

PARTNERSHIP BUYOUTS

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Partnerships do not last forever. Whether you are buying out your partner, or you are the one being bought out, and whether the buyout is friendly or bitter or sudden or planned, there are many things you need to think about.

Why Partners Fight

Even a perfectly friendly partnership buyout can take a turn for the worse when the parties get down to details, and the implications and impact of the split-up become apparent. Knowing how to avoid partnership disputes is an essential first step in planning or implementing a partnership buyout, no matter what circumstances you think exist when you get started.

After assisting many clients manage partnership disputes, it is my belief that partnership disputes usually arise for one of two basic reasons:

- **There is a perceived disparity between contribution and reward.** Most of us are only willing to carry our partners for so long. Whether we are really carrying them is a different question. In this situation, perception truly is reality.
- **There is a breakdown in trust and respect.** Like any other relationship, trust and respect are the foundations of a business partnership. When they erode, the partnership breaks down.

Issues can simmer below the surface for a long time, only to surface when a partner is ready to retire, or his partners believe he should be retired.

Ironically, nothing stresses a partnership more than success. After all, there's nothing to fight about if a business is unsuccessful. There may be a lot of finger pointing, but no one wants to spend money fighting over it and everyone needs pay their mortgage. On the other hand, the more successful the business becomes, then the more heated a business dispute can become. There is more to fight about, and more financial resources to fund the fight. This can become a serious problem during a partnership buyout.

The Role of Partnership Agreements in Partnership Disputes

Good professional advisors will always counsel clients to have a partnership agreement. If you are dealing with a succession issue and have a partnership agreement, you should review it carefully and understand how it impacts what you can or would like to do. However, there are a couple of things to keep in mind:

- **You can still do what you want as long as you all agree on it.** The partnership agreement does not limit your options; it simply provides something to fall back on if you fail to agree on something else. The best solution for all partners may be different than the one anticipated when the agreement was first drafted. Do not be afraid to explore other options.
- **If there is something worth fighting about, and the willingness to spend the money, having a partnership agreement will not keep you out of court.** There are partnership agreements

in place in about 50% of the partnership disputes I am involved with which go to court. A party can always find some reason why the partnership agreement should be overturned by a judge. Having an agreement is no guarantee you will not end up in a messy situation.

So why do we bother with them?

- **The process of doing a partnership agreement is very important.** It produces alignment. It's like finding out if you want to have children before you get married. It smokes out hidden agendas and divergent assumptions. It makes sure everyone has the same goals. It should built trust and respect between the partners.
- **It forces someone who wants to do something different to explain.** Legal contracts are taken very seriously. They are not overturned without darn good reasons. They substantially reduce the risk of a messy situation.
- **It creates a road map that third parties can follow.** Even if you and your partners are completely synchronized, and have a very high degree of trust and respect, you cannot always count on your partner being there at crunch time. If they become ill or die, a partnership agreement can be important to show third parties – such as your partner's spouse –what you and your partner agreed.

Avoiding Partnership Disputes at Exit or Separation

There are some things you can do which will reduce the risk of a partnership dispute at a time when one partner is planning to or wants to exit the business or sever a partnership relationship, including:

- **Have a realistic assessment of the value of your share of the business,** Know how your business is valued.
- **Keep in mind that there is more to a good deal than price and value.** You have to keep an open mind on price and value, and be prepared to bargain for other things of importance to you, such as payment terms, security and post-closing restrictive covenants.
- **Know what you have contributed to the business.** Do not overestimate your contributions, be fair and realistic. Appreciate how your partners see your contributions.
- **Appreciate your partners' contributions.** Know what they are. Be fair and realistic about them. Appreciate how they see their contributions.
- **Do not make things personal or take things personally.** You can criticize an idea, or a business practice, without attacking your partner on a personal level, and your business ideas and practices can be criticized without it being a personal attack.
- **Keep partnership issues within the partnership.** Pulling staff, spouses and others into partnership problems erodes trust and respect. There is one exception – good professional advisors. Most business advisors have seen more partnership problems than you ever will.
- **Have good professional advisors;** listen to them and follow their advice. Make sure they are experienced, practical, caring and strong without being adversarial. Getting help from the right advisor at the right time, especially if they know the partners and the business history, can be a good first step in nipping a problem in the bud.
- **If you have a partnership agreement, know what it says,** keeping in mind that it doesn't

matter what the agreement says if you agree on what you want to do. If there is a process for exiting in your partnership agreement that someone thinks is unfair or produces an unfair result, find out why and try to deal with those issues.

