BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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BUYING OUT YOUR CO-OWNER

by Mary Hanson

Most partnerships don't last a decade. Typically one of the partners or shareholders buys out the other before the 10-year mark.

The reasons for a split include lifestyle issues, personality differences, different goals, and differing management styles. Two individuals rarely have objectives and attitudes similar enough for long-term co-ownership of a business. Often one individual is more dedicated to work than the other. One partner may feel that he or she is carrying the entire burden of the business. Sometimes one individual faces personal problems, family challenges, or health issues that take his or her focus away from the business.

Being on different paths in managing a business is not just frustrating to the partners; it is also damaging to the business.

Businesses owned by two or more people are typically operated as a corporation. The typical buyout of a partner is a purchase of stock, either by the continuing owner or by the corporation itself. The departing co-owner does not ordinarily get any assets of the business. It is not a split of assets, but a purchase and sale of corporate shares. Co-owners of a service business may split up the business (for example, by each taking his or her clients), but the split-up plan has to consider how other corporate assets will be transferred to the shareholders.

The split-up of a business must address the same issues as the purchase of an entire business. However, the different circumstances often warrant a purchase price and terms quite different from the purchase of an entire business. The key issues are purchase price, terms of payment, a covenant not to compete, protection of proprietary information, and agreements regarding liabilities.

Purchase Price

How is a purchase price determined for a shareholder's shares of stock? The most common method is by negotiation and agreement between the co-owners, without any formal appraisal. The shareholder continuing the business should have some ability to determine the value of the other shareholder's shares. By considering future prospects, profitability, stability of the business, vulnerability, cash flow, and the loss of the benefit of the departing partner, the remaining partner should be able to determine what he or she should be willing to pay for the shares.

The purchase price desired by the selling partner should carry less weight than the analysis of the partner making the purchase. Most often there is no market for the shares of stock in a closely held business – unless another existing shareholder is willing to purchase the shares.

Tax advice is important for both the buyer and the seller, and no binding agreement should be made without both parties determining the tax consequences of a buyout. Among other things, the buyer of stock

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(which can be an existing shareholder or the corporation itself) needs to anticipate the tax consequences and cash flow impact of payments that are not tax deductible. The purchase of stock must be made with after-tax dollars and it is incorrect to assume that payments of the purchase price to the departing shareholder will be similar to past payments of compensation.

The seller needs to find out what taxes he or she will pay on capital gains (the difference between his or her basis in the stock and the price paid on the sale of stock), plus any income tax from employment income, dividends, and any other aspects of the agreement between the parties.

Payment Terms

Typical payment terms are either a down payment with the balance paid over a number of years or a discounted amount paid immediately. A substantial down payment assures the seller that the buyer has a commitment and something to lose if the business is not handled well. Payments over a number of years assure the buyer that the seller has something to lose if his or her actions impair the business.

It is unwise to pay the entire purchase price up front unless it is discounted to reflect the risks undertaken by the buyer. If the purchase price is not discounted, a portion of it should be withheld for some period of time to assure the co-operation of the departing shareholder. Future payments to the departing shareholder should be subject to offset if the corporation or remaining shareholder later discover undisclosed claims from third parties, financial irregularities, unpaid taxes, or other problems known to the departing shareholder.

The buyer of the stock (whether the corporation or a shareholder) needs accounting advice to assure that the purchasing shareholder or corporation has adequate cash flow, after taxes, to make the payments to the departing shareholder.

Covenant Not to Compete

The purchase of stock at a reasonable price warrants the inclusion of a covenant not to compete. If a selling shareholder is being paid more than a token amount, the buying shareholder or corporation should insist on a covenant not to compete. A covenant not to compete included in an agreement for the purchase of stock is enforceable in California despite laws that make covenants not to compete unenforceable in many other business transactions.

Even if the departing co-owner is ill, is retiring, is moving away, or otherwise has no plans to compete, not having a covenant not to compete can be an expensive mistake. A former partner may intentionally or unintentionally compete or assist others in competing if a non-compete provision is not included in the purchase agreement. If a departing partner says he or she has no plans to compete, then he or she should be willing to agree to a broad covenant not to compete.

