# Structuring a Partnership Agreement

by Paul Barbahen

Although partnerships are common in the construction business, they're full of potential pitfalls. The first of these is your choice of a partner. Remember that your partner will help determine your income, your assets, your liabilities, and your reputation. It's often less painful to divorce a spouse than to break up a partnership.

This article discusses the formation of a partnership through the use of a partnership agreement. It assumes that you've already reached the decision to form a partnership and that you're willing to accept the personal and tax liabilities that come with it (for instance, partners must pay self-employment tax and can only partially deduct the cost of medical insurance). Although each partnership has its own unique needs, and each partnership agreement must conform to local statutes, the principles for drafting an agreement are similar across the country. The guidelines in this article are based on the Uniform Partnership Act (UPA), which has been adopted, in some form, in every state except Louisiana. I suggest that you get a copy and read it before you do anything. The UPA is available free of charge from state governments (try the Secretary of State's office).

The partnership agreement should be drafted by an attorney. This may be done by one partner's attorney, but each partner's counsel should review it. Otherwise, an argument could be made that the agreement is biased, an argument that could lead a court to negate the entire agreement.

## Definitions

The agreement should begin with a statement of the partnership's purpose. This will set limits on what partners can do. For example, if the partnership is formed to pour concrete foundations, a partner who invests partnership money in a travel agency has clearly exceeded the scope of the agreement.

The partners themselves must be classified as well. Every partnership requires at least one general partner, who assumes unlimited liability, and who usually reaps the larger share of the profits. There may also be limited partners, whose liability resembles that of stockholders in that it's limited to the value of their original investment (limited partnerships have to comply with special rules that are not discussed in this article). Don't confuse a limited partner with a silent partner. A silent partner is simply a general partner who doesn't get involved in running the partnership.

The agreement should define what authority each partner has to make business decisions. Although partners have a right to participate in management, the agreement may limit that right. The agreement should spell out who has the authority to hire employees, set salaries, and make everyday decisions. The same goes for larger decisions such as the sale of property. For example, a unanimous vote might be required to establish a line of credit, or at least a unanimous vote of all the general partners.

The agreement should also specify under what terms a new partner may be admitted. Remember, admission of a new partner may reduce your percentage interest and your share of the income.

## Dividing The Profits

Although working partners may receive a salary from the business, the allocation of capital and profits are usually determined by each partner's percentage interest in the business. The agreement should define these percentages in detail. This is especially important where one partner's contribution is something other than cash, as when a skilled woodworker without the money to start his own business teams up with a capital partner to open a cabinet shop.

The agreement should set rules for the transfer, purchase, and sale of each partner's interest in the business. It should also state how that interest is to be determined. For example, if a partnership is formed to purchase a building, the value of the building may be the value of the partnership. But what if the partners can't agree on the building's worth? To avoid conflicts, the agreement should include a mechanism to value the partnership. The book value of assets is not always the fairest measure. A general contractor may do millions of dollars worth of quality work each year, with tangible assets totalling $4,000 in office equipment. In cases like this, the agreement can provide for a neutral third party to value the partnership.

The partners are joint-tenants in any partnership property, which means that each partner's share is protected from attachment by creditors for nonpartnership debt. There are exceptions to this. For instance, the rules for what happens to a partner's share during a divorce vary from state to state. Similarly, statutes differ on what to do when a partner dies. The partner's interest usually doesn't become part of the estate unless specified in the partnership agreement.

## Dissolution

A good agreement is often more important when things *don't* work out than when they do. When a partnership ends, dividing its assets and liabilities can turn even the best partners into bitter adversaries.

If one partner wants to sell his or her share in the business, the other partners should be offered the right of first refusal. That is, the departing partner should be required to first offer his share to the other partners, and should be required to give the other partners a specified period of time to respond. The agreement can also specify how much time the other partners have to raise the necessary money.

You may want to include a noncompetition clause for departing partners. Be aware, however, that the clause must be reasonable to be upheld by the courts. For example, a partner who leaves a general contracting partnership to set up another construction firm may be required not to compete within a certain mile radius. What's reasonable depends on location: in Chicago it might be 5 or 10 miles; in rural Iowa it might be 50 miles. The noncompetition clause should require the departing partner to respect the confidentiality of customer lists, and may prohibit that partner from contacting former customers or revealing business secrets. Be careful to make these provisions reasonable, or else a court could strike them down.

After a partner leaves, the partnership may want to publish a notice in the paper to that effect. This will protect the remaining partners if the former partner tries to use the good name and credit of the partnership for personal gain. It also protects the departing partner from debts and other obligations of the partnership.

Not all partnership breakups are traumatic. A partnership agreement may simply expire after a set period of time. If, after that time, the partnership continues with no amendments to the agreement, the UPA provides for the partners to continue in a partnership at will until they've wound up all partnership affairs. Simply declaring a partnership dissolved, however, does not in and of itself terminate it. You should also tell your creditors, and anyone else whom you regularly do business with, that the partnership is no more. A published notice is best. ■

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