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Buy-Sell Agreements Should Protect You, Your Co-Owners And Your Company

Imagine, on the eve of your wedding, that you plan to divorce, on a friendly basis of course, in 15 years or so. During those 15 years, you will work diligently, and quite successfully, to build a business.

On the preordained day that your marriage ends, you announce that you are willing to give your soon-to-be ex-spouse one-half of your company's business value—in cash. And you let your "ex" value your company because those are the terms of the agreement the two of you signed a year after you were married.

Sounds ridiculous, no? Yet, you may have done something quite similar (and similarly ridiculous) in your business with your co-owners.

Few owners begin working together with an expectation of future acrimony, much less litigation. Fewer still give thought to one day leaving the business—even on friendly terms. Indeed most exits are not precipitated by a disagreement among co-owners; instead owners leave for a variety of reasons and simply want to do so with their share of business value.

And remember, one day you will leave your business.

Over time, in business as in marriage, partners can grow apart. We've all witnessed the resentments, discord, and wastefulness of a friend's or acquaintance's needless nasty divorce. Business divorces can be equally unpleasant—with an added twist: One may be *unable* to leave the business, or force a partner to leave, without appropriate tax and legal planning.

When you or a co-owner wants out, what will happen? Chances are that when you turn to your company's buy-sell agreement, you will find that it is woefully out of date. You may also find that it controls the terms of your (or any owner's) exit from the business not only upon death, but also during lifetime.

If you haven't looked over your company's buy-sell agreement since you signed it, dust it off and check out at least four key provisions:

1. Lifetime and death transfers of ownership:
   - When must an owner sell, or offer to sell?
   - When must an owner (or the company) buy and when does it have the option to buy?
2. How will the value of the company and the value of a departing owner's interest be determined?
3. Does the agreement mandate the use of an independently determined Fair Market Value at the time of transfer? If not, the valuation will favor you or the other owner. It will not treat you even-handedly.
4. What are the terms (length, down payment, interest and guarantees) of the buyout?

We generally assume that buy-sell agreements control the transfer of an owner's interest when he or she dies or becomes disabled. Indeed, they do that. But they usually do much more and if you don't appreciate how much more, disaster looms.

At his annual physical, Steve Hughes complained that he was bone tired. After a battery of tests, Steve's doctor observed that, while there was nothing physically amiss, Steve did seem depressed. After some introspection, Steve was able to articulate that he had no interest in continuing as a partner in a successful CPA firm. Like many owners, Steve had lost the passion and commitment to the business that still stoked his younger co-

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owners. He decided to sell out before his partners demanded it.

Steve broke the news of his departure to his two partners and noted that their buy-sell agreement controlled only a buyout at death and an option for the company to buy Steve's stock if he were to sell it to a third party. Attempting to sell a partial interest in most businesses to a third party is always a difficult proposition, but current economic challenges made that course of action impossible.

Steve and his partners were left in a classic dilemma: remaining shareholders want to purchase the departing shareholder's interest so that future stock appreciation—due solely to their efforts—would be fully available to them. Conversely, because the profits of a closely-held corporation are either accumulated by the company or distributed to the active shareholders in the form of salaries, bonuses and other perks, the departing shareholder (now an inactive owner) rarely receives significant income in the form of distributions or dividends.

Naturally, Steve wanted and needed maximum value for his interest while his co-owners were convinced that the company's cash flow could not support Steve's buyout.

So, look again at your business continuity agreement: If you are the one leaving, is it as fair as it is if you are the one left behind?

When you sit for the first time *across the bargaining table* from your partner, you will want that table set with a fair valuation method, a thoughtfully designed lifetime buyout provision (that may well reduce the cash flow required for a buyout by 20 to 30 percent), and manageable payment provisions. Since it is exceedingly difficult to design these provisions when buyer and seller are at the bargaining table, agree to and document the valuation, cash flow, tax, and payment provisions long before potential discord or differences of outlook arise.

Your first step toward avoiding the problems described in this article is to conduct a thorough review of your business continuity agreement. If you would like a more extensive checklist as well as additional information about this most important of all business documents, please contact us.

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