Key Issues for Buy-Sell Agreements for Closely Held Businesses

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Buy-Sell Agreements – The Basics

"The future's hard to predict. It hasn't happened yet." Yogi Berra

- A buy-sell agreement may be one of the most important documents signed by the owners of any small business, to help ensure succession and continuity.
- A buy-sell agreement is often triggered during circumstances which are most stressful to the operation of the business and the cohesion of its owners.
- A well drafted buy-sell agreement should help steer a business through and clear of major or business-ending disputes and deadlocks.

Buy-Sell Agreements – The Basics

- A big benefit of a buy-sell agreement is that it forces the owners of the closely held business to think and plan ahead, for good times and bad.
- A buy-sell agreement is likely an important component of the owners' estate plans.
- One size does not fit all – significant effort and thought should be put into the buy-sell agreement upon its creation, avoiding the simple use of a "boilerplate" agreement form without any due diligence or planning.

Buy-Sell Agreements – The Basics

- The buy-sell agreement should be re-visited periodically.
- Once a triggering event occurs, the owners' interests very often diverge, sometimes immediately, which makes the pre-planned terms of the buy-sell agreement that much more important.
- Ignoring the importance of future planning because it may be difficult is a very bad choice.

"You've got to be very careful if you don't know where you're going, because you might end up there." Yogi Berra

Buy-Sell Agreements – The Basics

A well drafted buy-sell agreement can protect against:

- Risk of a divorcing owner’s spouse gaining interest in the business
- Risk of other owners combining their interests to the detriment of minority owners
- Risk of another owner with greater resources buying additional control
- Risk arising from the bankruptcy of an owner

Buy-Sell Agreements – The Basics

- Disagreement among owners as to whether to accept a purchase offer from a third party
- Termination of an employee-owner's employment
- Failure to make distributions
- Application of minority or lack of marketability discounts to any redemption or cross-purchase of interests

Key Issues in Creating a Buy-Sell Agreement

"When you come to a fork in the road … take it." Yogi Berra

Buyout Triggers

What are the triggers?

- Retirement
- Disability
- Death
- Divorce
- Involuntary withdrawal: Termination of employment; breach of separate shareholder or employee obligations to the business entity

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

- Voluntary withdrawal
- Sale to a third party
- Bankruptcy or insolvency of an owner

Does the type of business require the ownership interest to continue to be held and controlled by the current ownership group? (e.g. business that owns an apartment complex versus a computer programing services business)

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

What do the triggers actually trigger?

- Remaining owners' or business entity's option to cross-purchase or redeem the selling owner's interest
- Selling owner's option to force the business entity and/or remaining owners to buy out his/her interest
- Mutual obligation for the selling owner to sell to the business entity or remaining owners

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

What do the triggers actually trigger? (cont.)

- Proper trigger events should appease both the potential selling owner, by ensuring that his/her interest will be purchased upon any of the agreed upon trigger events, and the buying owners, by ensuring that they are not forced to buy a selling owner's interest which they cannot afford or do not want.

"We're lost, but we're making good time." Yogi Berra

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- The proper buyer must be one who will fit in with the ownership group and can continue to successfully operate the business.
- A selling owner's interests are often paid for in future installments, funded principally from the continuing operations of the business, therefore, making the decision as to the proper buyer (future operator of the business) being that more important.

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- Does a family member work in the business?
- Is a family member interested in becoming a part of the business?
- Does the size and value of the business require that the ownership interest be spread amongst numerous siblings/family members? Some of whom may not be involved in the business?

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- Is it appropriate to consider providing both non-voting interests and voting interests to such siblings/family members?
- Is there any risk of a majority of the owners combining their interests after a triggered sale to oppress or bully a minority owner or owners?
- Should each of the remaining owners have an equal right to increase their ownership interest? Is there a risk that one of the remaining owners may have disproportionately greater resources than the other remaining owner(s)?

Key Issues in Creating a Buy-Sell Agreement

"A nickel ain't worth a dime anymore." Yogi Berra

Choose the Proper Mechanism to Set the Purchase Price

- Owners mutually agree on the purchase price each year
  - Strengths: Can more accurately reflect the value of the business year-to-year.
  - Weaknesses: Owners may forget to set the mutually agreed price; circumstances may change to the point that the owners' interests diverge substantially, with some part of ownership pushing for a significantly higher purchase price and the other remaining interest holders pushing for a significantly lower purchase price.

