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Buy-Sell Agreements: The Legal Protection You Need Beforehand

Planning ahead of time is the key to avoiding costly legal fees and loss of bargaining advantage. Dealing with various contingencies before they arise will protect the parties entering into a business partnership. Regardless of the harmonious relationship with business partners, the Buy-Sell Agreement will help to define terms before any potential issues arise. This Agreement is a binding contract between business partners or shareholders regarding the future ownership of the business.

Why is a Buy-Sell Agreement Necessary?

Whenever there are two or more owners of a business, there are events that may require one owner to sell his ownership interest. When one person goes bankrupt and is forced to liquidate or becomes incapacitated or dies, the question arises of how to sell this business partner's interest and how the interest is valued. The agreement ensures continuity of ownership in the business and fair treatment for both the buyer and the seller. These issues are easier to address when everyone is getting along in the business formation stage, rather than at a time when the partners have opposing interests. The solution is a carefully worded contract, typically called a Buy-Sell Agreement.

What does a Buy-Sell Agreement Contain?

A Buy-Sell Agreement should be carefully drafted, as it is the precedent for what may come. When a Buy-Sell Agreement encompasses the parties' negotiated consensus, all parties are protected. The sections below provide some factors to consider when consulting a legal professional regarding a Buy-Sell Agreement.

What events will trigger a buyout?

The Agreement instructs the parties as to which events trigger a buy out of a partner's interest. The common events are:

- An attractive offer from an outsider to purchase a partner's interest in the company,
- A divorce settlement in which a partner's ex-spouse is entitled to receive an ownership interst in the company,
- The foreclosure of debt secured by an ownership interest,
- The personal bankruptcy of a partner, or
- The disability, death, or incapacity of a partner.

Who can buy a departing partner's or shareholder's share of the business (this may include outsiders or be limited to other partners/shareholders)?

- <u>Cross-Purchase Agreement</u>: In this type of Agreement, a withdrawing owner agrees to sell his interest to the remaining owners. This type of agreement works well in a closely-held small business.
- <u>Entity-Purchase Agreement</u>: In this type of Agreement, the withdrawing owner agrees to sell his interest to the entity. The entity then dissolves the ownership interest or redistributes it among the remaining owners.

- Hybrid Agreement: This Agreement is a combination of the first two. The withdrawing owner must first offer his ownership interest to the entity. If the entity declines or is unable to make the purchase, then the shares must be offered to the other owners.

What price will be paid for a partner's or shareholder's interest in the partnership?

There are a number of different methods of valuing a business interest. Most individuals have a difficult time agreeing on a set method. If this method is not set beforehand, each party may favor the formula that saves or earns the most money for their respective interests. This is why the formula for determining a price is one of the vital parts of a Buy-Sell Agreement and should be carefully negotiated. Once the parties have agreed to the formula, it is highly unlikely that it can be successfully challenged in the future. Some common examples of valuing business interests include the following:

- Book Value: This is an allocated amount as recorded in the entity's accounting records. Therefore, it is not a value that is appraised, but an amount equal to the various owners' equities as calculated by the recorded assets minus the recorded liabilities. It is typically lower than fair market value (defined below) because it does not account for a successful business's most valuable asset, its goodwill. Goodwill reflects what a market participant would be willing to pay in addition to the business's tangible assets because the entity has the ability to make a higher profit than what is shown in the accounting records.
- Fair Market Value: This value is determined by an appraisal of the entity based on the recorded assets and its goodwill. More generally, fair market value is described as what an unrelated willing buyer would pay to a willing seller. This takes into account any appreciation in the value of the entity's recorded assets and allows the seller to have a market check of the value by adding goodwill. The problem with using Fair Market Value as a valuation method, however, is the expense and time involved in appraising the value. Although this method may bring more of a fair calculation, there are still different methods of appraisal. There may be a need for mediation or arbitration to finalize any disputes in appraisal.
- Formula Approach: A formula may be used to determine the value of the business interest. This can be at a fixed, agreed upon formula, such as book value, plus a certain percentage (e.g. 6 percent). Or it can be a capitalization of earnings at a fixed percent. This formula takes the average the entity's annual net earnings for the most recent years (e.g. the past four years) and divides this number by the fixed percentage. This amount is the presumed fair market value for all the entity's assets, including goodwill. This fair market value is then subtracted by the entity's liabilites. There are a number of different formulas that can be used to value a business, and each of these formulas may have several viable variations based on the inputs of the business owners.

How do you fund the purchase paid for an interest in the partnership?

When cash is not available to fund a sale under a Buy-Sell Agreement, insurance may be used instead. There may be a **cross-purchase agreement**, where each owner takes out life insurance policies on the others' lives. Once the life insurance policy pays, the surving owner(s) will use the proceeds to pay the deceased owner's estate for his ownership interest. There may also be an **entity-purchase agreement**, where the entity itself takes out life insurance on the lives of its owners and the entity is named as the beneficiary of the policy. The entity can then buy back the decedent's ownership interest. Similarly, if a permanent disability is an event that triggers a buyout, the partners can take out disability insurance on each other.

A Price Too Big to Pay

Although this article serves as an introduction to Buy-Sell Agreements, it is important to understand what might happen if business partners do not have an Agreement in place. There may be lengthy and expensive court battles and serious interruptions in your business if one of your partners sells his shares, quits, gets divorced or becomes incapacitated. The business may be dissolved, or an outsider who is inexperienced or untrustworthy may share control of your business. With all of the difficulties you may encounter, ask yourself whether you are willing to take such a risk in your personal life and business.

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