There are many reasons for business owners to consider adding new partners, including to secure additional capital, to add needed expertise to help grow the company, to bring family members or close friends to join in building the business and to put a succession plan in place. Adding new partners can therefore provide a boost to the company's revenues, lighten the load carried by the founder, and put the business on course for long-term success. But this decision is not without risk because the new business partners may create conflicts, disrupt the business and insist on making changes that put the company's existence in peril.

If after carefully weighing the pros and cons, business owners decide to move forward in adding new partners, this post reviews important steps they can take to protect themselves and the business from the decisions and actions of these new stakeholders in the company.

**Equity Ownership Can Be Conditional or Subject to Cancellation**

One protective step business owners can take when adding a new partner is to make
the addition of a new partner’s conditional or subject to cancellation. This approach permits the owner to wait to grant the ownership interest in the company to the new partner until he or she has met specified business goals by a certain date or to cancel the grant of equity to the new partner if the specific goals have not been achieved by the agreed date.

The addition of a new business partner is conditional when the partner does not receive equity in the business until the prescribed business goals are met. For example, if a new partner is tasked with generating new investments or growing sales for the business, the partner will not receive any equity in the company unless these business targets are met by the stated date. This conditional arrangement prevents a potential new partner from becoming an owner if he or she has failed to deliver on important goals right from the outset.

Under a cancellation arrangement, the new partner may receive equity in the company initially, but the grant of this ownership stake is subject to being cancelled if the set goals are not met. Using the example above, if the new business partner is tasked with raising funds or with increasing sales for the company and cannot meet these goals by a specific date, the equity grant will be cancelled automatically or it can be made subject to cancellation. In the latter case, the business owner has discretion to extend the time for the new partner to meet the specified goals.

The use of a conditional or “cancelable” approach to adding a new business partner gives the business owner an “out clause.” These are contract rights that authorize the business owner to avoid adding a new partner who has failed to meet clear and defined expectations.

Securing a Buy-Sell Agreement Is Essential

We have written frequently about the importance of a Buy-Sell Agreement, which gives the business owner the right to redeem the ownership interest of a new partner. This is a key provision to permit the majority owner to exercise rights to remove an investor as an owner of the business who has become disruptive or even adversarial. Absent a Buy-Sell Agreement, a business owner may be “stuck” with a minority investor who cannot be removed, and who is demanding access to financial records and who may also assert claims against the owner for alleged breaches of fiduciary duty.

To avoid this situation, business owners should secure a Buy-Sell Agreement with all of their new partners at the time they become owners in the company. The specific terms and the issues associated with Buy-Sell Agreements have been discussed in previous posts [here] and [here].

Consider Confidentiality Provisions and Restrictive Covenants

New business partners may not be employed by the company, but they will likely receive access to the company’s trade secrets and other business sensitive information. For this reason, all new business partners should be requested to sign confidentiality agreements to protect all of the company’s confidential information. This confidentiality agreement should be in force, of course, while partners have an
ownership stake, as well as for at least some period of time after they no longer hold any interest in the business. A majority owner will not want to be forced to compete with former business partners who are using the company’s confidential information immediately after they sever ties with the company.

For this reason—avoiding competition with former business partners—majority owners may want to require their new business partners to also agree to non-competition and non-solicitation agreements as a condition of becoming new owners of the company. These may not be multi-year agreements, but it is not unreasonable for a majority owner to require former partners not to engage in competition for a period of 12-18 months after departing as owners of the company. A non-compete agreement may not be warranted if the new partner will be holding only a small stake of less than 10% of the company. But for partners who receive a substantial ownership stake in the business, the majority owner will want to consider requesting some type of non-compete and non-solicitation agreement with these partners.

Allow Competition by Owners

As a final note, Texas law permits the duty of care to be eliminated as fiduciary duty by officers, directors and managers and that duty should therefore be removed from the company’s governance documents. Texas law does not permit company owners, however, to eliminate the fiduciary duty of loyalty owed by governing persons, but the owners can agree that each of them are permitted to engage in competition with the business and they can agree that certain officers or managers are not required to devote full-time efforts to the business. Therefore, if a business owner wants the freedom not to work full-time for the company and/or the owner is engaging in activities that may be seen as competitive by other company owners, the company’s governance documents should expressly provide for the majority owner to have this type of flexibility.

Conclusion

A majority owner’s decision to add new business partners to the company can rejuvenate the business by providing financial capital, critical new vision, and helpful support. But these new business partners may also challenge the owner and create disruptive conflicts that harm the company and its prospects. Business owners should therefore be cautious when they decide to add new partners, and the addition of these new owners should be structured in ways that will ensure that the business remains successful. If things do not work out, as a last resort, the Buy-Sell Agreement that the majority owner should obtain from all new partners will enable the owner to exercise redemption rights to remove these new partners from the business when their presence threatens the company’s continued existence.

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