Alan Crone

An Executive Summary of BUY/SELL AGREEMENTS

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Founder of the firm, Alan is the Team Leader. Whether he's helping achieve a business dream or seeking compensation for someone who's been treated unfairly, he draws from a deep well of compassion and experience. He's a master at devising winning strategies and innovative tactics.

Sometimes the only thing to do is file a lawsuit and fight it out in court. And other times it's better to negotiate a settlement. Either way, Alan knows how to get the best outcome.

A fifth generation Memphian, he is a voracious reader, semi-avid golfer. The art of political negotiation has always fascinated him. He has been active in local and state politics for more than 22 years. He is former head of the Shelby County Republican Party and currently serves as Special Counsel to the Mayor of Memphis.

WHAT IS A BUY/SELL AGREEMENT?- "Every business needs to have an exit strategy in place in the event an owner leaves the business. When no plan is in place, the departure of a key figure can lead to uncertainty and political infighting – or even litigation – between owners. A buy/sell agreement stabilizes what might otherwise be a turbulent transition by allowing the remaining owners to maintain managerial control, while also facilitating liquidity of ownership interests. But to provide these benefits, the agreement needs to be in place in advance, during the life of the business. "

ALL businesses need advance planning on what to do when equity holders have irreconcilable differences

WHY DO I NEED A WELL-DRAFTED BUY/SELL AGREEMENT?-

"Well-drafted buy/sell agreement sets forth a roadmap to follow in the event an owner dies, becomes disabled and unable to work, is divorced, or elects to leave the business – whether due to retirement or conflict with other owners. Depending upon the needs and nature of the business, the agreement defines who is permitted or required to purchase a departing owner's interest, how that interest will be valued, and which occurrences trigger the buy-out."

WHAT PROTECTIONS DO I HAVE WITH A BUY/SELL AGREEMENT? - "Death and divorce in particular can seriously destabilize the management structure of an unprepared business. When an owner dies, his or her heirs inherit the deceased owner's shares or other ownership interest in the business. Similarly, a divorce decree may transfer some or all shares to an ex-spouse, who might have hard feelings toward the business or not care about it at all. A buy/sell agreement can prevent heirs or former spouses from taking managerial control by stipulating that, upon either event, the owner's interest must be purchased by other owners or the business itself. "

WHAT TRIGGERS A BUY/SELL AGREEMENT? - "Buy/sell agreement is triggered and requires a buy-out of the departing partner's interest, the next complication is reaching a consensus as to a fair purchase price. Fortunately, a professionally drafted buy/sell agreement can resolve that question as well by defining an agreed method for equitable appraisal of ownership interests, thereby avoiding potentially costly litigation. Depending upon the nature and complexity of the business, the agreement can either adopt an appraisal formula based upon revenue and assets or require hiring of a business valuation expert. Either way, it's always preferable to agree on a fair system in advance rather than arguing over share value while emotions are running high or, even worse, fighting about it in court."

PROTECTING YOUR BUSINESS WITH A BUY/SELL AGREEMENT

Nearly every business owned by more than one person will eventually have to deal with the departure of an owner. The turbulence created by the loss can lead to a host of problems for the business: decreased revenue, managerial instability, strategic uncertainty – not to mention the strain placed on the remaining owners in attempting to continue business operations while simultaneously dealing with the transition.

These problems, though, are not unavoidable. Careful exit strategy and succession planning, including a well-drafted buy/sell agreement, can immensely mitigate the risks and uncertainty caused by an owner's departure. In general, buy/sell agreements (also referred to as "buyout agreements," "business prenups," or "business wills") set forth in advance what will happen to an owner's interest in a business when the owner departs. The agreement controls when an interest in the business can be sold, to whom it can be sold, who can or must purchase the departing owner's stake, and how the value of the exiting partner's interest is determined. By defining these matters in advance, a buy/sell agreement decreases the chance of conflict when an owner leaves and promotes the long-term stability of the business.

To reap the benefits of a buy/sell agreement, a business must execute the agreement early on, during the life of the business, and not wait until a partner's departure appears imminent. The death of an owner can come at any time, so a co-owned business operating without a buy/sell in place is unnecessarily carrying substantial risks to its long-term stability. A buy/sell is particularly important for closely-held and family-owned businesses because the agreement can delineate a succession process and ensure that ownership interests remain with owners approved by the remaining partners.

