The Importance of a Partnership Agreement

Many business partnerships start out informally, as industry associates, friends, or family members band together to start a new business. Partners bring different strengths and skills to the table. One partner may understand certain aspects of the business especially well, while another provides the financing, and another has the professional contacts.

Despite the mutual dependency that exists, business partnerships are as prone to conflict—and even breakdown—as all human relationships. Because the collapse of a partnership can mean the end of the entire venture, it is essential for business partners to protect their personal interests, as well as those of the business, by drafting and signing a legally binding partnership agreement. Besides improving the chances that the business will survive a crisis, a partnership agreement can provide an opportunity for partners to discuss issues that are critical to the operation of the business, including the specification of roles and responsibilities.

Partnership agreements typically cover several key areas, including an outline of the duties and expected contributions of each partner, the division of equity, a formula for determining compensation, the distribution of profits and losses, and a plan that allows for an orderly exit by one or more of the partners.

A comprehensive buy-sell agreement is an especially important element of the partnership contract. It can help to ensure the survival of the business should one or more of the partners die, retire, divorce, or leave the firm for other reasons. Even if a business is not expected to continue when a partner exits, a well-executed buy-sell agreement will improve the chances that partners and their families are properly compensated for their stakes in the company upon dissolution of the business. As many business owners and their families have learned, failure to have a viable exit strategy in place can lead to huge losses or protracted legal battles.

When two or more people start a business together, it may seem obvious that each should get an equal stake in the firm. But when no single party has a majority stake in the business, a deadlock can occur, interfering with the ability of management to make time-sensitive decisions. In exchange for contributing more equity or agreeing to take on more of the work, one partner may be awarded a larger stake than the others, therefore ensuring that the firm is not debilitated by a dispute between partners. If deciding to maintain equal stakes in the business, a process for voting on, or otherwise resolving, potential conflicts should be included in the agreement.

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Regardless of how the equity stakes are divided, the partnership agreement should outline in detail the investments each partner is making in the business, including cash, property, client lists, and relevant knowledge and skills. Detailed records of each partner's initial and ongoing contributions can simplify any subsequent division of assets.

However, a partnership agreement is not only useful in the event of a dissolution of the partnership. It can also help the partners work together more effectively and increase the value of the business. The partnership agreement may, for example, stipulate that the partners must meet at regular intervals to discuss and analyze certain aspects of the business. These meetings can detect any problems and provide the partners with a regular forum for discussing how operations may be improved.

Keep in mind that a partnership agreement may provide sufficient legal protections to owners in the early stages of the business. But, later on, it may also make sense to file for incorporation or to form a limited liability company (LLC). These legal structures can provide greater protection from personal liability and may also offer certain tax advantages.

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