

Beware of an Out-of-Date Buyout Provision

By Betsy G. Ramos

Partners in business together, regardless of whether the company is a corporation, an LLC, or a partnership need to address buyout terms of the ownership interest of another owner in the business. Buyout provisions are commonly addressed in a shareholder agreement if a corporation, a partnership agreement if a partnership, and an operating agreement if an LLC.

A recent New Jersey appeals court decision, *Estate of Cohen v. Booth Computers*, which upheld net book value as the buyout formula for a family partnership, points to the need to review your company's buyout provisions and determine whether it needs to be updated. In this case, the court found this buyout provision enforceable despite an almost 60 times difference in value between book value and market value.

Buyout provisions typically will contain clauses governing the types of events that would trigger a buyout, as well as the valuation methodology of the company and the owner's interest. A mandatory buyout is usually triggered upon death and permanent disability and could be triggered upon the occurrence of other events such as divorce or dissociation from the business.

The tricky part is usually how to value the interest of the owner to be bought out. Agreements do not always provide a workable methodology. Sometimes the agreements will provide an initial valuation which is to be updated annually - except the owners fail to do so, which leaves no current valuation.

Other agreements provide formulas or mechanisms which have become outdated for the business as the company grows. However, the owners fail to revisit the valuation formula until it is too late because, as an example, one of the owners dies suddenly and the mandatory buyout provision is invoked. If the parties cannot agree on a formula, litigation will ensue.

In the *Estate of Cohen* case, some years ago, the father, Robert Cohen, had set up Booth Computers, a partnership for the benefit of his three children. The partnership eventually acquired various pieces of real estate. The partnership agreement provided that, if a triggering event occurred, the partner's interest would be bought out at the cost of net book value plus the sum of \$50,000.



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When one child died in 1998, his interest was bought out, using this formula. When the second child died in 2007, the remaining child notified her estate of his intention to buy out her interest based upon this formula.

One of the properties, a Palm Beach property, had appreciated significantly since its purchase. The disparity between net book value and fair market value of the partnership was a significant one. While the net book value of the deceased child's interest was \$178,000, the plaintiff (the estate of the deceased child) claimed it was entitled to a buyout based upon the fair market value of that interest, \$11,526,162.

The trial court's decision found that the parents who set up the agreement could have provided for a buyout based upon fair market value, but chose not to do so. This fact, coupled with the prior buyout based upon this provision, led the trial court to enforce the agreement.

The appeals court upheld the trial court's ruling. Moreover, the appeals court found that the partnership agreement was not unconscionable despite the gross disparity between the fair market value and net book value. The court stated that the agreement provided a recognized standard of valuation which was a valid and workable basis for calculating the buyout.

The lesson to be learned from this case is that owners should examine their agreements containing buyout provisions and determine whether the buyout provision reflects the intent of the parties as to the buyout price. If not, the owners should revise their agreements before a triggering event occurs and it is too late to make a change.

This article was prepared by Betsy G. Ramos, Esq., Co-Chair of Capehart Scatchard's Litigation Group. She has over 25 years experience as a litigator handling matters including estate, business, employment, construction, and general litigation as well as tort defense. Should you have any questions or would like more information, please contact Ms. Ramos at 856.914.2052 or by e-mail at bramos@capehart.com.

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