A solid buy/sell agreement will address four key factors: triggering events, purchase requirements, valuation, and funding. This article will examine each in greater detail below, but, in general, "triggering events" are the specific occurrences (e.g., death, disability, termination, retirement) which activate the buy/sell terms. The agreement should enumerate each triggering event and may set forth specific restrictions and requirements relating to each named event.

Purchase requirements are the terms of the agreement relating to who can or must buy the ownership interest upon the occurrence of a triggering event. In general, a buy/sell agreement can be mandatory or optional – meaning the designated purchaser is either required to purchase the exiting owner's stake or has a right of first refusal. Agreements which wholly restrict alienation rights without providing for a purchaser are typically disfavored under state law. Thus, a buy/sell that completely prohibits sales to third-parties but does not require purchase by the business entity or other partners may be difficult to enforce.

"Valuation" refers to the method used to determine the value of the exiting partner's interest and, as a result, the sale price. Valuation methods range from simply stating an agreed value in the buy/sell to agreeing to hire a third-party valuation expert upon the occurrence of a triggering event. Finally, "funding" is the means by which the sale price will be paid – whether through life insurance proceeds, cash, a promissory note, or some combination thereof.

Typically, a buy/sell will be a stand-alone contract entered into by the partners and the business entity after consultation with legal counsel and/or tax professionals. However, buy/sell terms can also be incorporated within a business's bylaws, operating agreement, or partnership agreement. To provide the desired protections, the agreement should be individually tailored to the unique character of the specific business and the purposes it is trying to accomplish. A buy/sell thrown together with little contemplation, or which is simply copied from forms found online, can often cause more problems than it solves.

What are the Purposes of a Buy/Sell Agreement?

The essential purpose of a buy/sell agreement is to maintain consistent managerial control by restricting the sale or transfer of ownership interests when a partner leaves or an event occurs, such as bankruptcy or divorce, which could cause transfer of a partner's interests by operation of law. An owner is usually only permitted to sell or transfer his or her interest to the remaining partners, the business entity itself, or to a purchaser approved by management and/or the remaining partners. Thus, the owners are protected from a situation in which an outsider acquires a say in the management of the business.

Similarly, a buy/sell can be structured to ensure that ownership percentages remain stable among partners. For example, in the event of a partner's death, the other partners may have the right to purchase the departed partner's shares in proportion with the existing ownership interests. Or, the business can purchase the shares and then allocate the repurchased shares to remaining partners proportionally. As a result, remaining owners retain their existing ownership percentages, and a majority owner can keep managerial control.

Perhaps just as important as ensuring continuity in managerial control, a buy/sell also helps a business continue running smoothly through tumultuous times by minimizing conflict and allowing the remaining partners to focus on continuing business operations. Because a succession plan and potential conflict-causing issues have been addressed ahead of time, the business is less likely to get bogged down with arguments and litigation. And, in the event that conflicts do arise, a buy/sell agreement can provide for speedy, cost-effective dispute resolution procedures, such as mandatory arbitration. Buy/Sell agreements can also address internal conflicts between partners by establishing a mandatory buy-out process if irreconcilable disputes arise.

For departing owners and their surviving spouses and children, buy/sell agreements help to ensure fair compensation when an interest is sold. By guarantying a ready buyer and a fair price, the agreement allows, for example, the surviving spouse of a deceased partner to liquidate an asset which, though valuable on paper, may otherwise be unmarketable. Along the same lines, partners can better plan for retirement with a reasonably good estimate of the return they will receive for their shares in the business, and disabled partners are afforded a ready source of funds for their support.

Buy/Sell agreements can also protect a business's goodwill and know-how by including non-competition and non-solicitation provisions, which become effective upon a partner's exit. A non-competition clause prohibits an exiting partner from competing with the business or using its trade secrets for a pre-determined term, and a non-solicitation provision prevents the partner from taking the business's employees with him or her when departing. The purchase of shares pursuant to a buy/sell can serve as consideration for both non-compete and non-solicitation terms, thereby promoting the enforceability of either or both.

