

BUSINESS EXIT STRATEGIES

Perhaps you started a business with a few of your closest friends. In order to save on the start-up costs you decided to employ the services of an online incorporation business such as Legalzoom or Bizfilings. Although the business may be going well for now, ask yourself this: would you ever walk into a building not knowing whether you'll ever be able to exit? If your answer is "no", why would you ever invest in a business without knowing whether you'll ever be able to walk away from the investment? What if, in the lifecycle of your business, you get to a "it's not you, it's me"-moment? Wouldn't it be nice to know that you can split up on amicable terms?

The point of this article is that unless viable exit strategies are examined and agreed upon early, a business co-owner may find it difficult or impossible to walk away from the investment on favorable terms.

First, the law:

Co-venturers have four basic choices for structuring their business: general partnership; limited partnership, limited liability company and the corporation. Limited liability partnerships are available for a limited group of professionals and will not be a topic of discussion.

- General Partnerships: under California law, a partner who withdraws (the actual term used is "dissociates") from the partnership is entitled, unless otherwise provided in the partnership agreement, to a buy-out of his partnership interest, except where the dissociation occurs within 90 days prior to the dissolution of the partnership. The buy-out price is determined by assuming either a liquidation sale of the partnership's assets or a sale of the business as a going concern on the date of withdrawal.
 - Limited Partnerships: - General Partner: assuming that the general partner is allowed to withdraw (per the limited partnership agreement), unless otherwise provided in the agreement, the general effect of withdrawal is that the general partner becomes a limited partner. - Limited Partner: assuming that the limited partner is allowed to withdraw (per the limited partnership agreement), unless otherwise provided in the agreement, on withdrawal the

limited partner is entitled to receive any distribution to which he or she may be entitled under the partnership agreement. In addition, within a reasonable time after withdrawal, the limited partner is also entitled to receive the fair value of his or her interest in the partnership.

- -NOTE: The California law governing limited partnerships is subject to change as of January 2008. For limited partnerships organized after that date (or for all partnerships after January 2010) the new provisions do not entitle a withdrawing limited partner to a return of his investment. This is a substantial shift from present law which is certain to catch a number of LP investors by surprise.
- Limited Liability Company: assuming that the member is allowed to withdraw from the LLC (per the operating agreement), unless otherwise provided in the agreement, the member will not be entitled to payment for the member's interest in the company.
- -NOTE: Typical operating agreements provide that a member has the right to withdraw. Don't read terms into this provision which aren't there. Unless the operating agreement specifies that the withdrawing member is entitled to a buy-out of his interest, no such right is granted by virtue of this provision.
- Corporation: a corporate shareholder is not entitled to have his investment purchased either by the corporation or the remaining shareholder.

Second, the pitfalls:

Even if the default provisions under California law entitle a withdrawing investor to have his/her investment purchased, either by the entity or by the remaining investors, a number of issues are left unanswered, for example:

- 1) How does one determine the liquidation value of assets or value of the business as a going concern?
- 2) Who makes this determination?
- 3) What is a "reasonable time" for return of a limited partner's investment?
- 4) Which funds are to be used for purchasing a withdrawing partner's interest? The entity's? The

remaining partners'?

5) What if some investors desire to buy-out the withdrawing investor's interest, but others do not?

How does this effect the control and viability of the business? 6) What are the tax implications of

a purchase of an investor's interest by the entity v. the remaining investors? 7) How does the exit

strategy that you think you may have fit in with your estate plan? 8) Etc.

Conclusion

Parties involved in a closely-held business entity should not fail to include exit strategies in their venture agreements. Significant litigation fees can be saved by simply including concise buy-out provisions as part of the investment. Furthermore, as operating businesses are usually worth more than the liquidated value sum of their parts, the withdrawing investors can be assured that s/he will realize the maximum financial benefit of his/her interest upon withdrawal.