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Breaking Up is Hard to Do: Review of Issues and Case Law Relating to Business Divorce in Texas LLC's and Partnerships

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I. THE BUY-SELL AGREEMENT A/K/A THE "CORPORATE PRE-NUP"

"From a relational standpoint, people enter closely-held businesses in the same manner as they enter marriage: optimistically and ill-prepared." [1]

Every great business begins with an idea for a superb product or service that provides the company with a marketplace advantage. Yet, many potentially great companies flame out relatively early in their existence when conflicts arise among the founders regarding their vision for and direction of the company. No contract term can immunize a company from future ownership disputes, but an agreement that includes a mechanism for allowing investors to exit the business on terms agreed to at the outset of the venture provides a vehicle for resolving the ownership conflicts because it provides for an exit strategy that enables or requires one or more of the owners in conflict to leave the company. We often refer to these various kinds of exit rights, whether structured as a buy-sell, redemption right, or warrant, as "corporate pre-nups" that, when necessary, will facilitate a so-called "business divorce" among the owners of the business.

As creative as they are, entrepreneurs are often so focused on the development of their product or service that they fail to consider how to structure the company's ownership and succession plan. It is critical, however, for both the controlling majority owners of the business and minority investors who may want to leave the business in the future to provide for an exit strategy. A buy-sell provision is the euphemistic term that provides a contractual means for majority owners to buyout the interests of the minority owners in the company and for minority owners to be able to cash-out and leave the business, i.e., to monetize their otherwise illiquid interest.

A. Critical Importance of Buy-Sell Provisions

The importance of securing a buy-sell agreement cannot be overstated. The buy-sell agreement should be obtained either at the outset of the business or at the time the investment in the company is made. It provides a plan for future events, many of which are not anticipated, but which may include all of the following: (1) the death, disability or divorce of a partner/investor, (2) an investor who needs to leave the business on short notice, (3) criminal conduct or bankruptcy filing by a partner, (4) actions by a partner that put the business at risk, such as disclosing the company's trade secrets or engaging in competitive behavior and (5) conflicts arising among the owners regarding the desire to raise capital or assume debt.

In the absence of a buy-sell agreement, fights are likely to erupt among co-owners that are highly disruptive, if not devastating, to the business. These "business divorce" battles among the co-owners of the company are so fundamental to the business that the resolution of the dispute may require the company to shut down, force a sale of the entire business for a low-ball price, or result in expensive and protracted litigation with the departing minority investors.

In practical effect, the buy-sell provision operates to break deadlocks that arise between the majority and minority owners of the business. The buy-sell provision is able to break this deadlock by forcing at least one party to exit the business. Specifically, once one of the parties triggers the buy-sell provision, it leads inevitably to at least one party leaving the business.

[1] Charles W. Murdock, The Evolution of Effective Remedies for Minority Shareholders and Its Impact Upon Valuation of Minority Shares, 65 NOTRE DAME L.REV. 425, 425 (1990).

Not surprisingly, the best time to negotiate and implement a buy-sell agreement is when the business is being formed. At the entity formation stage, the founders/investors are on good terms and optimistic about the company's prospects. Down the road after the partners are in conflict over the direction, finances and value of the business, it is likely to be very difficult for them to reach agreement on an exit strategy.

Further, the Texas Supreme Court in *Ritchie v. Rupe* held that minority shareholders no longer have the right to secure a court-ordered buyout based on oppressive conduct by the majority owner. For this reason, the Court uncharacteristically took the opportunity to offer legal advice to minority owners considering an investment in a private company. The Court recommended that minority investors enter into a contract at the time they made their investment to ensure that they would have the right to obtain a buyout of their interest when they are ready to cash out.

B. Different Types of Buy-Sell Agreements

There are several different types of buy-sell provisions or agreements, but three of the most common are: (1) the "co-owner buy-out" in which the owners of the business agree to purchase the ownership interest of the departing investor, (2) the "redemption agreement" in which the company agrees to purchase the interest of the exiting owner and (3) "right of first refusal" which gives the company and the co-owners the right to first purchase the departing investor's interest before it is offered to any third parties, or alternatively, which gives them the right to match any third-party offer.

Once the owners of the business have decided to put an exit strategy in place, the negotiation and drafting of a buy-sell agreement is straightforward. It is also a helpful exercise for the owners to go through the process as they will be required to consider and implement a succession plan.

The key elements of a buy-sell agreement consist of the following:

- Who has the right to exercise the buy-sell and when?
- How is the right exercised and under what circumstances?
- What is the formula for valuing the interest to be transferred?
- How is the purchase price to be paid and when?
- What dispute resolution procedures apply?

- **Time for Exercise** - The agreement will provide the time at which the owner can exercise/trigger the right to leave the business (the owners may decide that no investor can cash out for a period of years after the business has formed);

- **The Right to Trigger** – the buy-out enables a minority owner to secure a buyout from the company and/or from other owners, but may also include a redemption right in which the majority owners(s) have the right to redeem (repurchase) the minority owner's stake in the company. This provision therefore defines what events may give rise to the right to trigger the option. Common triggers include:
    - Resignation of a shareholder from their role as an employee or officer
    - Termination of a shareholder as an employee for cause.
    - Expiration of a fixed waiting period.
    - Use of financial milestones regard profit, revenue, assets or customers.

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