Buy/Sell agreements can also be set up to protect a business entity's tax status or, in certain circumstances, to reduce estate tax liabilities upon the death of a partner. The agreement can void any transfer that would alter the tax status of a partnership, or which would cause an S Corp to be taxed as a C Corp. Similarly, if the business is a professional corporation, the buy/sell can void any transfer which would cause it to lose its professional designation under state law.

Triggering Events

One of the most important decisions in crafting a buy/sell agreement is deciding which events will trigger the agreement. Some - like death, disability, and retirement - are obvious, and are included in nearly every buy/sell. Others – like divorce, bankruptcy, and termination – are not as obvious but can be just as critical. Which triggering events are included, and what happens upon each event, will depend upon the nature of the business and the strategy it wishes to adopt for dealing with an exiting owner.

The death of a partner can be especially disruptive to a business because it is so often unexpected. Absent a buy/sell, the deceased partner's interest will descend to his or her surviving spouse or other heirs. Sometimes, this does not present too much of a managerial problem, as when a spouse or children have been actively involved in the business and have been groomed to replace the departed partner. Often, though, a spouse or heirs have had nothing to do with the business and do not desire to get involved. In the latter scenario, a buy/sell serves two vital functions: it protects the surviving partners by preventing disinterested heirs from exercising managerial control, and it protects the heirs by guarantying they will receive fair compensation for their inherited business interest.

Businesses in community property states should consider requiring the business to purchase the community property share owned by a partner's spouse in the event that the spouse passes away with heirs other than the surviving spouse. A provision along these lines prevents a scenario in which, for example, a partner's step-children inherit a stake in the business derived from the community property rights of a partner's deceased spouse.

If, as is usually the case, "disability" is included as a triggering event, the agreement should set forth a precise definition as to what constitutes a disability. Generally, a buy/sell will provide that an owner is "disabled" when, for a medical or health reason, he or she is no longer capable of participating in the business and will not be capable of resuming participation in the foreseeable future. As with most triggering events, in the event of a partner's disability, a buy/sell protects both the disabled partner and the remaining partners. If a disabled partner is no longer capable of participating in the business, it may be unfair to the other partners to allow him or her to continue sharing in the profits. At the same time, a mandatory buy-out ensures that the disabled partner receives compensation, thereby serving as a sort of informal disability policy to help support a partner who is no longer able to work.

"Divorce" is often included as a triggering event, though not necessarily to require a partner to sell if he or she becomes divorced. For family-owned businesses, a mandatory sale upon divorce can serve to keep ownership within the family. But, for any business looking to restrict managerial control, a buy/sell will address interests which might be transferred to a former spouse through a property settlement and/or divorce decree. Ideally, the spouses of partners will sign the buy/sell and agree that, in the event they receive any interest in the business through a divorce, they will immediately sell the interest back to the business. This can be of the utmost importance to professional corporations if state law requires anyone holding an ownership interest to be licensed in the particular profession.

In the case of bankruptcy, a buy/sell can require a member to sell his or her interest back to the business entity or other partners prior to a bankruptcy filing so as to prevent business assets from attachment by a bankruptcy trustee. Typically, the agreement will require the partner to give the other partners notice of an anticipated bankruptcy prior to filing, and the notice essentially serves as an offer to sell. The cash or other consideration provided then becomes an asset of the bankruptcy estate which the trustee can use for distributions to creditors. This prevents a situation in which a trustee liquidates the business or its assets to get at the bankrupt owner's share.

When owners are also employees of the business entity, a buy/sell agreement should also provide a plan in case an owner decides to resign or the business is forced to terminate his or her employment. In either scenario, the remaining owners will probably not wish to continue sharing business profits with an owner who is no longer contributing. Frequently, buy/sell agreements will discourage early resignations by stipulating a discounted share valuation in the event an employee-owner resigns or is terminated prior to a specified date.

Preferably, when a partner leaves the business, it will be due to retirement. Provisions for buy-out at retirement benefit the business by facilitating a smooth succession. The transfer of the retiree's stake, and accompanying managerial interest, will be planned out ahead of time, avoiding confusion and internal power struggles. The retiring partner is better able to plan for retirement by having a good approximation of the compensation he or she will receive and the schedule upon which it will be received.

