



PROTECT YOURSELF AND PRESERVE YOUR BUSINESS WITH A BUY-SELL AGREEMENT

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PART I.

BUY-SELL AGREEMENTS—AN OVERVIEW

A. WHAT IS A BUY-SELL AGREEMENT?

If you own a business with others, eventually a change in ownership will occur. An owner will retire, die, or move on for some other reason. A change in ownership could spell disaster for your business unless you and your co-owners have developed a plan for the transition. A buy-sell agreement is your business continuation plan. A properly prepared buy-sell agreement enables a smooth transition for the departing owner, the remaining owners, and the business.

Sometimes referred to as a buyout agreement, a buy-sell agreement is a contract among the co-owners of a business that governs the purchase and sale of ownership interests in the business. More particularly, it determines when owners can or must sell their interests, who can buy an owner's interest, and how the price for that interest will be determined.

A buy-sell agreement is often compared to a prenuptial agreement in that it specifies how the business owners will separate their interests in the event of a "business divorce." The agreement comes into play when a triggering event occurs. Typical triggering events include an owner's death, retirement, and disability, as well as various other situations in which it is desirable or necessary for an owner to leave the business. See Part III.

A buy-sell agreement is a complex document and not a do-it-yourself project. To get the best outcome for your business, you will likely need to work with a team: your attorney to ensure your agreement meets all legal requirements; your accountant to evaluate tax consequences; an insurance agent if you will be funding the agreement with insurance; and a business appraiser to assist with the pricing provisions.

There are a number of online templates for creating a buy-sell agreement as well as some DIY books. You may find these helpful as a starting point for discussions with your co-owners. Even if you prepare a preliminary draft of an agreement, do not sign it without having it reviewed and revised by your team of professionals.

B. WHO NEEDS A BUY-SELL AGREEMENT

If you own a privately held business with one or more co-owners, you need a buy-sell agreement. This is true whether your business is organized as a corporation, limited liability company, partnership, or joint venture. Even if you own your business with your spouse or a child, you may want to put a buy-sell agreement in place to deal with the possibility, however remote, of one of you wanting to leave.

If you operate your business by yourself, you may want particular family members to take over the business on your departure, or you may want to hand the business over to a key employee when you leave. A buy-sell agreement will ensure that goal without other family members being able to interfere.

C. FOUR REASONS WHY YOU NEED A BUY-SELL AGREEMENT

1. To control who can own an interest in the business. A buy-sell agreement can allow business owners to agree on an owner's successor when the owner retires, dies, or becomes disabled. The heir to the estate is not necessarily the right person to take over the business. Perhaps the family member has another occupation, is unfit to manage the business, or does not want the responsibilities of running a business. An inexperienced or emotionally volatile family member can run your business into the ground and erase your years of hard work. The uncertainty of who is going to take over if you or one of your co-owners leaves does not allow you to plan. A buy-sell agreement can give the remaining owners or the business itself the right to purchase the departing co-owner's share so that the surviving co-owners can retain control of the business. As much as the buy-sell agreement can keep the family business "in the family," it can also help keep your business interest outside of the family or your co-owner's family, a sometimes more desirable outcome.
2. To protect the rights of the departing owner. A buy-sell agreement can ensure that the departing owner has a purchaser for his or her interest, the price will be fair, and a mechanism to fund the purchase is in place.
3. To remove the lingering influence of a disgruntled owner. Sometimes the business partnership can be strained from contrasting business philosophies. To avoid this scenario, a buy-sell agreement can provide for a buyout of the unhappy owner at a price that you can be comfortable with should you fear it will be a battle to buy the co-owner out.
4. To deter conflicts among the owners and reduce the risk of litigation with its accompanying expense. Much like a divorce, the buyout of a co-owner can be a highly emotionally situation. A buy-sell agreement can more than pay for itself if it eliminates a legal dispute upon a co-owner leaving the business.

