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Courtesy of Derrick Sims

THE BEST-LAID PLANS

BY CHRIS COOPER

A shareholders' agreement can prevent problems, but few gyms have one. How can they help CrossFit affiliate owners?

Courtesy of Derrick Sims

The clear lines of the parking lot were not reflected in ECFF CrossFit's business plan, and Derrick Sims soon found himself at odds with his partner.

New CrossFit affiliate owners sometimes consider taking a partner at startup. The burden of labor and risk can be lightened when spread across several broad shoulders, and pooling funds means avoiding the moneylender.

But sometimes the coach's vision doesn't match that of the investor, or circumstances change quickly. Other times, deals are struck with friends, and more than money is lost if the partnership breaks up.

When Derrick Sims partnered with his longtime friend to open ECFF CrossFit in Pensacola, Florida, he believed his relationship was stronger than any legal agreement could be. A year later, he's been through a bitter battle for his gym, and he's facing the future alone.

"It's just me now. I'm scared to shit," Sims said.

Good coaches want to coach for a living, and many see partnership with an investor or friend as a shortcut to the entrepreneurial dream. And partnerships can work out for everyone involved if they're set up well. But if proper care isn't taken at the beginning of the relationship, even the best coach could find himself unhappy.

A solid partnership agreement can save money, lawyers and friendships, and creating one isn't difficult or expensive.

Starting on the Right Foot

At its core, a partnership agreement should contain the responsibilities of each party, remuneration details and opportunities for growth (if any), according to the U.S. Small Business Administration. It should also describe the method for valuation in case of sale and define how one party can buy the other out.

Shareholders' roles and associated tasks should be delineated from the start, including job descriptions and estimated time spent at each task. In some cases, one partner will assume more of the day-to-day operational responsibilities while another builds the business. According to the Small Business Administration website, it can be hard for each partner to appreciate the other's effort when it's out of sight, so clearly defined roles and responsibilities can eliminate speculation and confusion.

Considerations for pay—salaries, dividends and rates—should be recorded on paper. Each partner should know how to increase his or her share of the business, and each should understand his or her responsibilities when the business needs cash. Other important considerations include how much money should be left in the bank account before dividends are paid, when and how much equipment should be purchased, and how each person can escape the contract if everything goes wrong.

In many shareholders' agreements, partners are given a "right of first refusal"—a first crack at the seller's shares—for a certain window of time if the other partner wants out. If the partner can't come up with the money or doesn't want to increase ownership, the seller can accept an offer from anyone. Most box owners wouldn't even consider hiring a stranger to coach; sharing intimate financial details with a new partner someone else selects could make for an uncomfortable venture.

When it comes to buyout procedures, anything is desirable over a bitter fight without any legal boundaries.

A buyout scenario brings up the issue of valuation. Valuing a new or young company is a challenge, especially in a service business built around one or two dominant personalities. Some gyms have an "icon problem": Clients are more attached to one coach than to the business and will follow the coach to a new venture. Others don't use contracts and can't accurately predict their revenues from month to month. Fitness equipment is often valued at 30 percent of its purchase price after it's been used once. And discussing a "goodwill" value can make even an amenable buyout volatile because any number placed on a partner's passion and hard work will seem low.

Ultimately, share value can be hard to determine, so many business owners will spell out the process in advance. Share price might be based on gross revenue, assets of the company or salaries—or something else entirely. But deciding how to determine value in advance can save a lot of stress later.

Another option for a quick-and-dirty resolution is the "shotgun clause," in which one owner can reverse a purchase offer. For example, if Bill offers Martha $100 for her 50 percent stake, Martha can buy out Bill for the same amount. It's quick and clean but favors the shareholder with more money: He or she can simply dangle an offer just beyond the reach of the partner.

When it comes to buyout procedures, anything is desirable over a bitter fight without any legal boundaries. When anything goes, everything often does.

Last Man Standing

Getting into a shareholders' agreement requires two cups of coffee, an hour with an attorney and a few hundred dollars. Without an agreement, changes in ownership can take months and cost thousands of dollars—as well as friendships and sleepless nights.

"Me and (my former partner) were best friends," Sims said. "We were cops together. We worked overseas doing various things for the government. He lived with me for three years while he was trying to get back on his feet after his divorce."

He continued: "Last August (2013), we decided we were going to pull the trigger on our affiliate. We just found the space and ordered equipment. Then he decided to go back to being a cop. So I sucked it up and got the gym running while he was in cop training."

