Planning for Business Divorce

The Partnership Agreement Is Your Client's Prenup

BY LAUREN THOMPSON

This article seeks to challenge transactional attorneys to shift their approach to partnership agreements to try to better equip their clients for the potential that the relationship does not go as planned. A partnership is not unlike a marriage in business, and in that respect, a client's partnership agreement is their prenuptial agreement. When viewed as a fundamental resource to safeguard a client's interests in the event of divorce, the need for drafters to focus on clear mechanisms to achieve that objective becomes all the more apparent.

I am a civil litigator with a focus on partnership, membership, and shareholder disputes in closely held entities.[1] That means I get the privilege of Monday-morning quarterbacking the work of transactional attorneys when the honeymoon phase is long since over, the client's relationship with their partners has run its course, and the parties are now at each other's throats in ways no mere mortal could have possibly anticipated. In 15 years of practice, I've seen loopholes, carveouts, and ambiguities exploited in so many ways that drafting around almost any of these scenarios would have taken months that excited clients would never waste, and thousands of dollars that frugal clients would never spend, particularly when launching a new venture.

But despite the uniqueness of every fact pattern that hits my desk, a theme emerges in most cases in which my clients find themselves particularly stuck: their "partnership agreement" lacks the necessary tools to help them separate their interests or end their tumultuous relationship with their partners. And without this critical guidance, parties who can't settle their differences themselves are left with no choice but to start down a value destructive path to try to forcibly preserve their rights.

I recently searched on Westlaw for the purpose of a prenuptial agreement. In a 1982 case, the Colorado Supreme Court answered the inquiry as follows:

> Such agreements provide a means by which the parties can arrange their affairs, both prior to and subsequent to marriage, and are fully consistent with the public policy of this state. It is well recognized, however, that the parties to nuptial agreements do not deal at arm's length. Rather, a confidential relationship exists between them, and each has a responsibility to act with good faith and fairness to each other.[2]

The foregoing is equally applicable to the purpose and circumstances of a partnership agreement, particularly in the case of a closely held company. I submit that if more transactional attorneys drafted partnership agreements with an eye toward thoughtfully mapping out the parties' potential divorce than guiding nuanced governance and tax matters that are likely to be disregarded in any event, clients may be more self-sufficient in navigating their own separations. At a minimum, this may materially narrow the issues that attorneys like me bill hourly to help resolve. Certainly, partnership agreements are important to dictate governance matters, including voting procedures and operational responsibilities. But once agreed, following these mandates to the letter of the agreement when all parties are otherwise getting along is such an anomaly in practice that closely held companies are often excused under the law from the rigidity of corporate formalities.[3]

Therefore, rather than focusing on drafting overly nuanced corporate formalities, transactional attorneys should prioritize drafting separation mechanisms that are practical and cost-effective based on the specifics of their clients' businesses. A one-size-fits-all approach will likely come back to haunt the parties if they ever need to resort to it. There are a variety of separation mechanisms that I've seen employed.

Some are more effective than others depending on the nature of the company and the circumstances of the partners. The following is my assessment of the strengths and weaknesses of the separation tools that often make their way into partnership agreements.

Forced Buy-Sell— aka "Texas Shoot-Out"

This is a process by which one partner names a price and the other has the option to buy or sell at the stated price. Sound simple? Not always.

As a practical matter, buy-sell agreements do not work in multiple-partner companies or in two-partner companies with unequal ownership. Thus, they are of limited application. If the parties do not have equal ownership, then the party with a larger share runs the risk of a minority owner naming a price that overvalues their own interest while undervaluing that of the larger owner. In theory, the price can be named on a per-unit or share basis, but the process would still require all non-triggering partners to coordinate their responses, which defeats the purpose of having a reliable mechanism to resolve any conflict.

In contrast, a buy-sell approach is very simple and effective for 50/50 partnerships, and it avoids third-party appraisals that can be costly and controversial. Some criticize that this mechanism favors the wealthier partner because they will have more flexibility in controlling the outcome. This may be true, but this same risk exists equally or with greater force in litigation—the partner who can outspend the other usually has an advantage. While transactional attorneys should be cognizant of the challenges disparate wealth can pose, I do not find this risk to outweigh the efficacy of this approach in its ability to swiftly end a deadlock between equal members.

