Mortal Combat

Without careful planning, the death of a business partner can lead to expensive legal battles with his survivors.

By Kris Frieswick

AFTER WORKING TOGETHER for 25 years, brothers Frank and David had risen to the top of their profession, equal partners in a New Jersey firm that developed and managed real estate and owned a number of fast food franchises. David, who asked that *Worth* not use their real names, says that by 1994 the company had gross revenues of $20 million.

Then the older of the two, Frank, learned he had a terminal illness.

Anticipating the worst, the brothers decided to liquidate Frank's equity and pay it out to his family over time, so the company would not be forced to disgorge a crippling amount of capital all at one time. The result, after some arbitration over asset values, was a promissory note that delivered 50 percent of the net asset value of the company, a little more than $7 million, to Frank's family over 10 years. The two men further agreed that all legal fees and settlement costs for a pending court case with a lender would be paid equally from each of their shares when it was finally resolved. Frank retired from the company and passed away in 1996.

As wrenching as it had been to watch his brother's slow decline, for David things deteriorated further after Frank died. He says that lawyers converged on Frank's widow and convinced her to negotiate an out-of-court settlement with the lender for less than the 50 percent her husband had agreed to pay. The lender then came after David for the remaining amount, which was much more than he had agreed to pay. David paid it, but withheld money

from the promissory note payment to compensate for the difference. "They drew the first sword by trying to make an end-run settlement," David says. "Why would you circumvent an agreement that everyone agreed to?"

The resulting court case landed David and his brother's widow in court for six years and consumed tens of thousands of dollars in legal bills. David eventually won the case, but the fight ruined the relationship he had with his brother's wife. The combination of the legal fees incurred and the regular payments due under the promissory note "sent me back to square one in this business," he says. "It was an incredibly stressful time." David, however, does not blame his sister-in-law. "She was unequivocally manipulated by her attorneys," he says. "They were taking advantage of her. She had no way to understand the depth of the business issues involved."

Kurt Olender, the Union, N.J., attorney who represented David in the suit, explains that the brothers made one very common mistake that allowed the case to drag on for so long: The promissory note agreement and the lender payout agreement between the brothers were not integrated with one another. This left all parties feeling wronged. "What [David] did worked legally for a variety of reasons," Olender says, "but from the spouse's perspective, she had a promissory note; it said she was supposed to be paid X per month, and she wasn't getting it."

COMPETING INTERESTS

This case, while painful, illustrates just how quickly and profoundly problems can spiral out of control when one member of a partnership dies. Despite careful planning, many partners are not aware that even the smallest omission in the agreements that they create can drive a wedge between surviving partners and the family of the deceased, each of whom has a different interest. The family wants what is owed as quickly as possible. The surviving partners want to keep the business solvent. The two interests often clash.

Through careful legal planning, however, most partnership succession problems can be avoided. Partnerships, perhaps the least restrictive business entities, are governed by state statutes, but those statutes assume that the parties will draw up agreements to fill in the details where the laws are vague. In most states, for example, a partnership dissolves if one of the members dies or leaves, unless a binding agreement is drawn up indicating otherwise. Yet many partnerships are formed without benefit of any documentation whatsoever. "It happens over and over," says Joe Lunin, a partner in the law firm of Pitney Hardin in Florham Park, N.J. "Some people are fearful that if they get lawyers involved in drawing up agreements, they'll foster mistrust."

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Partners avoid drafting these agreements for a variety of reasons. Some claim they do not have the time or money to invest in drafting a comprehensive document, including a buy-sell agreement. Others may want to avoid the emotionally charged conversations that can result. "At the start of a partnership, people are in love," says Abraham Rudy, a business litigation attorney at Weissmann, Wolff, Bergman, Coleman, Grodin & Evall in Beverly Hills, Calif. "The last thing they want to be forced to think about is, 'What if I get upset? What happens if you or I steal something? If we split up, who gets the typewriter?' "

Partnership agreements often fail to contemplate the many scenarios that can befall a partnership during, and after, the lifetime of its members. But when partners do finally sit down to write up partnership and buy-sell agreements, they must remember one overriding principal: No one knows who will die first, so the agreements apply to every partner—and to the spouses. "Whatever you want to do for your spouse, you better be ready to do the same thing for your partners' spouses," explains Paul Vogel, CEO and president of Enterprise Trust, the St. Louis asset management division of Enterprise Financial Services. "Sometimes partners forget that these agreements go both ways."