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Appraised value

– Strengths: More accurately reflects the value of the business year-to-year; does not require the owners to agree on the actual price year-to-year; the purchase price should be determined by an appraiser who is knowledgeable in the valuation process.

– Weaknesses: Can lead to litigation if guidance provided to the appraiser in making the valuation is not detailed enough; will still require the owners to either agree upon a single appraiser or go through a more cumbersome and expensive process of choosing multiple appraisers; fertile ground for litigation if the issues of minority interest discounts and lack of marketability discounts are not properly addressed.

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Accountant's calculation of the purchase price based upon an agreed upon calculation
  - Strengths: Calculation formula can be narrowly tailored for the uniqueness of each business entity and to more accurately reflect FMV year to year; typically a cheaper and quicker option, especially if the accountant is agreed upon in the buy-sell agreement
  - Weaknesses: Corporate accountant may be considered as more favorable to one ownership group over another; corporate accountant may be unwilling to make such calculation due to relationships with each owner

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Fixed price
  - Since these types of agreements are not always updated, they can be ticking time bombs.

The purchase price calculations are most often tailored as to "favored" (e.g. retirement, death and disability) and "disfavored" sales (e.g. voluntary withdrawals, bankruptcy, sales to third parties, and breaches of other agreements with the business entity).

Key Issues in Creating a Buy-Sell Agreement

Terms Determining Value

- Fair market value
- Fair value
- Formula pricing
- Book value

Key Issues in Creating a Buy-Sell Agreement

Include Appropriate Purchase Terms

- Notice periods for the parties' exercise of their various rights under the buy-sell agreement
- Time period between exercise of option to purchase and closing
- Amounts due at and after closing – down payment, installments, interest, etc.
- Security/collateral for any installment payments/personal guaranties
- Terms of promissory note/loan

Key Issues in Creating a Buy-Sell Agreement

Include Appropriate Purchase Terms

- Acceleration of payments due upon events such as the sale or merger of the business
- Voting rights/dividends/capital calls during installment payment
- Clarification of the equity ownership position of the buyers and sellers during any installment payment period
- Events of default on buyer's non-payment and remedies therefor

Key Issues in Creating a Buy-Sell Agreement

Funding the Purchase

- Life insurance
- Installment sale
- Borrowing/loans
- Personal resources

Key Issues in Creating a Buy-Sell Agreement

Miscellaneous Terms

- Covenant not to compete
- Non solicitation provisions
- Terms regarding permitted and/or prohibited transfers of interests to third parties
- Non-selling owners' right of first refusal to purchase
- Guaranteed employment terms
- Election of Directors and Officers

Factual Issues Which Affect the Drafting of Buy-Sell Agreements

"It's like déjà vu all over again." Yogi Berra

- Number of owners today and as expected in the future
- Family-owned?
- Type of business involved – Does it require special terms (e.g. professional licensing issues)?
- Age, status and insurability of each owner
- Relative percentages owned by each owner

Factual Issues Which Affect the Drafting of Buy-Sell Agreements

- What level of restrictions do the owners want to put on the transfer of interests? First right or refusal?
- Which trigger events are "penalized" for not being favored?
- Are there separate agreements or organizational documents with which the buy-sell agreement must be aligned?
- Do the parties prefer dispute resolution by litigation, mediation or arbitration?

Potential Tax Pitfalls

- IRC Section 302: If less than 100% of a shareholder's interest is sold by redemption, and the complete termination or substantially disproportionate requirements are not met, the distribution to the selling shareholder will be deemed a dividend.

- If purchase price is greater or less than FMV, the selling owner or purchasing owner(s), respectively, may be deemed to have received a gift or compensation.

- Insurance proceeds could trigger business entity's AMT

Conclusion

A Buy-Sell Agreement is an excellent tool to help business owners plan for today and tomorrow, and to help avoid costly and time-consuming disputes which can cripple and devastate an on-going business.

“Love is the most important thing in the world, but baseball is pretty good, too.” Yogi Berra

“It ain’t over till it’s over.” Yogi Berra

“I really didn’t say everything I said.” Yogi Berra