Triggered Buyout

Under this approach, the happening of one or more enumerated events triggers the remaining partners' rights to purchase the interest of a separating partner. Often the company will have a right of first refusal, and then the remaining partners will have an opportunity to buy the interest in accordance with their pro rata ownership.

This approach too is not without its limitations. For example, I have never seen a triggered buyout agreement drafted in a manner that allows an unhappy partner to force a sale or redemption of their interest. More often than not, the only mechanism for an unhappy partner to leave the company, if one exists at all, is to accept a material discount on their equity value regardless of the events that spur the desire to separate. The triggered buyout approach is instead focused on the circumstances that give rise to a right of purchase by the company or remaining partners and not a right of sale by an exiting partner.

To that end, this mechanism requires two primary areas of consideration for the drafter: (1) the appropriate triggers and (2) the appropriate price.

Defining Appropriate Triggers

Commonly drafted triggers often include a separating partner's acts of dishonesty, breach, insolvency, bankruptcy, or separation of employment. The latter is where I've encountered the most contention. All too often partners in closely held companies expect that each will provide services, but they do not adequately flesh out their respective roles and responsibilities. Moreover, partners who perform services are not typically "employed" by the company, so drafters should pay particular attention that their terminology aligns with the parties' legal relationship. If the agreement's intent is that a partner who stops working may be forced to sell their interest, then the drafter should talk with the clients about whether the cessation of work must have been voluntary or involuntary and the role, if any, of termination for cause. If a partner's services for the company may be terminated under simple "at will" circumstances, then that too should be explicitly stated. Indeed, unarticulated rights and obligations among partners cause more conflict than the express ones, particularly where each partner may have entered into the business with disparate expectations and understandings.

Determining the Appropriate Price

As to price, the two processes to determine an appropriate buyout price that I commonly encounter are a formula-based approach and an appraisal-based approach. Under a formula-based approach, the price is determined according to a set formula using the company's financial records. Provided the parties agree on the accuracy of the financials, this approach is far more cost-effective than an appraisal method because no professionals other than the company's controller or accountant are required. If the business is likely to be small, or the clients are particularly cost-conscious, then this approach is probably a better fit than one requiring one or more professional appraisals. The downside of a formula-based approach is that recent losses are often compounded by a valuation multiple. For example, the parties may agree to a purchase price that is based on two or three times the average profitability of the company for the past few years times the exiting partner's percent interest. This type of methodology can amplify the effect of a recent downturn in business performance, such as recent losses attributable to the partners' communication breakdowns that are not truly representative of the company's overall performance and future value. Thus, a separating partner who is already suspicious of the accuracy of the financials or their partner's role in recent company performance (or lack thereof) may feel slighted by the outcome of the formula. Ideally, the risk of a formula-based method resulting in an expensive dispute could be mitigated by a candid conversation with the clients about these and other pros and cons of the approach at the time of drafting.

Attorneys and clients often think of a professional appraisal method as fair and objective, but that is not always the case. While the framework for a business appraisal is standard, the outcome depends significantly on the appraiser's professional discretion, which is usually informed by client-driven goals. Appraisals are time-consuming and expensive, and buyout processes that require multiple appraisals are even more so. There is no perfect solution to a "fair" appraisal process, but I've encountered more disputes in a process that requires several appraisals (usually where a first and second appraisal are commissioned by each respective side and then a third is used to create an average or identify an outlier) than in a process that requires one.

Both sides should have input into the appraiser selection, but I find that the more variables there are to contend with among parties who are already at odds with each other—as in a multiple appraisal protocol—the more likely it is that they will reach an impasse.

Another commonly overlooked aspect of a professional appraisal process is the valuation standard. If the intent is to value the separating partner's interest in a going concern business according to their ownership percentage, then the standard should be fair value not fair market value. Fair market value includes the application of minority discounts for lack of control and/or lack of marketability and can easily, and unfairly, reduce the value of an exiting partner's interest by up to 40%, if not more. The theory behind a lack of control discount is that a hypothetical buyer purchasing the interest at arm's length with complete information, as is required under a fair market value methodology, will pay less for a non-controlling interest than a controlling one. The theory behind a lack of marketability discount is that unlike a public company, there may be a very limited market for purchasers who desire to acquire an interest in the subject closely held company.