Though the pair did form a limited-liability company (LLC) to protect it from some risk, the arrangement was vague: There was no description of each partner's role or responsibilities, no clear valuation process and no buyout clause.

"We did well at first—we had 100 members in the first 10 months—but his participation fluctuated greatly. He went from doing half the work to almost none. I had a full-time job, too. I asked him to do more," Sims said.

"Of course, there was a girl involved, too," he added.

His partner's new romantic interest might have felt she had a vested interest in the gym; she acted as if she was an owner, according to Sims.

The long hours, dramatic relationship and high workload took their toll on Sims. Still working full time as a police officer, he would spend his shifts nervously praying his classes were being covered at the gym.

"Our first real blowup was in May (2014). I was tired of doing all the work and not getting any help. We had a sit-down discussion, and he agreed to take on some administrative roles like programming and following up with leads," Sims said.

Things seemed to be improving, but his partner's work was unsatisfactory to Sims. In July, the situation worsened when his partner took a promotion at the sheriff's office. He offered to sell his shares to Sims for $40,000, but Sims still preferred to share the work and proposed weekly meetings to coordinate ownership better.


Courtesy of Jeff Lynch

At CrossFit Alpha 1 Athlete, Jeff Lynch (delivering choke) provided cash for startup as part of a clearly defined arrangement with his partner.

"That lasted two weeks," Sims said.

Over the summer, Sims had to release an employee who'd been hired by his partner. Further complicating the issue, the programming was becoming inconsistent, and the partners disagreed on their responsibilities in the box. When Sims left for a weekend CrossFit seminar, his partner closed the gym and took a vacation.

Feeling the situation was irreparable, Sims handed over control of the box via text message at the end of September.

"I just said, 'I'm out. Go ahead and run everything,'" Sims recalled.

The box couldn't close because clients had already been billed for October. Sims got an attorney who made the case that Sims owned more than a 50 percent share because he'd contributed all the original equipment. Because those terms hadn't specifically been spelled out in the LLC contract, the original contributions of each partner were open to interpretation. In this case, an ambiguous shareholders' agreement worked out in Sims' favor, but it easily could have gone the other way.

Sims' partner found a buyer for the equipment, but the money would barely cover the lease for the next year. With little to gain, the partner accepted an offer from Sims.

"I offered him 5K to just walk away. He signed the papers," Sims said.

Courtesy of Jeff Lynch

Assigning specific roles to each partner helps people play to their strengths and interests. Some are more suited to coaching, and some are more suited to business management.

Courtesy of Jeff Lynch

Rod Rodriguez (in white) is the operating partner at CrossFit Alpha 1 Athlete. His role reflects the fact he's the partner who will be in the gym every day.

Sims lost members during the transition. The unpredictable schedule, tension between coaches and doubt about the gym's future caused several clients to train elsewhere. Now Sims is trying to repair the damage as sole owner.

"I wish I'd done it sooner," he said. "Now I have to rebuild membership."

Over a year into ownership, Sims is starting from square one—this time alone.

The CrossFit Inc. Perspective

To protect the trainer-cum-owner, CrossFit Inc. has taken precautions with its licensing procedures. These precautions require some extra consideration when drafting a shareholders' agreement, according to Dale Saran, head of CrossFit Legal.

"In most businesses, the licenses they own are part of the assets," Saran said. "But ours is non-assignable and non-sub-licensable."

In other words, gym owners granted permission to use the CrossFit brand name for an affiliate can't shift ownership to a corporation, LLC or another coach.

To protect the trainer-cum-owner, CrossFit Inc. has taken precautions with its licensing procedures.

"We don't license companies or entities. We license Level 1 trainers," Saran said.

"It's not up for discussion in a partnership agreement, like the equipment or somebody's salary. The ownership over the name 'CrossFit' plus whatever moniker before or after is entirely something we control."

This arrangement protects coaches who want to open gyms because the coaches carry the right to use the brand name. Investing partners can't take the name in a hostile buyout.

According to Saran, many shareholders' agreements have another issue: non-compete clauses.

"First, the law generally disfavors them," he said. "Second, they're usually limited in scope."

Those concerns are common to any business, but Saran's more concerned about a potential problem specific to new CrossFit gyms: "We just found that if we allow non-competes, people would put, 'You can't open another box within five miles (in their coaches' contracts). People would start creating their own protected areas. So we just don't allow it."

