

Business Divorce: Partnership Buyouts

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There are various options when faced with a "business divorce," including resolution, dissolution, appointment of a custodian, appointment of a neutral director, the hiring of an outside consultant, and mediation. However, if none of these are acceptable to resolve the issues, another possibility is for one partner to buyout the other as an alternative to dissolving the entity.

The first order of business is who buys whom? In the absence of a shareholder agreement, or the like, in a retirement scenario, obviously the non-retiring partner is going to buy out the retiring partner. However, when there are issues of "stalemate", dishonesty by one partner, resentment, or distrust, the resolution of who buys whom becomes more difficult. Usually, in a theft situation, the purchaser is the innocent partner and part of the purchase price is paid by issuing a credit against the buyout price for money or property misappropriated. In the other situations, excluding retirement, factors such as one partner being more capable to operate the business than the other; one partner being willing to work and the other not; or general acquiescence by the partner being bought out are controlling. Once it is determined who buys whom, the next step is to determine the value of the departing partner's shares or interest. Frequently there are shareholder agreements or the like which define the procedure for a partner who wants to sell his or her interest. It is not unusual to see an agreement which provides for an annual evaluation of a shareholder's interest. Unfortunately, it *is* unusual to see that the valuation of the interest has been kept up on a yearly basis. As a default position, most agreements provide for an appraisal. Either both parties agree upon one appraiser or each party picks his own appraiser and the average of the two is the appraised value of the selling shareholder's interest.

Once agreement upon the value of the interest being sold is reached, payment terms will be discussed. If there is a wrong doer, the payment term is usually long term, which is equal to somewhere between five and ten years. If retirement is the reason, the payment term can be significantly shortened. Ultimately, the payment term is negotiable and should favor the company so that the company does not have to sacrifice liquidity to make the payments.

A provision for confidentiality and non-competition is essential in a hostile buyout situation. Certainly, the purchasing shareholder does not want to finance a competitor. It is not unusual to have a non-compete agreement lasting five years or more depending on the business and

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whether it is necessary to protect the company from a competitor that knows all of its intricacies and trade secrets.

In the event of a dispute or default under a buyout agreement, the agreement should either provide for binding arbitration or allow the matter to go to court. Each of these tribunals have their advantages and disadvantages. Arbitration is increasingly the resolution forum of choice, although arbitration fees are calculated upon the amount in controversy and arbitration can be very expensive. Frequently the arbitration provision provides that the loser pays the arbitration costs and the attorneys' fees of the winning party.

One of the frequently overlooked issues in a buyout is the tax implications. Pass through entities, such as Sub S Corps and LLCs charge the individual with the receipt of income or losses that they don't know they have until the end of the tax year. As the seller of a business interest, there may be a tax liability for this income. The buyout agreement should provide for payment of these taxes as a distribution. Of course, in the event of a loss, the use of that loss will counter some or all of the capital gains tax incurred from selling one's interest.

Another important issue to consider is the company's line of credit. Most companies have one and for small companies, the line is usually personally guaranteed. Banks or other lenders almost never release a guarantor and the departing owner does not want a knock on his or her door from a lender at some unknown time in the future, should the company default on the line of credit. Most companies don't want (or aren't able) to pay off the line and rewrite the loan. The standard resolution of the problem is to provide notice to the Lender that one Guarantor will not be responsible for an increase in the line beyond the notice date. Then the buyer (other guarantor) agrees to indemnify the seller from any claims against him or her on the line. This solution definitely benefits the buyer but is usually the best arrangement that the seller can manage.

The foregoing is the bare bones of a buyout agreement. There are usually special considerations and those things that are particular to a business which appear in the agreement. Also, the shareholder agreement or the like between the parties will generally control many terms of the buyout agreement. It is always a good idea to conclude the buyout quickly and to provide for a release of each party for any claims that either has against the other. Avoiding a court battle by coming to an agreement on the buyout is certainly a benefit to all parties.