- **Find out what everyone's legal rights and remedies could be**, both yours and your partner's.
- **Take the moral high ground.** The only thing more important than being right is doing the right thing. If you ever end up in court, giving the judge a reason to want to help you will be very important. In court-resolved partnership disputes, the partner who has acted with the most integrity, fairness and common sense is most likely to get the court's assistance.
- **Do not act like you have anything to hide.** Many partners try to control the situation by controlling information. This is counterproductive in the long run. The more forthcoming and open you can be, the more you will be trusted. Without trust, the situation costs more to resolve, both financially and non-financially. You will also look better if you end up in court.
- **Communicate and keep communicating.** Although it may seem difficult at times, if both sides keep communicating progress will be made. Often trust and respect are so far gone that it takes a lot of convincing to rebuild even the smallest amount. But remember that if you cannot communicate, lawyers are going to make a lot of money off your inability to work together.
- **Be creative and supportive.** The most obvious solutions are not always the best ones. Solutions built around the needs and fears of all the partners are most likely to be perceived as breakthroughs by everyone involved.
- **Be open and honest.** It is hard to get what you want if you do not ask for it, and explain why it is important to you. Manipulating a process through deception or withholding key information rarely accomplishes anything. Things that just do not add up in business are pretty easy to spot. Remember that given a choice of explanations it is human nature to assume the worst of someone when it comes to money. Do not give your partners that option. Honesty is the best policy.
- **Work toward a win-win.** Emotion will trick you into thinking that a win-lose solution will really be satisfying. But in the long run, a win-win solution will be easier to live with. On the other hand, if that becomes impossible, know what you need and make sure you go for it.
- **Make a business decision.** Mutually perceived fairness is an admirable goal in resolving a partnership dispute, although it often proves very elusive. Revenge is not an admirable goal and is even harder to get, although I find most of my clients can get "revenge" in the marketplace that they can never find in the boardroom or the courtroom. In the end, make a good business decision. That is the only test that really makes sense anyway.

A Checklist to Consider

There are lots of other issues to consider when a partner is being bought out. A suggested checklist is set out below.

There are often more issues to be considered in a partnership buyout than in a third party sale. The more partners there are the more complex it can become. In most succession planning

situations the buyout is likely to be friendly. But that is not always the case, and therefore this checklist can be used in friendly and hostile buyout situations.

Background and Personal Issues

- What kind of business is it? Is it incorporated? How long has it been going? What are its dimensions (annual sales, number of locations, number of employees)?
- Who are the partners? What have they each brought to the table? Are there disparities in perception in that regard?
- Who or what is triggering the split up? Why?
- To what extent will this be amicable? Why or why not?
- The legal/share structure of the business, including number and type of shares and any special attributes.
- Is there a partnership agreement? What does it say? Does anyone find any of it objectionable? If yes, what and why?
- Who are the current company accountant and professional advisors? What are their competencies? Where do their loyalties lie? To what extent can they or do they want to be involved?
- Are their potential mediators or third party intervenors, if necessary?
- To what extent should we anticipate the involvement or interference of other third parties (e.g. spouses, family members, friends)?
- Are the partners willing and able to talk face to face, now or at some future time, in an open and honest way?
- Who will be emotional about this? Why? How?
- Are there any resentments or legacy issues to be considered?
- Have there been recent issues about trust or disparity in contribution to be considered?
- Is there a basis for the buying partner to want to help the selling partner through the process?
- Does the departure of one partner change the balance of power or influence in the partnership? What is the impact on the remaining partners?

Valuation Issues

- What is the business's current financial situation? Have there been any recent changes? If yes, what and why?
- What is the present value of the business, and the extent to which it is dependent on personal goodwill of individuals in the business?
- Particulars of any shareholder loans or unpaid dividends, salary or bonuses.
- Potential "fair market values" and "fair values" of each shareholder "investment".
- The amount of cash or cash equivalent resources in the business.

- What does the shareholders' agreement say about valuation? Or the process for determining value?
- Other shareholder discussions or agreements on value or the process for determining value.

Partner as Employee Issues

- Who is employed in the business? In what capacity?
- Is there an employment contract? If yes, what does it say?
- What does it do to the business if the employees leave?
- Do any need to be replaced?
- How dependent are they on their salary to support themselves and their families?
- Are there wrongful dismissal issues?
- Are their written confidentiality, non-competition or non-solicitation obligations? If yes, what do they say?
- What confidentiality, non-competition or non-solicitation obligations are there to be concerned about?
- Do the partners have family members or close friends who are employees of the business? If yes, how does that impact things?

Stakeholder and Third Party Impact Issues

- Customers and referral sources.
- Suppliers.
- Subcontractors.
- Investors or shareholders.
- Lenders and creditors.
- Employees.
- Government regulators.
- Landlords.
- Licensors and other key third parties.