D. THREE DISASTROUS SCENARIOS A BUY-SELL AGREEMENT CAN PREVENT

Numerous disasters can arise on the back end of a business partner leaving the business. Here are a few common scenarios that can be avoided or mitigated with a buy-sell agreement:

1. Your business partner dies, retires, gets divorced, or goes bankrupt and is replaced by someone you hardly know or do not trust. Your new partner could be your former partner's spouse or child, or a complete stranger. He or she could be someone who had a minimal role in the business or no prior involvement whatsoever and now he or she has the same authority over the business as your departing partner.
2. Your retirement is obstructed because your co-owners undervalue your interest. You were relying on cashing in on your years of hard work only to find yourself seemingly penalized. There's a limited market for your interest and your co-owners know it. Consequently, they offer you less than a fair price. If you had a thorough valuation done as part of a buy-sell agreement, your exit would be less susceptible to dispute and you could plan better for your retirement. Your heirs could face the same problem in the event of your death. Your surviving spouse and children could end up with a fraction of what you hoped to provide them with after years of hard work.
3. You and your co-owners fire an owner-employee who is performing poorly. The owner-employee still has rights to the business. Just because someone is voted out by other owners and so no longer has specific job responsibilities, the individual does not automatically forego his or her interest in the business. A disgruntled individual can hamper growth and extort you for his or her interest.



A buy-sell agreement is often compared to a prenuptial agreement in that it specifies how the business owners will separate their interests in the event of a “business divorce.”

E. ISSUES YOUR BUY-SELL AGREEMENT SHOULD ADDRESS

To accomplish a smooth ownership transition and avoid situations like those describes above, a buy-sell agreement should deal with the following issues:

- Sales of interests that are permissible, not permissible, and mandatory. See Part II. The events that trigger the buy-sell agreement. See Part III.
- Who the buyer will be for a departing owner’s interest: the other owners; the business; a third party with the other owners’ consent or after owners pass on a right of first refusal. See Part IV.
- How the price of the departing owner’s interest will be determined. See Part V. How the payment of the price is to be funded. See Part VI.
- Payment terms. See Part VI.

In addition, a buy-sell agreement typically contains non-compete agreements for departing owners to prevent one from starting a competing business, soliciting your employees, and using your trade secrets.

PART II.

WHAT A BUY-SELL AGREEMENT CAN ACCOMPLISH

A. GUARANTEE A BUYER IF AND WHEN YOU OR YOUR HEIRS WANT TO SELL

An ownership interest in a small business can be difficult to sell. Few people want to buy less than 100% of a small business and even fewer want to buy less than 50% because a minority owner will have little control over management decisions. Realizing this, the remaining owners may not be willing to offer a fair price when an owner leaves the business. A buy-sell agreement can require the remaining owners or the business itself to buyout the departing owner at a fair price.

If you are the sole owner of your business, you can make an agreement to be bought out by a relative, close friend, or a long-time employee emotionally invested in the business just as much as the family. Guaranteeing this buyer not only protects the continuity of the business, but also mitigates family co-owners fighting over valuation and management succession.

B. RESTRICT THOSE WHO CAN BE OWNERS

Small business owners usually prefer to prevent outsiders from becoming owners. Several mechanisms can be used to restrict ownership in a buy-sell agreement. Some common mechanisms include:

- **Rights of first refusal:** Other co-owners may require the selling owner to give them or the business the opportunity to purchase the interest first before an offer from a third party can be accepted. The co-owners or business can be required to meet the same terms as the third party offer to exercise the right of first refusal.
- **Consent:** The selling owner may be required to obtain written consent from the other owners before selling the interest. The parties can negotiate restrictions to the consent itself. For example, the parties consenting must consent (or refuse to consent) within a specific time (e.g. 30 days) or they lose their veto power.
- **Creation of a limited market of professionals who are allowable buyers:** Although this method assumes the owners are qualified people and mitigates the risk of disrupted management, it can risk devaluing the purchase price to the company because an open market would increase offers.
- **Mandatory buyouts:** The agreement can require the co-owner to sell his or her interest and the company or other co-owners to purchase the interest on the occurrence of certain triggering events. See Part III.

