BUY-SELL AGREEMENTS IN A DIVORCE (PART 2)

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My last article discussed a typical provision found in shareholders agreements (for corporations) or operating agreements (for limited liability companies) giving the other owners a right to step in and buy any shares or membership interests of a divorcing owner that would otherwise pass to his or her ex-spouse. That article introduced issues which should be considered in determining whether such a "buy-sell" provision should be enforced or set aside. A 1994 California case, *In re Marriage of Nichols*, 27 Cal. App. 4th 664, established a useful three-part test on this question, with the key issue being how the value resulting from the buy-sell provision "is similar to the value produced by other approaches." The typical buy-sell provisions for determining what price the other owners will pay when they exercise their rights to force such a sale take several forms, including:

The Book Value Approach. Some agreements set the purchase price at the "book value" of the relevant ownership interest. With most active businesses, this will likely produce a number well below the actual market value since it is generally based only upon the depreciated value of fixtures, furniture and equipment plus the excess of receivables over payables, minus any long-term debt. This approach ignores the company's goodwill value as a growing concern, which is often a substantial sum paid by a third party buyer in a negotiated transaction.

The Multiple Approach. Another provision might produce a fairer result: The agreement sets the price at a stated multiple of net profits or EBITDA (earnings before interest, taxes, depreciation and amortization, which ignores those non-operational items to focus on the true business profit). For example, the purchase price might be the seller's pro rata share of "five times EBITDA for the past 12 months". This is an approach which many third party buyers take in deciding what price they are willing to pay in acquiring a business. However, setting the correct multiple depends on a variety of industry and market conditions, which may change dramatically over time. For instance, when the M&A market is hot, multiples will go up; in a weak market, multiples may drop sharply. So the reasonable multiple set in an agreement today may yield an unfairly high or low result down the road.

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The FMV Approaches. Two other common approaches are to have the "fair market value" (or "FMV") for the interest determined by an independent business appraisal expert, or by the Board of Directors or Manager of the Company "in good faith". The danger in the latter provision is obvious: it places determination of the buy-out price for the ex-spouse's interest in the hands of the remaining owners exercising their right to buy that interest. In contrast, having FMV determined by an independent appraiser can produce a fair result if the agreement sets appropriate criteria for that process. First, the agreement should require the selection of an experienced appraisal firm with significant expertise in valuing companies in the relevant industry, as well as an efficient mechanism for choosing the particular appraiser. Second, the agreement should state the criteria which will govern the appraiser's determination, such as: (a) whether there will be discounts for the lack of marketability of this private company's equity and lack of control with a minority voting position (these could combine to reduce the appraised value by as much as 40%); (b) whether particular factors will be included or omitted from the calculations (one-time write-offs, extraordinary income or loss, etc.); and (c) the appraisal method to be used in valuing the company.

In short, when a "buy-sell" provision would force the sale of an interest which may otherwise pass to an ex-spouse through a divorce, any contract-mandated method for determining that purchase price should be carefully examined by the Family Law attorney. Under the *Nichols* decision, particular scrutiny should be given to other, perhaps fairer, methods for determining the buy-out price. The party challenging the provision will have to provide a convincing case for why the formula agreed to at the outset by the founding owners for a valid business reason does not reflect a fair value for the ex-spouse's interest. While that may be difficult, given the possible high dollar stakes involved, careful consideration of these factors is critical.

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