VALUES AND VALUATION

Buy-sell agreements are the centerpiece of any plan designed to protect the interests of both surviving partners and the spouse of the deceased

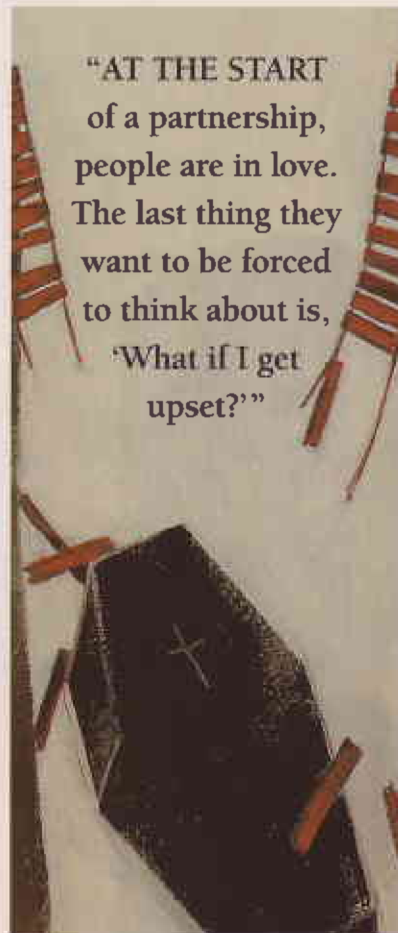
TOP VIEW | When a business partner dies, the surviving partners may find themselves in a legal struggle with the family of the deceased over the disposition of the late partner's equity. To avoid this all-too-common (and expensive) dilemma, partners should work with their attorneys to craft airtight agreements that address dissolution scenarios in ways that are acceptable to everyone—including heirs.

in the event of a partner's death. Such agreements attempt to balance the desire of a spouse to receive quick and fair compensation for a husband's or wife's life work, with the company's need to stay solvent.

The core of the buy-sell agreement is the company valuation. Partners must decide who will estimate the value of the company, the evaluation method (for example, whether cash flow and goodwill will be factored into the equation) and whether or not a liquidity discount will be applied to the deceased partner's share. Such discounts often apply when a share would be particularly difficult to sell to an unrelated third party, which is one of the standards against which fair market value is judged. "The more specificity you have about the methodology, the more you'll have agreement over the basis for the valuation, and there will be less opportunity for disagreements down the road," advises Jay Rosenbaum, a partner at the law firm of Edwards Angell Palmer and Dodge in Boston.

Some companies assign book value as the valuation methodology, but that has fallen out of favor with many firms, primarily because the IRS assumes that most sellers will insist upon fair market value. In fact, the IRS taxes the transfer of assets in family partnerships at fair value, regardless of what method was used to calculate the payout. "The IRS assumes that a third party would be more diligent in getting full value than a family member," Rosenbaum adds.

Buy-sell agreements also stipulate how the purchase of the spouse's share will be financed. Some companies purchase a life insurance policy for each of its partners that funds, in whole or in part, the payout of that partner's share in the event of death. Often, that policy payout serves as a down payment, with the bulk of the payments coming in the form of a promissory note. The note outlines the terms of installment payments over time.



In some cases, a partnership may not have the cash needed to buy out a spouse, now or in the future, leaving it with no other choice but to make the spouse a partner. This is usually the last-resort option for both partners and the spouse. Many state statutes give the surviving spouse the right to ownership of the late partner's share, and rights to the income from the partnership, but not managerial rights. Such an arrangement presents a number of problems, primarily that the spouse will be subject to taxation on the distribution of the profits from the partnership, even if the those profits are rolled back into the business.

LIVING DOCUMENTS

Regardless of how the partnership agreement is crafted, once it is in place, it must be updated frequently as the company grows or shrinks. As a firm's value changes, partners must update the valuation methodology to reflect any shifts in its asset mix. Funding methods, such as life insurance policies and special set-aside funds that are intended to pay for a buy-out of a spouse, must also keep pace with the changing value of the partnership.

As the case of Frank and David illustrates, as a company expands, all new agreements and documents must incorporate by reference the previous agreements, so that there are no surprises if one partner dies.

More often than not, the surviving spouse who litigates does so not because of malevolence or avarice, but because there is a fundamental disagreement or misunderstanding over how governing agreements are being interpreted. Partners must understand that no matter what side of the argument you are on, all parties are suffering, both emotionally and financially. However, there is simply no way to avoid court if one of the parties knowingly violates the terms of the agreements.

The single most important move a business partner can make to protect the company and the family in the event of death is to ensure that the business is not the family's only source of money. Investing in adequate life insurance policies will lift the financial burden off a bereaved spouse. "To have a big infusion of liquidity will relieve the pressure of the family to go to the business with hat in hand," Rosenbaum says.

If one fails to do so, surviving partners who do not wish to pay on the agreed terms know full well that all they need do is drag the legal maneuvering out long enough, and eventually the spouse will not be able to continue to fight. In time, the spouse will be forced accept whatever the partnership will offer. "Sometimes, the bad guy with the money wins," Olender says.

Kris Frieswick is a Boston-based business and finance writer.