FROM ONCE UPON A TIME TO HAPPILY EVER AFTER: BUY-SELL AGREEMENTS

BY NICOLE M. VANCE, ESQ.

Once upon a time, there was a client with a successful business, a happy family, good health and money in the bank. All was well until his partner declared bankruptcy, got divorced then died unexpectedly. Alas, the client had ignored advice to implement a buy-sell agreement[1] for his business. Consequently, he lost his business, and he and his remaining partner[2] are depleting their savings fighting in court with their deceased partner's bankruptcy trustee, ex-spouse and executor. The client himself is heading down the same path; his wife is divorcing him, his children won't speak to him, his savings are gone and his health is failing due to ongoing stress. He no longer speaks to his advisors out of fear they might say, "I told you so," or at least raise an eyebrow.

All right, perhaps this is a slightly exaggerated case; however, we have all seen similar situations, and this story is hopefully persuasive for any client thinking buy-sell planning is unnecessary. Of course there are circumstances where a buy-sell is unwarranted, namely for clients that:

1. Do not mind being in business with their deceased partner's spouse, children, pets or, worse, a bankruptcy trustee, executor or unknown third party;
2. Do not care how the business is valued if a partner's interest must be bought out; or
3. Have no concern over whether funding is available for such buyout.

I have yet to meet a business owner with partners that fall into any of these categories. In the unlikely event such a person exists, this is almost certainly due to lack of education. In short, a comprehensive buy-sell agreement is the best way to protect a business and its owners. The purpose of this article is to provide a general overview of buy-sell planning, including the specific factors clients must consider in implementing a buy-sell agreement.

Who Needs a Buy-Sell Agreement?

Every business owner with one or more partners needs a buy-sell agreement. This is true whether or not the other

owners are original owners, friends, family members, silent investors or key employees.

What Is a Buy-Sell Agreement?

A buy-sell agreement is a binding agreement between business owners that governs what happens upon the occurrence of certain unexpected "triggering events," such as the death or departure of an owner. It sets forth the specific terms and conditions applicable to an ownership transfer caused by a triggering event. Essentially, a buy-sell is the business equivalent of a prenuptial agreement. A buy-sell is not required by law but makes good business sense.

Any type of entity with multiple owners may have a buy-sell. The agreement may take the form of a standalone agreement, a shareholder's agreement for C corporations or S corporations, an operating agreement for limited liability companies or a partnership agreement for partnerships.

When to Implement a Buy-Sell Agreement?

Ideally, a buy-sell agreement should be in place from business inception. Practically, however, a buy-sell may be implemented at any time as long as the owners can agree on key terms. This is important because owners often neglect buy-sell planning as they focus on getting the business started and soon after are consumed with daily operations. Some business owners wait years before getting the buy-sell done. Nevertheless, sooner is better when it comes to such planning.

Why Have a Buy-Sell Agreement?

A buy-sell is necessary to protect the business, the owners and the owners' heirs. It eliminates or reduces uncertainty regarding the terms and conditions of ownership transfers upon the unexpected departure of an owner. A well drafted buy-sell:

1. Prevents undesirable owners from acquiring business ownership;
2. Creates a market for a departing owner's interest;
3. Establishes a methodology for calculating the price of the ownership interest; and
4. Determines the appropriate method for funding the buyout.

By accomplishing these objectives, buy-sell planning allows the owners to preserve their wealth, both inside and outside of the business, and thus maintain their own personal financial security.

How to Draft a Buy-Sell Agreement?

Seven key factors should be to be considered and addressed in a buy-sell agreement. As a buy-sell is unique to each business, it must be customized based on the goals, objectives and circumstances of both the business and its owners.

Type of Agreement

There are two types of buy-sell agreements: cross purchases and redemptions. In many cases, agreements are drafted as a hybrid of the two.

In a cross-purchase agreement, the remaining owners have the option or obligation to purchase a departing owner's interest. This type generally works well for businesses with fewer owners. A cross-purchase agreement is advantageous because:

1. The buyers take a stepped up basis;
2. Insurance funding does not subject the proceeds to the alternative minimum tax (as can happen with company redemptions);
3. The proceeds are not subject to the reach of company creditors;
4. Loan agreement and state law redemption restrictions generally do not apply; and
5. The tax expense is lower since the interest is purchased using after-tax dollars and individual owners are generally in a lower tax bracket than the business.

With a redemption agreement, the *company* has the option, or obligation, to purchase a departing owner's interest. This form works best for businesses with many owners. Advantages include:

1. Simplicity, as only the company and departing owner are involved;
2. Less complex insurance structuring because fewer policies are required;
3. Increased financial security since the company is often better positioned to fund the buyout; and
4. Deductibility of interest paid on installment payments (usually).