C. PROVIDE A METHOD FOR DETERMINING THE PRICE FOR SALE OF AN OWNERSHIP INTEREST

Setting a price or method for determining the price for sale of an ownership interest is generally the most important part of a buy-sell agreement. Not surprisingly, pricing can be a hotly contested issue. Here are some options for valuation (for more see Part V):

- The owners hire one or more appraisers to value the business and the price of an ownership interest. The advantage to this approach is that it is often less contentious because the price is not being negotiated by the co-owners themselves.

- The owners use a formula that all co-owners can agree on. Fixed formulas have pitfalls, however. The most glaring issue is how will that formula hold up over time? When a formula is created, the formula naturally is based on current market data and economic factors.
- The co-owners negotiate a price, and the price is susceptible to a periodic uplift through amendments to the buy-sell agreement. The uplift in price can be based on milestones or revenue growth. How this price aligns with the fair market value may pose tax issues.

D. PROVIDE A SOURCE OF FUNDS FOR PAYMENT

Funding can be done in many creative ways. A CPA or attorney can help you tailor your funding mechanism to the needs of your business. Here are a handful of options that are commonly used (for more see Part VI):

- The current business owners can purchase life and disability insurance policies on each other or the business can purchase policies on each owner. The proceeds of the policy can then be used to purchase the interest of a deceased or disabled owner.
- The owners can “self-insure” by withholding funds or a portion of their salary to allocate towards the purchase price. The risk here is that an abrupt death would not allow the buyer to secure the full purchase price.
- If the business itself is the designated buyer, and the company is light on cash flow, installment purchases based on growth metrics can be effective. At the same time, this approach can inadvertently inhibit cash flow.
- Another option, although typically the least preferred option, is for the buyer or the business if it is the buyer, to take out a loan. There is, of course, the additional cost with paying interest, but also the additional liability the business must carry. The loan may impair the ability to secure other loans for growing the business such as loans for investing in technology and purchasing additional inventory.

E. ESTABLISH A PAYMENT METHOD

Like any commercial transaction, the parties can structure the payment terms based on their preferences, but the seller will want to make sure the risk of not getting paid is minimal.

The parties can agree to payment in a lump sum or installment payments. See Part VI. Whenever payment terms are being negotiated, tax implications need to be considered.

Below is a list of typical trigger events to discuss with your co-owners and consider including in your buy-sell agreement. You may be anxious about bringing these topics up if your business is humming along and you and your co-owners are on good terms. But now is the best time for these discussions. Once a trigger event happens or appears imminent, the departing owner and the remaining owners will have conflicting goals making an agreement harder to reach. See Part VII.

In each of these situations, a buy-sell agreement can give the remaining owners or the business the obligation to buy the departing owner’s interest for a price determined in the agreement. See Part IV. The buy-sell agreement could also provide a right of first refusal giving the remaining owners an option to buy the interest before it is sold to an outsider by matching the outsider’s offer.

PART III.

EVENTS THAT CAN TRIGGER A BUY-SELL AGREEMENT

A. DEATH

A deceased business owner's interest passes to his or her heirs, usually a spouse and/or children. These individuals may demand an active role in the business even though they lack the knowledge or ability. Even family members who have spent their entire lives working for the business may not have the skill set to manage it. Sometimes family members do not want to be involved in the business and are happy to just collect their share of the profits without making any contribution to the business's success.

A buy-sell agreement that delineates what happens to an ownership interest on death significantly reduces the risk that the wrong person gains control. Death is stressful enough and ensuring the continuity of the business can ease the concerns of other owners.

Much like preparing a will or trust, drafting provisions for when an owner dies can be a sensitive situation, particularly in a family business. You may need advice from an estate planning attorney and tax professional to deal with estate tax implications and management continuity issues.