Depending upon the complexity of the business, it may be beneficial to include a provision in a buy/sell requiring the business to hire a trustee or lawyer whenever any triggering event (or a specific triggering event) occurs. Implementing the buy-out could end up being a complex transaction. By hiring a trustee, the other business owners can continue focusing on business operations, and both sides can be confident the transaction will be handled neutrally.

Purchase Requirements

If an exiting owner is required to sell, then there must also be someone to purchase the stake. A buy/sell agreement will designate the remaining partners ("cross-purchase agreement"), the business entity itself ("redemption agreement"), or a combination of the two ("hybrid agreement"). The purchase obligation is frequently mandatory, but agreements providing a right of first refusal are not uncommon, and some buy/sells will permit sale to a third-party as long as the purchaser is first approved by the other partners.

Cross-purchase agreements work well when only a few partners are involved. The agreement should define which remaining partners have the right or obligation to purchase and in what amounts so as to prevent internal power struggles. Commonly, buy/sells will allow partners to purchase an exiting partner's stake according to their proportional ownership interests so that existing voting interests remain consistent. Or, the agreement can establish an order of priority with descending rights of first refusal. For a sole proprietorship, the agreement can provide a purchase option to a key employee or chosen successor.

A redemption agreement can simplify things if numerous partners are involved. A common approach is that the business entity will purchase the exiting partner's shares and then divide them proportionally among the remaining partners or use the shares to bring in a chosen replacement partner. The structure of the agreement can affect remaining partners' tax bases and the tax treatment of payments, so it is often a good idea to consult a tax professional when creating and implementing a buy/sell agreement.

A "hybrid agreement" typically gives the business entity an option to purchase an exiting partner's interest, with the option assignable to the remaining partners. Under the "wait and see" approach, the buy/sell provides that the circumstances – such as the specific triggering event and the company's financial situation at the time - will dictate whether the purchaser is the partners or the entity.

Valuation

Valuation is, practically speaking, the method of determining the price to be paid for an exiting partner's stake. It is vital to have a method agreed in advance, as arguments over valuation are one of the largest sources of litigation involving buy/sell agreements. When a triggering event occurs, the departing owner will obviously argue for a higher price, and the remaining partners will want a lower price. However, if a method is determined in advance, all partners are more likely to think objectively when they are uncertain whether they will be buyers or sellers. Moreover, a predetermined valuation method avoids the awkward situation of bargaining with a deceased partner's grieving spouse or children.

There are three basic valuation methods frequently used in buy/sell agreements. The simplest is to stipulate to an agreed value. While this approach can simplify the transaction, it is generally disfavored because business values can change dramatically over time. A modification on this approach uses an agreed value but updates the number annually. The weakness here is that it is difficult to get partners to agree (a partner expecting to depart will argue for a higher number), and the partners may not be able to objectively judge the true value of their business.

A second approach is to adopt a valuation formula based upon the business's revenue and assets. The formula is determined up front and built into the buy/sell agreement. This approach can save money and conflict, though it is difficult to develop a formula that accurately values certain types of businesses, especially if intangible property such as goodwill, reputation, or intellectual property, make up a substantial portion of the business's assets.

For larger and more complex business, the best approach is usually to hire a valuation expert upon the occurrence of a triggering event. The valuation expert will review the company's financial records, appraise all assets including intangible assets, and determine a fair market value as of the time of the triggering event. The potential problems with the valuation expert approach are that it can be expensive and that there is a potential for conflict if the business and the exiting partner each hire experts who arrive at different figures. In the event of an irresolvable conflict over valuation, a buy/sell agreement can provide for mandatory arbitration to resolve the dispute without litigation.

A buy/sell can also stipulate that differing valuation methods will be used depending upon the triggering event that occurs. For example, an agreement might provide that, upon a partner's retirement, the business will hire a valuation expert and value the retired partner's stake proportionally according to the partner's percentage ownership compared to the total fair market value. On the other hand, if a partner voluntarily resigns early or is terminated, the agreement might use a formula that does not necessarily result in as high of a value, and the valuation might be discounted based upon factors such as minority ownership status.