Prohibition on Sale and Right of First Refusal

The agreement should prohibit the sale or transfer of a departing owner's interest to any third party without the written consent of the remaining owners. In addition, right of first refusal language should be included, giving the company and remaining owners the option to buy such interest.

Triggering Events

Various unexpected circumstances must be contemplated in a buy-sell agreement. These are commonly referred to as "triggering events" and should include the following with respect to any owner:

1. Death;
2. Disability;
3. Divorce or legal separation;
4. Dire financial circumstances, including bankruptcy or insolvency; and
5. Departure, whether voluntary (e.g., retirement) or involuntary (e.g., expulsion).

Owners should also consider including language that requires automatic conversion of the ownership interest into a nonvoting interest upon occurrence of a triggering event.

Purchase Rights and Obligations

For each type of triggering event, the buy-sell should specify whether the resulting right to purchase the departing owner's interest is optional or mandatory. Additionally, the

continued on page 12

BUY-SELL AGREEMENTS continued from page 11

agreement must indicate whether such buyout right is to be exercised by the company or the individual owners. More often than not, both have buyout rights and, in such case, the buy-sell needs to address the order of priority. For example, do the owners have the option to purchase the interest only after the company declines to redeem the interest? If the owners have the right to purchase, and all remaining owners wish to exercise such right, will each owner purchase the interest on a pro rata basis or otherwise?

Valuation – Methodology and Date

The buy-sell agreement needs to establish a specific methodology to value the interest of a departing shareholder, and the valuation approach may differ based on the type of triggering event that occurs. The agreement should also specify the valuation date for each type of triggering event.

There are various approaches to valuation. These include:

1. Independent appraisal, in which case the agreement should address required qualification of the appraiser;
2. Agreed-upon price;
3. Fixed price with provision for annual or other regular review;
4. Formula;
5. Asset-based approaches, such as book value, adjusted book value/net asset value, liquidation value;
6. Earnings-based methods such as capitalization of earnings, net cash flow or gross cash flow, discounted net cash flow or future earnings;
7. Market approach; and
8. Other approaches, including valuation of goodwill and other intangible assets, excess earnings or multiple of discretionary earnings.

Many buy-sell agreements provide that the departing owner's interest will be valued based on an agreed-upon price, yet it is hard to reach agreement on price or anything else upon an owner's unexpected departure. Moreover, when value is to be determined pursuant to "fixed price with adjustments upon regular review," the required review has often been neglected over time. In such circumstances, the buy-sell often includes independent appraisal as a contingency. In any case, business owners should consult with both their attorney and tax professional to determine the best approach for their situation.

Funding

The rights and obligations in a buy-sell agreement mean little when the purchasing party does not have funds for the buyout. Funding is therefore a critical element to address so as to ensure there is available means for payment.

Many buy-sells are fully or partially funded with "key person" insurance, which provides coverage to protect the company in case of an owner's unexpected death or disability. Another common form of funding is a seller-financed payment plan pursuant to a promissory note from the purchaser, whereby a portion of the purchase price is paid up front and the balance is payable over time. Payment terms commonly require regular payments of interest and principal over a one- to six-year term, and the purchased interest must be pledged as collateral by the purchaser. Including provisions for a structured payment plan provides a higher level of certainty that all potential buyers will be able pay for the buyout if a triggering event occurs.

The funding strategy should accomplish various objectives. Generally, these include creating liquidity, providing financial security for the departing owner and family, mitigating financial risk to the company and remaining owners and minimizing taxes.

Spousal Waiver

The buy-sell should require that the spouses of all owners execute a waiver of any and all rights to any ownership interest in the business in the event of a divorce, legal separation or otherwise. This is especially important in community property states like Nevada.

Conclusion

Once upon a time, there was a client with a successful business, a happy family, good health and money in the bank. All was well until one of his partners unexpectedly retired. Fortunately, this client was smart and had taken the time to implement a comprehensive buy-sell agreement. As a result, he and his partner exercised their option to buy out the retiring partner for a fair price pursuant to a reasonable payment structure. No court involvement was necessary, and the business continued to prosper. More importantly, the client maintained his marriage, happy family, good health and life savings. Thanks to the buy-sell agreement, he lived happily ever after. ■

---

1 The terms "buy-sell agreement" and "buy-sell" are used interchangeably throughout this article.

2 For purposes of this article, the term "partner" is used to refer to any co-owner of a business, whether a shareholder in a C corporation or S corporation, a member in a limited liability company or a partner in a partnership.

NICOLE VANCE is an attorney with her own practice, the Law Offices of Nicole M. Vance. She works with individuals, families and entities, advising her clients on estate and business planning matters, including advanced wealth transfer strategies, general estate and trust issues, business formation and choice of entity, business succession planning, charitable giving and asset protection planning. She can be reached at nvance@nmvlaw.com.