WHAT MAKES FOR A SOUND BUY-SELL AGREEMENT – AND WHY YOU NEED ONE

By: Marcus Urlaub

If you own an interest in a closely held business, whether a collision repair shop, brewery, restaurant, manufacturer, distributor or contractor, no matter the industry, it's critical to have a well-designed, properly funded buy-sell agreement. It provides a business's owners and their families with valuable protection and assures continuity in the business.

THE RISKS

The most obvious risk facing a business owner who does not have a buy-sell agreement in place is a co-owner's death, which may force the surviving owner to go into business with the deceased partner's spouse, family or other heirs. And if you die, your family's financial security may depend on your co-owners' ability to continue operating the business successfully and willingness to regularly share and make distributions of profits.

There are many other situations where having a plan for the a business owner's departure is important. For instance, many businesses have key employees that own a minority interest in the company. What happens if they leave the company, either voluntarily or involuntarily? What if they go to work for a competitor? Do they maintain their ownership interest, or does the business (or the other owners) have a right to buy them out? These and other business continuity issues can be addressed in a buy-sell agreement.

WHAT IS A BUY-SELL AGREEMENT?

A buy-sell agreement requires (or permits) the company and/or the remaining owners to purchase the interest of an owner who dies, becomes disabled, retires or otherwise leaves the business. It also establishes a valuation mechanism for setting the price and payment terms (more on this later).

There are two basic types of buy-sell agreements: (1) a redemption agreement, which requires or permits the company to buy back a departing owner's interest, and (2) a cross-purchase agreement, which requires or permits the remaining owners to buy back the departing owner's interest.

DRAFTING AN EFFECTIVE AGREEMENT

A buy-sell agreement can either be a stand-alone agreement between the business's owners, or it can be a component of a broader operating/ member control agreement or shareholder agreement that also governs other aspects of the business. In either case, an effective agreement should detail the following:

1. Triggering Events

The agreement should identify what events trigger an option or requirement to repurchase an owner's interest. Examples of triggering events include death, disability, divorce, bankruptcy, lawsuit judgment, retirement, attempted sale or transfer to a third party, and termination of employment (e.g., for cause, without cause and voluntary resignation for good reason).

2. Mandatory or Optional Purchase

The agreement should indicate whether the occurrence of a triggering event causes a mandatory purchase and sale, or whether it instead creates an option to purchase or right of first refusal. Such purchase rights and obligations are negotiable and may vary depending on the triggering event. For example, the death of an owner likely triggers a mandatory purchase and sale, while termination of employment for cause may only provide an option on the part of the company (or the other owners) to purchase the departing owner's interest; and an attempted sale to a third party may result in a right of first refusal to the company and/or other owners.

3. Redemption, Cross-Purchase (And in What Order?)

Related to the mandatory or optional purchase decision is the issue of whether the purchase will be a redemption of the owner's interest by the company, a cross-purchase of the owner's interest by the other owners, or a combination.

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Depending on the structure of your business and other factors, redemption versus cross-purchase may have significant business, finance, and tax implications. For example, with inadequate funding, a buy-sell agreement's requirement that the company purchase a departing owner's interest may create significant financial stress on the company and may trigger loan covenant and other issues with the company's lenders. On the other hand, depending on the value of the owner's interest, it may be simply unaffordable or impractical for the remaining owners to buy out their partner's interest. Given these and other complexities, it is common to draft flexibility into your agreement by providing the company the first right to purchase, followed by a pro rata purchase right to the other owners if the company declines (or vice versa).

4. Determining Value

Perhaps the most important, and often the most debated, issue among business partners is how the value of an owner's interest should be determined. There are multiple valuation methods to consider, including valuing the company as a going concern (e.g., a multiple of EBITDA), a calculation of average earnings over a determined number of years, book value, liquidation value, or a combination. You should also consider who will actually calculate this value upon the occurrence of a triggering event. Will it be the company's accountant or an independent third party? Will there be an appeal right or right to a second opinion on the value determination? Arriving at a decision on what a proper valuation method looks like often involves a collaborative discussion with your attorney, accountant, and other financial advisors. Thinking through these issues now will save trouble down the road.

5. How will the Purchase Price be Paid

This is where the rubber meets the road. In order to have a successful buy-sell agreement, it is critical to pin down how and when the purchase price will be paid. In the case of death, the buyout is often funded by life insurance, which provides a source of liquid funds to purchase the deceased owner's interest and cover any estate taxes or other expenses. A life insurance funded buyout is generally an all-cash payment within six to twelve months after the death of an owner. However, other triggering events may require a more flexible payment structure that includes some cash down and the remainder of the purchase price to be paid in the form of an installment note, with payments made either by the company or the purchasing owners. An installment note sale is a typical structure for triggering events such as termination of employment for cause, disability, or retirement. Regardless of the payment method you choose, the most important part is that the buy-sell agreement provide adequate detail on how and when the purchase price will be paid so there is no confusion or dispute after a triggering event occurs.

THE TAKEAWAY

A carefully drafted buy-sell agreement is a must-have for business owners – the sooner you take the necessary steps to put one in place, the better your chances are of successfully navigating any potentially costly disruptions to the continuity of your business.

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