Strategic Issues

- Should a non-buyout strategy be considered?
 - _ Informal winding up.
 - _ Division of assets.
 - _ Third party buyer.
 - _ Formalized winding up on consent.
 - _ Court ordered winding up.

- _ Legislative “minority rights” remedies.
- _ Oppression remedy litigation.
- What are the relative financial strengths and needs of the partners, and their ability to raise financing?
- What is the likelihood of arbitration or litigation? Who should start? When? Using what approach?
- Are there shareholder agreement remedies and clauses to consider?
- Are there other contractual remedies?
- What is the likely timeframe in which a deal will be done, a likely cut-off date and a likely closing date?
- Cost and expenditure issues – cost follows animosity, time and complexity; who should pay what costs?

Preservation of Value Issues

- How do we operate the company while we are sorting this out?
- Are there issues around sharing the same physical space?
- Are there issues around the distribution of salary, bonuses, profits etc. earned in the meantime?
- What will be the impact on employees, including who to tell, when, what loyalties will be affected and how they will be managed?
- What will be the impact on key suppliers, including who to tell, when, what loyalties will be affected and how they will be managed?
- What will be the impact on customers, including who to tell, when, what loyalties will be affected and how they will be managed?
- What will be the impact on accounts receivable collection?
- What will be the impact on work in process?
- What third party approvals will be required? E.g. government licenses, landlords, etc.
- What third party guarantees will need to be released?
- Are there any personal use or special assets that need to be considered?

Non-Competition and Non-Solicitation Obligations

- What exists today?
- What is necessary in the future?
- How to manage them?
- What compensation should be paid for them?
- What form should that compensation take?

Purchase Price Issues

- Are there shareholder loans or unpaid dividends?
- What about earned but undistributed profits?
- What about employment issues – severance packages or obligations?
- Is there a role for post-buyout consulting fees?
- What about restrictive covenant payments?
- Are there royalty or earn out issues or possibilities?
- How is the value of the shares determined?
- How do we time the payments, and are there contingencies or dependencies before payments are made?
- Are there purchase price adjustment issues to be considered?

Financing Issues

- Is there an opportunity to lever the company financially to fund a buyout? If yes, to what extent?
- Can the buyer provide funding from his or her own resources?
- Is third party financing availability, and on what terms?
- Will the seller provide financial support to the buyer or the business? If yes, on what terms?
- Will the seller or the buyer consider an earn out component? If yes, what are the pros and cons, and on what terms?
- If the seller provides financing or an earn out is used, what sort of security for deferred payments is possible?
 - _ Shares escrowed or subject to share pledge agreement.
 - _ Personal guarantees and security.
 - _ Corporate guarantees and security.
 - _ Payment terms and maturity.
 - _ Rights on default.
- Are there any redundant assets in the business that could be used as part of the buyout?
- Does the seller have personal assets they want removed from the business?
- Are there personal guarantees or covenants that need to be released as part of the deal, and how does that impact financing opportunities?

Income Tax Issues

- Who will provide tax advice to the parties?
- What are the capital gains issues for the buyer and the seller?
- What different tax treatments for buyer and seller on various deal structure issues need to be considered? How do they impact the deal?:

- _ Return of shareholder loans.
 - _ Dividends.
 - _ Severance payments.
 - _ Consulting payments.
 - _ Retiring allowances.
 - _ Personal pension plan funding.
 - _ Non-competition payments
- Is there change in control or deemed year-ends to consider?

Miscellaneous Legal Issues

- What guarantees need to be released?
- What representations and warranties are required?
- What special covenants are required?
- What releases are required, and from who?
- What indemnities are required, and from who?
- What resignations are required, and from who?
- Who needs what representation, including independent legal advice?
- Company name change required?
- Company corporate records updated?
- What restructuring of the remaining partners is required?
- Do we need an amendment to the existing partnership agreement? Or a new one altogether?

Structuring The Deal

Since other articles on our website www.thompsonlaw.ca get into the details of structuring deals, I will go into great detail here. Of particular interest are articles on price negotiation, management buyouts and deferred payment transactions.

Some Final Thoughts

The spirit of partnership was well expressed by Bobby Kennedy:

“No matter what talent an individual possesses, what energy he might have, no matter how much integrity and how much honesty he might have, if he is by himself ... he can accomplish very little. But if he is sustained [by others] dedicated to the same things that he was attempting to accomplish, he can accomplish a great deal.”ⁱ

This is just as true when a partner is leaving a business as it is when starting or building a business.

Unwinding a partnership under any circumstances is a test of character for all concerned. Use the opportunity to say something about yourself and your values that you will not be ashamed of in years to come.

ⁱ Kennedy, Robert F., *Address to the Democratic National Convention*, Atlantic City (August 27th, 1964).