

Co-Ownership Agreements

Presentation to Jones Partners Insolvency and Business Recovery

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1. Co-Owners Must Have a Co-owner's Agreement

Clients who own a business jointly with another person, whether as partners in a partnership or shareholders of a company, must have a co-ownership agreement. There is little doubt that the absence of such an agreement will almost certainly lead to unhappiness when parties want to re-consider their options and find that there is no 'rule book' to regulate either their behaviour or that of their co-owner.

2. Convincing Clients Can Be Difficult

Convincing clients of the need for such an agreement can be difficult. As most life insurance salesmen will tell you, it is hard to convince someone to buy a raincoat in the middle of summer.

Joint owners just starting up their business are in the early stages of their commercial 'romance' and believe that nothing will go wrong. There is an air of excitement about the new enterprise and no-one wants to dampen that air by even talking about the possibility that things may be different in the future.

In later stages, even though the commercial 'romance' may have faded somewhat, if the business is happily sailing along joint owners are again reticent to rock the boat with discussions about how that relationship might end. Bad karma to even discuss it.

As understandable as these attitudes might be psychologically, it is the role of the professional adviser to bring their objectivity to the advising process and to convince co-owners that the process of agreeing a co-ownership agreement need not be a negative experience and is truly vital to the secure future of all concerned. The adviser might even fake that objectivity in advising themselves on the need for that agreement in their own circumstances.

3. All Parties Need to Know What the Rules Are

It is as important for a co-owner to know what their rights to leave are, as it is for them to know what they're entitled to if their co-owner wants to leave. I recently advised one of the shareholders in a two-lady company when her co-owner unexpectedly announced she was pulling out of the relationship.

The solution was difficult because the leaving owner had an unrealistic view of her rights to abandon the enterprise and leave the business' liabilities behind her.

4. Co-Owners Leave for Many Reasons

Co-owners seek to leave their jointly owned business for many reasons (some avoidable and some not) such as

- serious illness of the co-owner or a member of their family that may or may not constitute total and permanent disablement
- untimely death of a co-owner
- personality conflict with their co-owner
- marital breakdown and or changed family circumstances
- different life priorities for co-owners of substantially different ages resulting in different views on how to take the business forward
- financial problems of a co-owner that do not relate to the business
- wrong-doing by a co-owner whether criminal or regulatory
- retirement from the workforce or at least the particular profession/industry that the person works in.

5. Leaving Raises Many Questions

Whatever the reason for the desired departure, the same questions need to be answered:

- how will it affect the business and will the business survive?
- how can the remaining co-owner(s) be suitably protected from the financial ramifications of the departure?
- how can the business continue to meet its liabilities notwithstanding the departure?
- who will retain the clients/customers?
- is the leaving co-owner entitled to receive something for their interest in the business and if so what are the payment arrangements that will apply?
- what will happen in the event of a deadlock?

These are simply the basic questions that the co-owners agreement must deal with. Each answer generates a mass of subsequent questions that the agreement must respond to in detail.

6. Good Co-Owner Agreements are Tailor-Made

And that is the other reason why co-owner agreements meet market resistance. They can be expensive. Ideally no two are identical because the needs and desires of the co-owners are unique and there is considerable work required

- firstly, to make sure the co-owners understand the issues they need to consider,
- secondly, to help them to reach the appropriate decision in respect of those issues and
- thirdly, to document those decisions in a manner fair to all concerned.

But as the life agent will also tell you, you won't remember the cost of that raincoat when it is keeping you snug and dry in the storm.

7. Quasi-Partnerships

It is not uncommon for a small group of individuals to operate a business using a company as the operating entity where in reality the relationship is more akin to a partnership.

In such cases the following principles and assumptions apply, namely

- each shareholder will be treated equally
- each shareholder will make an equal contribution of capital and effort
- each shareholder has the right to be a director
- minority shareholders are protected
- each shareholder is entitled to be employed in the venture
- most Income is distributed and the amount of income to be retained is subject to specific agreement.

Note that while corporations are governed by the Corporations Act, the Courts are prepared to look behind the structure and apply more general equitable principles to quasi-partnerships of this nature [*Ebrahimi v Westbourne Galleries (1973)*].