In reality, however, if the drafter intends to include a valuation standard for the purchase of an existing partner's interest by one or more remaining partners, it is unlikely that either of these theories will be apposite. For example, the sale of a 50% interest of one partner to a remaining 50% member of a limited liability company will result in the acquiring member having 100% control of the company. Further, the transaction in this circumstance is not occurring on the open market, and the purchaser is neither hypothetical nor unidentified.

For these reasons, when applied in the context of a purchase of an exiting partner's interest by one or more remaining partners, a fair market valuation standard will often prejudice the exiting partner and give a windfall to the purchasing partner(s), making this standard rife for disputes.

To avoid this incongruity, the drafter should provide for a fair value standard rather than a fair market value standard, the former of which does not include the application of discounts. Alternatively, the drafter can provide for a fair market valuation of the entity but then require that to arrive at the value of the exiting partner's interest, the entity value is multiplied by their percent ownership. This latter alternative arrives at the same value conclusion as fair value but uses the fair market value terminology that clients expect to see while avoiding disputes about discounts.

Mediation, Arbitration, or Litigation

Two other significant areas for drafters and their clients to consider are (1) whether to include mandatory mediation, and (2) whether to select arbitration or litigation.

I am a strong proponent of mediation, and I think it should be mandatory in all cases. To the drafter, please do not call it "nonbinding mediation" or "binding mediation." Those commonly used preambles are meaningless and often give the clients a false expectation of the process. Parties cannot be forced to reach a settlement at mediation, but if they do, then it is binding. The process of mediation is the same no matter what it is called, and clients should be encouraged to do it to try to avoid or truncate litigation or arbitration if at all possible.

A fundamental difference between litigation and arbitration that transactional attorneys must understand is financial, but not in the way they expect. Arbitration can be more cost-prohibitive than litigation. As such, it should be required in a partnership agreement only when all parties have the resources to engage in it. The client's attorney fees will be comparable between arbitration and litigation, but an arbitrator is additionally paid by the hour, and there are material administrative costs, all of which must be paid on an ongoing basis. If the parties do not have sufficient financial means, then mandatory arbitration can deprive an aggrieved party of reasonable access to a dispute resolution forum. If all parties to a dispute prefer arbitration, then they are free to agree to it regardless of whether it was required by their partnership agreement.

What I find uniquely worthwhile about arbitration is that the parties can select an arbitrator with significant knowledge and experience in their industry. If a client has a complicated or nuanced business, then the value of having a decision-maker who already understands the context in which the dispute has arisen cannot be overstated. This is one feature of arbitration that, where applicable, may result in material cost savings over litigation because the parties will be less reliant on expert witnesses to explain business concepts that are fundamental to their dispute. Moreover, because partnership disputes are generally contract disputes rather than riveting tort cases, the absence of a right to a jury in arbitration is unlikely to be impactful.

Additionally, litigators generally understand that the likelihood of overturning an arbitration award on appeal is extremely low because the available bases for a finding of reversible error are limited. For this reason, arbitration more effectively deters appeals than court trials, affording the parties a more direct path to finality.

Final Thoughts: Best Practices

As a litigator, I consider it my job, first and foremost, to help my clients avoid litigation. Attorneys who draft partnership agreements can work toward this goal by following a few best practices.

First, they should approach partnership agreements like prenuptial agreements. They should think carefully and critically about a possible "business divorce" and offer the parties "a means by which they [] can arrange their affairs, both prior to and subsequent to marriage."[4]

Second, they should include parties in the drafting process as much as possible. The more involved parties are in fashioning tailored separation mechanisms at the outset of their partnership, the less likely they will be to dispute these mechanisms if employed later.

And finally, they should strive to ensure that the exiting partner is adequately protected from company debt and personal guarantees that will remain in place after the partner's departure. This too will help avoid conflict by putting at ease the mind of a separating partner even in circumstances where the departure was not of their choosing. CL

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NOTES

1. For simplicity, this article refers to all entity types generically as "partnerships" and co-members or co-shareholders as "partners."
2. *In re Lopata's Estate*, 641 P.2d 952, 954 (Colo. 1982).
3. *See, e.g.*, *Forbes v. Goldenhersh*, 899 P.2d 246, 250 (Colo.App. 1994) (citing 2 Fletcher, *Cyclopedia of the Law of Private Corporations* § 394.10 (1990) and 1 Krendl, *Closely Held Corporations in Colorado* § 5.45 (1981)).
4. *In re Lopata's Estate*, 641 P.2d 952.

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