

Client newsletter



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Buy-Sell Agreements: Problem Solving before there's a Problem

If you own a business, or part of one, no one has to tell you what a struggle it was to get it started and how much work it takes to keep it going. Given the amount of time, money and energy small business owners invest into starting or growing their businesses, it is therefore important to plan for the various contingencies that can arise among co-owners of a closely held business. The death, retirement, disability, or even divorce of a business co-owner may all have significant impacts on the continuing, smooth, and profitable operation of a business.

Having a well crafted Buy-Sell Agreement can solve a number of potential problems and can help to achieve a balance between the needs of those continuing the business and the needs of the departing business co-owner. More importantly, having a Buy-Sell Agreement can help to avoid what could otherwise turn into a costly and heated dispute regarding the operation and control of the business or the price at which the business interest should be bought or sold. Some of the major reasons for having a Buy-Sell Agreement include: (1) to establish certainty in the continuity of ownership of the business; (2) to provide a market for the otherwise illiquid closely held

ownership interest; (3) to establish a funding source and mechanism for the purchase of the ownership interest; (4) to establish certainty as to the value of the ownership interest for estate tax purposes; and (5) to provide restrictions regarding current ownership interest and operational matters, including, among other things, voting control, protection of an S corporation's status, and payment of dividends.

Although Buy-Sell Agreements are typically stand alone agreements, "buy-sell" provisions can also be included in a corporation's articles of incorporation and by-laws, the partnership agreement, the limited liability company's operating agreement, or even employment agreements. Regardless of whether a Buy-Sell Agreement is stand alone or included as part of another agreement, there are certain key issues that every Buy-Sell Agreement should address. While not exhaustive, some of these issues include:

First, it is important to clearly define what events may trigger the provisions of a Buy-Sell Agreement and to specify whether these "triggering events" will cause a mandatory or optional buyout by the

company or remaining owners. By far the most common triggering event is the death of a shareholder, member or partner (an "owner"). Including death as a triggering event may allow the company to retain the investors it chooses by redeeming the owner's interest itself or allowing the remaining owners to purchase the deceased owner's interest. It is also beneficial to the selling owner because it provides for the liquidity of the owner's interest for his or her estate, which may not otherwise exist in a closely held business. If it is important to restrict the sale of an owner's interest in the company to outsiders, then a provision granting the "right of first refusal" or requiring the consent of all owners before recognizing new owners should be included to protect against a voluntary transfer to a third party. Where an owner is employed by the company, it is also important to include a provision to address what happens when the owner is unable to continue to perform his or her duties as an employee of the company. Other common triggering events, include, bankruptcy or insolvency, termination of employment and/or divorce of an owner.

Next, and equally as important, is the method used to determine the

purchase price of the shares subject to the Buy-Sell Agreement. The easiest method of establishing the purchase price is to have the parties agree on the value of their interest in a closely held business. This can be done by assigning each party's interest a specific price and providing for a periodic recalculation of the interest. While this approach certainly allows the parties to know up front the value of their interest in the business, problems may arise if the parties fail to periodically recalculate their interest or cannot agree upon a new price. If a business is one in which the assets may be accurately and reliably appraised, obtaining an "appraisal" of the interest at the time of purchase would more accurately reflect the value of the owner's interest in the business. A Buy-Sell Agreement that employs this method should also explain the procedure to be used to establish the purchase price, the name of a competent appraiser, and should detail the formula utilized to determine the amount of the appraiser's compensation. Another way to value an owner's interest in a business is to

use the "book value", computed on the valuation date. When used, it is important to carefully review and consider the accounting methods used by the company and to explicitly define book value and the method of accounting that will be applied to determine the book value.

Another issue that should be considered is whether the Buy-Sell Agreement should contain provisions to protect the trade secrets, confidential and proprietary information, and customer and client relationships of the company. Specifically, the Buy-Sell Agreement should require that all owners hold such information in confidence, protect it from disclosure and abstain from using it for personal gain. Where an owner's interest is redeemed by the company, it may be important to include a provision which that prevents the selling owner from competing with the company.

Although the above key issues should be addressed in every Buy-Sell Agreement, the specific provisions contained in a Buy-Sell Agreement

will depend in large measure on the factual circumstances of each business and the needs of its co-owners. Other issues that should be considered include, among other things, whether the Buy-Sell Agreement should (i) be structured as a redemption agreement or as a cross-purchase agreement; (ii) contain a buyout provision funded by life insurance and if so, what type of policy should be obtained and in what amount; (iii) be secured by a corporate pledge of assets or personal guarantee of the owners; or (iv) obligate the company to refrain from increasing salaries, paying dividends, or making loans until all outstanding liabilities to the beneficiaries are paid.

While most business ventures start with the best of intentions, not all of them end that way. Having a formal Buy-Sell Agreement in place that sets forth the specific rights, obligations and restrictions related to a closely held business is important. It is the surest way to protect each owner's interest and to ensure the continued, smooth, and profitable operation of business.

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