This means new affiliates have the same opportunities long-established gyms had when they opened. It's free-market capitalism at its best. Older gyms have to work hard to retain their spot at the top of the local pile and don't get to carve out territories that might allow them to coast. The arrangement eliminates complacency and ensures better coaches can make a great living as owners and operators.

Saran said the licensing agreement is built with this owner/operator coach in mind.

"Investors should understand that CrossFit isn't an investment-grade asset. That's not what it was designed for. The 'least-rents model' depends largely on keeping costs as low as possible. Any greed built into that business model would distort the market," he said.

CrossFit's "least-rents" model, described in The Founder's Views Part 3, means CrossFit's mission isn't to maximize revenue through affiliate fees. It's to grow the brand as much as possible.

"We're not trying to widen the pie," CrossFit Founder and CEO Greg Glassman said in an interview with Inc.com. Rather, his vision is to expand the pie itself to increase revenue without putting additional financial pressure on CrossFit affiliates. Non-compete agreements are contrary to that strategy.

Of course, a business has a right to protect its interests. One alternative to a non-compete clause is a non-solicitation agreement, in which partners and coaches agree not to approach former clients to entice them away from their current gym should a split occur.

"We're fans of a non-solicitation agreement. If a trainer leaves, he shouldn't be soliciting clients. That's just shitty behavior," Saran said. "The law looks at membership lists, contact info and all of that stuff as an asset of the business. So we're fine with that (level of protection)."

Shareholder buyouts have been discussed since the first affiliates were licensed, and changes in licensee are sometimes dictated by circumstance. For example, many affiliates are owned by military personnel, so it's sometimes necessary to move the official license from one shareholder to another.

"Let's say we're three years into this and I get deployed," Saran said. "How do I take my share out? Can I sell to anyone I want or do my partners get the first option to buy me out?"

In these cases, CrossFit Affiliate Support and CrossFit Legal work hard to ensure the licensee of record isn't being forced out. If the arrangement is amicable and all affiliation requirements are met, CrossFit Inc. will transfer ownership to a remaining partner.

An Ounce of Prevention

CrossFit Alpha 1 Athlete in Plano, Texas, was formed on a formal shareholders' agreement, and owners Jeff Lynch and Rod Rodriguez are involved in a good partnership. At startup, Lynch invested money and Rodriguez spent his days in the gym as the operating partner, making a salary. Rodriguez has a 10 percent stake in the business, with options to earn more.

Lynch (above left) and Rodriguez (above and below in white) set up a shareholders' agreement that includes goal-based milestones and buyout options. With everything laid out in advance, each partner knows what's expected of him and what options are available if either one wants to change his role.

"We fit the left-brain/right-brain analogy really well," Lynch said. "I see numbers of happy people; he sees happy people getting fit."

He continued: "Rod and I had a similar vision to create a better gym, but since I knew the gym wouldn't be my main source of income, and it would be for Rod, I wanted him to have an increasing ownership percentage as the gym grows."

Lynch built revenue-based milestones into their shareholders' agreement. Every year, they consider the numbers to see if their goals are met. If they are, Rodriguez will increase his shares. There's even an option to buy Lynch out. But an increased share doesn't just mean increased dividends in times of plenty. It also means increased risk, which Rodriguez willingly accepts.

While Lynch doesn't think his arrangement would work in all cases, he said it's important to know what motivates your partners.

"What drives them?" Lynch asked. "Is it pride? Is it money?"

It's also important for each partner to understand the combination of risk and reward that comes with ownership. A prospective partner might see only upside: the potential to earn his or her value as a hard worker. But the downside exists: A 10 percent stakeholder will be liable for 10 percent of the business' debts if it fails. And if one partner doesn't pull his or her weight, the other will have to shoulder a greater share.

Lynch noted new partners who are friends might be hesitant to broach the awkward subject of a formal shareholders' agreement. After all, friends don't sue friends—at least until they're business partners. While broaching the subject of a formal agreement with a friend might seem awkward, it's better than losing a friend—or your shirt—later.

Clients benefit from consistent, drama-free coaching, and when a bad breakup occurs, they can feel like children in a bitter divorce. Purchasing fewer kettlebells to cover a lawyer's costs at startup might not feel enticing, but it sure beats having a lawyer break your medicine balls later. ■

About the Author

Chris Cooper owns CrossFit Catalyst. He opened his gym in 2005 with two partners but successfully removed them from the business. Since then, he's launched several other partnerships and sold or purchased shares in more.