Whichever valuation method is chosen, it should be selected in advance, while all parties can view the agreement objectively. Even a method that does not capture the absolute fair market value with precision will be preferable to drawn-out litigation that distracts the business from its regular operations and costs all parties involved a fortune in litigation costs.

Funding

To implement a buy/sell agreement successfully, the business or partners must have sufficient assets or credit available to fund the buy-out. Once again, the optimal approach will depend upon the business's character and situation, but, generally, buy/sell agreement transactions are funded in three basic ways (or a combination thereof): insurance, cash, and installments. In order to ensure a smooth transition and fair compensation, it is almost always best to have the funding mechanism designated in advance in the agreement itself.

A life insurance policy can guaranty that sufficient funds are available for a buy-out in the event of a partner's death. Depending upon how the buy/sell is structured, either the business will take out policies on each partner or the partners will take out policies on one another. Then, when the time comes, the policy proceeds are used to purchase the deceased's interest from the estate. The insurance approach offers the advantages of ensuring sufficient funds and not burdening the business with a large, unexpected cash outlay. For the survivors, this approach provides up-front cash to handle estate expenses and provides money for the support of widowed spouses.

The primary downside to life insurance is that it does not address all triggering events. However, if a policy with a cash value is selected, the cash surrender value can be used to defray some of the buy-out costs in the event of a different triggering event. A cash-value policy will be more expensive to the business, so whether a cheaper term life policy is a better choice will depend upon the business's specific situation.

For businesses with high liquidity or cash reserves, a cash buy-out is also an option. Alternatively, the business can take out a loan to finance the purchase. Cash payments can be difficult if the business does not hold a large amount of liquid assets, and it is impossible to predict with certainty a business's precise cash situation when a buy/sell is triggered. With a loan, the business may find credit more difficult to come by after it has just lost a key partner, and the interest on the loan will add to the total cost of the transaction.

An installment agreement allows the business to purchase an exiting owner's stake in payments typically spread out over three to five years. If a promissory note is used, the buy/sell agreement should set forth the specific terms of the note, including whether it will accrue interest and whether any security will be provided. From a seller's perspective, the disadvantages of an installment payment are that it creates risk until the note is paid and, particularly for an estate, there is no large up-front cash payment to defray estate administration expenses. For the business, a substantial long-term obligation could negatively affect the business's credit rating.

A common approach designed to alleviate some of the downsides of installments is to have the business make an initial down payment (usually between 25 – 33%) and then pay the remainder over several years. This mitigates the hit to the business's cash flow while helping to ensure sufficient funds are available for estate expenses or to begin funding a partner's retirement.

A final approach worth considering is what is known as a "sinking fund." With a sinking fund, the business sets aside cash periodically over several years in order to eventually fund the buy-out. This approach can work will with a reasonably predictable triggering event, such as a planned retirement, but is often inadequate if the triggering event is an untimely death, disability, or voluntary or involuntary separation.

Structuring the Sale

The tax treatment of a buy-out presents an additional factor which should be considered when implementing a buy/sell agreement. Needless to say, tax law is immensely complex, so the optimal approach will depend upon the business's and selling partner's specific circumstances. Ideally, a tax professional should be consulted at the time the buy/sell is created and at the time the buy-out is consummated.

Generally speaking, a buy-out can be structured in a manner that avoids or reduces estate taxes by establishing the value of a deceased owner's interest for purposes of estate tax calculations. Importantly, to constitute a valid estimate, the valuation must comply with IRS regulations and guidelines, and, for family-owned businesses, Treasury Regulations set forth special rules designed to prevent the use of dishonest buy/sell agreements as a means of avoiding estate and gift taxes.

Depending upon the complexity of the business, a buy/sell agreement can be fairly straight-forward, or it can be a complicated legal contract requiring the input of more than one professional. Particularly for complex entities, the up-front cost of preparing the agreement will likely be higher than with simple contracts. However, the long-term benefits of having a professionally-drafted buy/sell agreement in place can more than make up for the short-term costs. By minimizing conflict and litigation, ensuring consistent managerial control and smooth succession, and providing partners with the peace of mind that comes with knowing they or their families will receive fair compensation when the time comes to sell, buy/sell agreements go far in safeguarding the long-term stability and vitality of a healthy business.