B. RETIREMENT

On retirement, an owner typically wants to "cash out" for the best price possible while the remaining owners have an incentive to keep the price low. The retiring partner does not want to be held hostage with an inappropriately low price to leave the business. Remaining owners want to ensure the business is not taking an unreasonable loss when a co-owner leaves and they do not want to be forced to accept a stranger into the business.

The buy-sell agreement should define what constitutes "retirement." Does the retiring partner have to sever all ties to the business or will the agreement be triggered if an owner wants to substantially reduce his or her involvement, but still work on a part-time or occasional consulting basis?

C. DISABILITY

A buy-sell agreement can require a buyout of a disabled owner. Triggering the buy-sell agreement for disability is most important when the disabled owner is involved in the operations of the business. If an owner is no longer able to function in a managerial capacity, a provision triggering purchase of the interest will prove invaluable to forestall a decline in operations.

Defining "disability" in the buy-sell agreement is critical. The impact of disabilities can vary widely and therefore it is important to spell out what level of impairment is necessary and how long the impairment must last to rise to the

level of a disability. The agreement should also specify what medical evidence of disability (e.g., a doctor's statement) is required and what happens if the disabled owner subsequently recovers enough to rejoin the business.

D. DIVORCE

If an owner divorces, his or her former spouse could receive an interest in the business as part of the property division. A former spouse can be a disruptive influence that most business owners would prefer to avoid. Including a fair pricing mechanism in the agreement is particularly important to avoid a spouse contesting the value of the interest later on.

Spouses are typically parties to the buy-sell agreement and should have the agreement reviewed by their own counsel.

E. BANKRUPTCY

Personal financial problems can force owners to make desperate decisions. It is therefore prudent for the buy-sell agreement to provide for an owner's becoming insolvent or filing for bankruptcy.

The primary risk to the other owners is that the insolvent owner does not have the assets to satisfy outstanding debt. The bankruptcy trustee may consequently liquidate that owner's interest in the business. A buy-sell agreement is not going to protect fully against all bankruptcy issues, but it can require an owner to notify the other owners in advance of the bankruptcy filing and provide the opportunity for the owners to buy the interest before becoming subject to the bankruptcy trustee.

F. LOSS OF PROFESSIONAL LICENSE

Losing a professional license can frustrate the owner's value to the business, particularly when the owner is an employee of the business. A buy-sell agreement can allow the company to buy out that owner, and/or require an amendment to the valuation of that owner's interest until the owner's license is reinstated. Obviously, this trigger event would be most applicable in professional organizations such as medical practices, law firms, and accounting firms.

G. VOLUNTARY SALE/OFFER FROM THIRD PARTY

You do not always need a life-altering event to trigger a buy-sell agreement. An individual owner may voluntarily depart the business to pursue other opportunities. Or the owner may want to sell part of his or her interest. In either case, more negotiation could be involved at the time of sale when the trigger is voluntary. A buy-sell agreement, however, could at least create the framework to negotiate within. For voluntary trigger events, buy-sell agreements generally provide as follows:

- If an owner wants to sell or transfer the owner's interest, the owner must first give notice to the other owners.
- The notice must include the proposed buyer and the terms of the sale.
- The other owners then have 30 days to buy the offered interest on the same terms offered to the third party buyer.
- If the other owners do not meet that offer, the sale goes through as long as it occurs within a certain timeframe.

Owners can always build in other conditions that suit their needs.

H. IMPASSE/CONFLICT AMONG OWNERS

Despite having good relationships, co-owners can disagree about aspects of the business. What if those disagreements create an impasse on a critical business decision (e.g. acquiring another business)? What if the owners' relationship is no longer amicable and communication is frustrating business operations? To address these scenarios, the buy-sell agreement can include what is commonly referred to as a "shotgun" clause.

One owner offers to buy the interest of the other owners at a specified price. The other owners can agree to sell their interests or to buy the offering owner out at the specified price. It can also work in reverse with an owner offering to sell his or her interest to the other owners for a specified price.