Protection of Proprietary Information

A co-owner being bought out typically has had access to valuable information of the business, including marketing plans, customer

information, employee and vendor information, pricing, and methods of operation. The proprietary information of the business should be protected from use or disclosure by the departing co-owner through an effective confidentiality provision.

Liability

If the partner continuing the business will be carrying a substantial burden of corporate debt, contractual commitments, and other ongoing liabilities, the purchase price payable to the departing owner should be reduced or deferred to account for the liabilities borne by the remaining owner.

Both the purchase price and the terms of the purchase agreement should make sense in light of the liabilities involved in the business.

A departing shareholder will often seek to be relieved of as much personal liability as possible – especially personal guaranties and any contracts that are in a shareholder's personal name. Shareholders may have personally guaranteed – or personally entered into – bank loans, leases, purchase agreements, equipment leases and other obligations for the benefit of the corporation.

The shareholder who is selling his or her shares should seek modification of agreements involving personal liability and releases from personal guaranties as key requirements in the terms of a buyout.

The shareholder or corporation buying the shares typically has no ability to relieve the departing shareholder of his or her obligations to third parties. Only the bank, landlord, or other party to the contract has the ability to release a shareholder from his or her commitment.

If the departing owner had more knowledge or control of the operation of the business, it may be appropriate to require the departing owner to make warranties and representations about the business and to indemnify the corporation and other shareholders from liability from events and obligations of which they are not aware. If a departing shareholder has failed to pay bills, covered up problems, made secret purchases or taken actions that expose the corporation to liability, a shareholder purchasing the departing shareholder's shares needs to obtain some protection.

Indemnification

The buying shareholder or corporation should consider the pros and cons of an indemnification provision in the buyout agreement, requiring the selling shareholder to hold the business and the purchasing shareholder harmless from losses or claims that arise in the future from the departing shareholder's acts or failures to act. Such a provision can be meaningful if amounts owed by the departing shareholder can be withheld from payments not yet made. Without the ability to withhold amounts owed from future payments to the departing shareholder, an indemnification provision may have limited value if the departing shareholder refuses to pay claims or reimburse losses.

Releases

If there are ongoing disputes between the shareholders over compensation, reimbursements, wrongful termination, breach of contract, or other issues, or if either side feels that claims may be made, the parties should resolve all ongoing issues

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Publisher's Note

After a buyout and the resignation of a shareholder as a director and officer of a corporation, the remaining shareholders must decide what to do about vacant offices and seats on the board of directors. If just one shareholder remains, the most appropriate action may be to reduce the number of directors on the board to one by amending the bylaws of the corporation and to name the one shareholder to serve as all the officers (President, Secretary, and Treasurer).

In California the change in officers and directors is reported to the Secretary of State by filing a Statement of Information with the new officers and directors of the corporation listed on the form. If the changes are reported as part of a corporation's required annual filing, the filing can be done online on the Secretary of State's website (https://businessfilings.sos.ca.gov/).

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and include a release in the buyout agreement.

A shareholder continuing to operate the business certainly doesn't want to be faced with an employment claim or other claim from the shareholder whose shares have been purchased.

A release offers the corporation and the buying shareholder peace of mind that the departing shareholder will not sue the corporation based on employment, compensation, reimbursement, breach of contract, or other claims as an employee or vendor.

Closure

As a practical matter, all loans, obligations, reimbursements, adjustments, advances, rights to creative works, understandings regarding cell phones, cars, and computers, and anything else of any nature between the departing co-owner and the corporation should be exchanged, paid off, forgiven, or resolved in some manner so that as many issues as possible go away. A buyout agreement between partners should offer "closure." A valuable benefit of buying out a co-owner (or being bought out) is the resolution of disputes, issues, difficulties, and claims, as well as some fair agreement on handling liabilities that arise from the past business operations.

Even if the financial aspects of a split-up are less than satisfying, the parties might be able to obtain the emotional benefit of closure. BA