benefit of such a provision is that you can put in writing when a partner can be forced out of the business. For example, you and your partners could agree that if one partner isn't pulling their weight, they can be forced out. But be certain your well-deserved, three-week vacation to Tahiti doesn't trigger the expulsion clause.

9. Noncompete provision. For example, you and your business partner(s) may agree that if one of the partners leaves the business, they cannot open a competing business or work for a competing business within a certain number of miles and for a certain period of time.

10. Miscellaneous provisions. Some examples include a provision for attorney's fees for the non-breaching party if they win a lawsuit, a mediation or binding arbitration clause so you don't have to go to court if you don't want to, or a venue or choice of law provision on which state law would be applied in a contract dispute and where the dispute would be litigated.

Make sure you sit down with your partner(s) to discuss the best- and worst-case scenarios. Have a competent and honest attorney represent the company or have each partner hire an attorney to review the partnership documents and address the above issues, as well as the individual and specific needs of your and your partners' particular situation.

The Best Entity for a Partnership

In most cases, the best structure for a partnership is the limited liability company (LLC). I realize there are unique situations where a corporation or a limited partnership might make sense; however, those are the exception and not the rule. In fact, if you need to save taxes, it's typical to have each member's share of the LLC owned by an S corporation.

There are three significant reasons why the LLC is such a perfect entity for partnerships. Here's a brief summary:

1. Its limited liability protection shields you from the acts of your partner (and vice versa). Without it, you have unlimited vicarious liability.

2. The operating agreement and corresponding initial minutes and formation documents are fantastic documents to define all of the partnership terms.

3. The flexibility of the LLC is beneficial for allocating profits, losses, and capital, as well as for allowing individual partners to do their own tax planning after they receive their allocated share of profit.

Partnership Management Tips

After all the documentation's been completed and you begin operating as a partnership, you should follow several procedures for a successful venture.

Here are the top three habits that will help a partnership succeed:

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1. Communication and documentation. As the business partnership evolves, record and document anything that's contrary to your initial partnership/operating agreement. A good partnership/operating agreement will allow for revisions due to changing circumstances, but these should always be in writing and signed by each business partner.

2. Be involved in your business. Don't ever think a partnership is a turnkey operation. People who aren't in constant communication with their partners will soon find themselves on the outside and in a dispute. Clearly understand your duties and responsibilities, and fulfill the expectations of your partners or readdress what those expectations should be.

3. Bookkeeping and tax deposits. Don't cut corners on bookkeeping and finances. This is the lifeblood of your business and will determine when and how your profits are distributed. Making sure your tax deposits are made on time and in the right amounts is also the backbone of good tax planning in your partnership. Beware of "phantom income," which is income from the partnership that exists on paper but has no corresponding distributions. This can wreak havoc on a partner's individual tax return without proper bookkeeping and planning.