The other owners can agree to buy out the offering owner or can sell out to him or her at the specified price.

Shotgun clauses are both a mechanism to set price and a way to break a deadlock among the owners. The idea is that the offering owner will choose a reasonable price since he or she must be willing to buy or sell at that price. However, a shotgun clause may not work fairly unless both sides have the financial ability to complete the sale and are sufficiently knowledgeable about the business to establish the price. Otherwise, the party with less cash or less knowledge is at a disadvantage.

I. ILLEGAL ACTIVITY/CRIMINAL CONVICTION

Some businesses lend themselves to criminal liability or investigations by law enforcement agencies more than others (e.g. short-term loans versus a bakery). Even if your business is not in a risky industry that provides exposure to white collar crime, your buy-sell agreement should address the arrest or criminal investigation of an owner. The agreement can include an expulsion clause providing that the occurrence of the arrest itself or an indictment can trigger a sale. Another way to structure the buyout is by basing the removal of the owner on a vote. Because false allegations do occur, the voting method can at least provide for an independent assessment of the accused owner. Still, the long-term reputation of the business needs to be considered.

PART IV.

TYPES OF BUY-SELL AGREEMENTS

A. CROSS-PURCHASE AGREEMENTS

Cross-purchase agreements are commonly used for family businesses or businesses with fewer than four or five owners. If the departing owner leaves voluntarily, is expelled from the business, or dies, the other owners agree to buy the departing owner out at a price determined by the buy-sell agreement. See Part V.

Cross-purchase agreements are often funded with life insurance. Each owner purchases a policy on each other owner and names himself or herself the beneficiary. If an owner dies, the beneficiaries use the proceeds to buy the departed owner's share in the business. See Part V.

The advantage of a cross-purchase agreement is threefold. First, it facilitates business continuity during a hectic time. Second, it mitigates disputes with heirs over the purchase price. Third, it allows for a cost-effective funding mechanism, life insurance.

There are potential pitfalls with a cross-purchase agreement. If there is a significant discrepancy in age and health among owners, younger, healthier owners may end up paying lopsided costs for policies insuring older or less healthy owners. Each owner's lack of control over insurance policies held independently by other members can create confusion. If the life insurance policy is not structured properly, adverse tax consequences may result. If you and your co-owners decide to fund a cross-purchase agreement with life insurance, be sure to consult with an attorney or CPA before buying a policy.

The cross-purchase agreement funded with life insurance supports business continuity by providing a source of funds so business operations are not compromised and shields against creditors' claims because the co-owners, not the business, own the policies. In addition, the fact the co-owners will not have to pay taxes on the policy proceeds provides additional savings. To discourage discretionary spending of the proceeds by an owner-beneficiary, the cross-purchase agreement can provide remedies for co-owners should an owner spend the proceeds for personal gain.

B. ENTITY PURCHASE AGREEMENTS

An entity purchase agreement is an agreement between the company and its owners. If the business is incorporated, the agreement is called a shareholder redemption agreement.

With an entity purchase agreement, the buyer of the departing owner's interest is the business itself. The transaction can be triggered by the same events as any buy-sell agreement (death, disability, retirement, divorce, bankruptcy, etc.). An entity purchase agreement is preferred over a cross-purchase agreement if the business has more than four or five owners because it will minimize the transactions between multiple owners. Funding with insurance quickly gets unwieldy with more than a few owners because of the number of policies each owner must purchase.

With an entity purchase agreement, the business is responsible for financing the purchase. The funds may come from various sources, including cash on hand, a loan, or life or disability insurance purchased by the business on each of the owners. When some owners are older or less healthy than others, having the business purchase life insurance relieves the younger, healthier owners of the burden of disproportionate premiums that they would shoulder if the owners insured each other.

A downside, however, is a purchase funded by the business's resources could drain the company's cash and limit buying power. It could also affect the business's ability to secure credit for other purposes.