8. Common Features of Co-Ownership Agreements

Typically co-ownership agreements will address at least the following issues:

- initial contributions
- rules re additional capital injections
- management structure
- management responsibilities
- entrenchment of employment
- decision-making
- matters requiring unanimous approval
- accounts
- restrictions on encumbering ownership
- transfer restrictions
- pre-emptive rights
- resignation from the enterprise
- retirement
- material incapacity
- death and TPD (buy/sell)
- valuation provisions
- compulsory transfer events
- drag along/ tag along

- restraint issues
- obligations and entitlements on departure
- dispute resolution
- deadlock
- obligations of exiting owners
- non-competition
- confidentiality

It is not the purpose of this paper to review each of these items in detail, but rather to point out several matters of interest in relation to a number of the items that might assist the reader to better consider these issues when preparing a co-ownership agreement.

Similarly, if your co-ownership agreement has been around for a while it may be necessary to review it to ensure it is as good as it can be.

For instance, if a shareholders agreement was in place before the introduction of the share buy-back provisions in Part 2J.1 of the Corporations Act, it may be worthwhile considering whether the agreement should be amended to enable a leaving shareholder's shares to be bought back under a 'selective buy-back' rather than purchased by the other shareholders direct.

9. The Affect of Departure on the Remaining Co-Owner

The answers to the essential questions outlined in section 5 above depend in part on whether the leaving owner's departure is avoidable or not. The various reasons given for departure can be categorised as

- due to reasons beyond the leaving partner's control (eg death or tpd)
- due to innocent reasons at least partially beyond the leaving partner's control (eg changes to family circumstances)
- due to intentional reasons (eg personality conflict or desire to join another organisation).

Depending on which of these categories applies the remaining owner may adopt a firmer or softer approach when it comes to delineating the leaving partner's obligations.

And regardless of the reasons there are still the requirements of ensuring that the enterprise's liabilities can continue to be met. If they cannot then receivership/liquidation would appear to be the only alternative.

10. Important Questions to Determine Future Action

The important questions to have answered when a co-owner seeks to leave the enterprise include

- are they leaving because they want to or are they leaving because they have to?
- are they going to continue to work in the industry or not?
- are they prepared to enter a restraint to enable the enterprise to have unfettered access to the

customers?

- is there a pool of funds that they are entitled to as a result of this departure (eg life insurance)
- what are their financial needs in the short, middle and long terms?

The answers to these questions will determine issues such as

- is the remaining partner going to pay anything for the leaving partner's interest in the enterprise?
- is the leaving partner going to need to continue to contribute to the enterprise's ongoing liabilities?
- if there is to be a payment by the remaining partner, should it be discounted because of the damage that the leaving partner's departure will cause the enterprise?
- can the remaining partner have time to pay?
- will the leaving partner be required to buy out the remaining partner's share in the client base?

The answers to these questions are far better determined by the parties when the relationship is healthy than when the relationship has broken down. The absence of negative emotional content at that early stage will make resolution easier, cheaper and less traumatic.

11. Valuation Should Account for Departure

The issues surrounding the valuation for the business include the following.

- who will conduct the valuation?
- to avoid unhappiness with one person's view, should there be more than one valuer?
- is the leaving co-owner going to take work with them or leave it all behind?
- what role will the ongoing liabilities of the enterprise play in the valuation?
- have the parties agreed a standard methodology for the valuation that ensures greater certainty of the likely outcome?
- would the parties want to agree the value of the business annually and apply that value if necessary during the year?

12. Acknowledging the Different Roles of the Co-Owners

Co-ownership agreements need to acknowledge that the individuals are likely to have different contemporaneous roles in the enterprise and need to ensure that all roles are suitably dealt with.

The three fundamental roles likely to be fulfilled by individual co-owners are

- equity owners (eg partners, shareholders, unitholders)
- management officers (eg directors)
- employees

It is fairly settled law that, in the corporate context at least, equity owners (ie shareholders) owe no duty of

care to other shareholders or the company but, subject to agreement otherwise, are free to act in respect of their shares as they see fit.

Directors on the other hand owe considerable duties to the company, to the shareholders and to other stakeholders such as creditors.

Employees owe basic employment duties to the company but have a much less significant role in the power grid of the enterprise.

Issues abound:

- what would happen if a co-owner were to behave in such a way that gave the management of the enterprise the right to terminate their employment notwithstanding that they were a shareholder and director?
- is there anything to prevent that in the co-owner's agreement?
- if so, would the failure nevertheless of the other directors to terminate a materially incompetent or ineffective employee constitute a breach of their duty to the company and its other stakeholders?
- would the other co-owners accept a co-owner who only had a financial interest in the enterprise when it was always considered that they would work in the enterprise as well?

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