

CORPORATE MATTERS: ONE CLAUSE THAT SHOULD BE IN EVERY PARTNERSHIP AGREEMENT

Authors

Simon H. Prisk
Stanley C. Ruchelman

Tags

Joint Venture
L.L.C. Agreement
Partnership Agreement

Our practice involves the drafting of many different types of partnership agreements and other agreements governing the relationship among individuals involved in a common enterprise. These agreements include general and limited partnership agreements, operating agreements or limited liability company agreements, and shareholder agreements for corporations. In this article, all these types of entities are referred to as “joint ventures.”

During the initial client discussions with respect to these agreements we highlight and discuss the usual laundry list of matters that co-investors should consider at the time of formation. One matter that we believe should be addressed in every joint venture agreement is what happens upon the death of a member of the joint venture. For obvious reasons, many do not want to focus on this point. However, the procedure to be followed when surviving spouses and heirs inherit an ownership interest is best handled at the beginning of the joint venture. While it may appear that all joint venture members have similar interests, relationships can change very quickly, and the bottom line is that while one may be very interested in being in partnership with a certain individual, the same interest may not attach to that person’s spouse.

A typical provision controlling what happens to a joint venture member’s interest upon his or her death may provide for the purchase of the joint venture interest by the joint venture, itself, or the individual members of the joint venture is as follows (assuming the joint venture is cast as a partnership):

Upon the death of any individual Partner, the Partnership and the other Partners may but shall not be required to purchase, and the estate of the decedent and any other person who acquires the Interests held by the Decedent at the time of his or her death as a result of the death of the decedent (collectively, the “Decedent’s Transferees”) shall be obligated to sell, such Interests in accordance with the provisions below.

The clause would then detail notice relating to the death and provide that the joint venture or individual members have a certain period of time to decide whether to purchase the interest of the decedent. In some cases, a joint venture agreement with the above clause may require the spouse of a partner to sign a spousal consent regarding the terms of the joint venture agreement.

Assuming the joint venture is to continue, the price to be paid for the membership interest can be determined in a variety of ways. A common method is to use fair market value as of a certain date, which is essentially the proceeds the partnership would have received if it sold all its assets as a going concern and then liquidated immediately after the sale, distributing the sales proceeds on that date. Failing an agreement as to value, an independent appraisal would be obtained from a qualified and acceptable expert.

The following clause in a partnership agreement is an example:

For purposes of this section, the price of the Interests being purchased shall be the fair market value as of the last day of the Partnership's taxable year closest to the date of Partner's death, as determined by agreement of the Partnership and the Decedent's Transferees or, if requested by such Decedent's Transferees, by the appraisal process described below (which, if requested, shall cause the closing date to be extended as necessary to accommodate the completion of the appraisal process).

The independent appraiser can be agreed between the parties or pursuant to the rules of the American Arbitration Association.

Alternatively, the members may want surviving spouses to enjoy the fruits of a joint venture's labor by participating in the future upside of the business. The following clause in a partnership agreement is an example:

Upon the death of any Partner (hereinafter referred to as the "Decedent"), the Partnership shall neither be terminated nor wound up but, instead, the business of the Partnership shall be continued as if such death had not occurred. Each Partner shall have the right by testamentary disposition to bequeath all or any portion of his or her Partnership Interest in the Partnership to a member of his or her immediate family (as defined) or to any trust in which any one or more members of his or her immediate family (as defined) retain the full beneficial interest; provided that in the case of any such bequest, the legatee or legatees shall hold the Partnership Interest received as a result of such bequest subject to the terms of this Agreement and shall be required to join in and execute, acknowledge, seal and deliver a copy of this Agreement as an additional Partner party hereto. In order to receive the Partnership Interest of the Decedent and be admitted to the Partnership, the recipient must first sign the Partnership agreement, agreeing to be bound by all its terms and conditions.

An agreement with this type of provision would typically give the person inheriting the interest the right to sell the interest to the joint venture for a limited time and provide for a purchase of the membership interest by the joint venture in the event of the death of that heir.

Funding the purchase by the joint venture is a separate matter, and key man life insurance is typically used to enable the venture to afford to purchase the membership interest of the deceased member. In such a case, however, the members typically agree to the value of the interest at the time the key man life insurance policy is purchased. If the value increases over time, more than one policy may be acquired for each member. Often, the expense, which is not deductible, is specially allocated for income tax purposes to the member whose life is ensured.

As can be seen by the above, wills and trust issues may also come into play, but those issues are mainly administrative, and some time and thought about this issue at an early stage can prevent a lot of headaches and potential conflict at a later time.