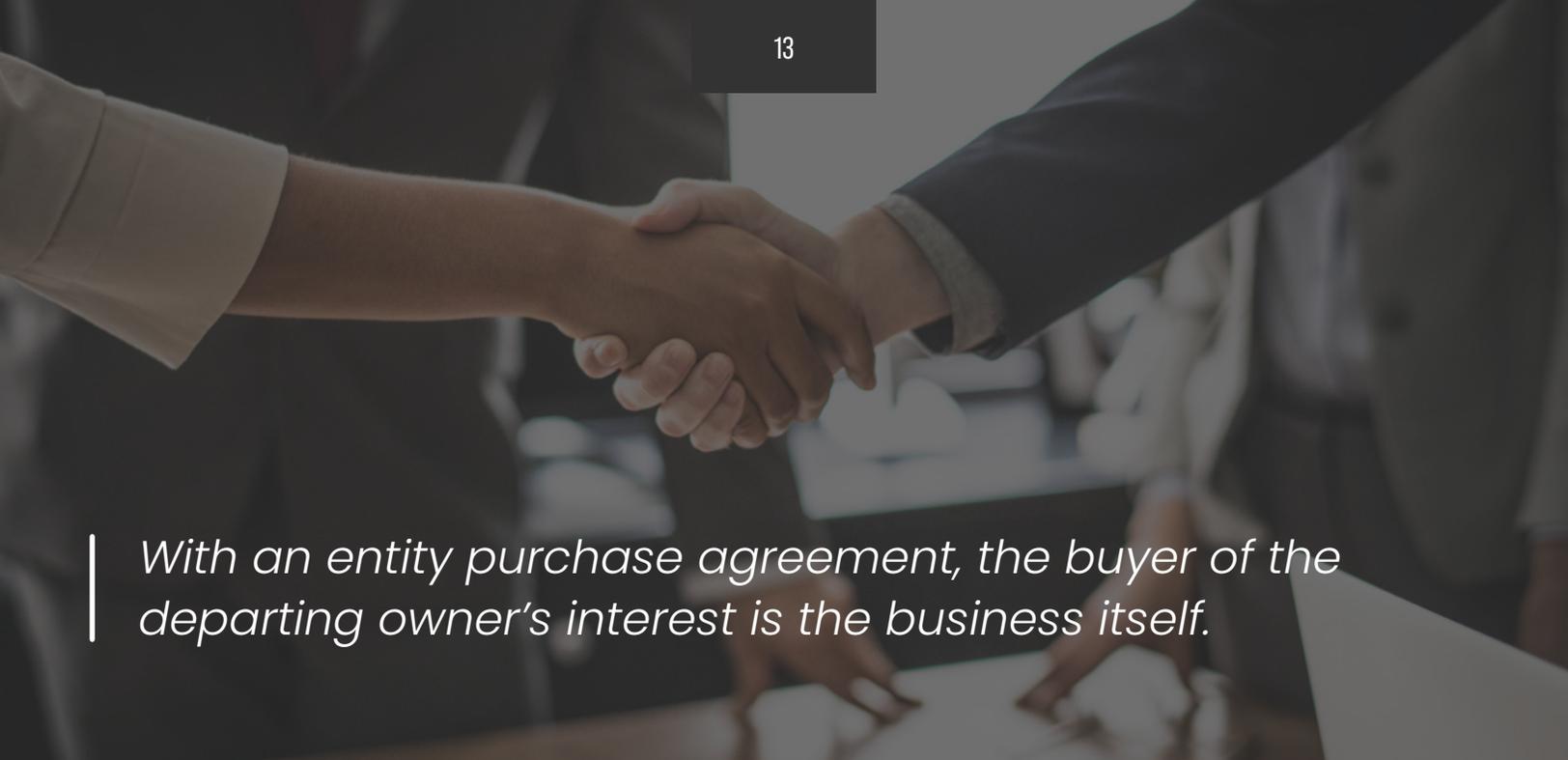
C. HYBRID AGREEMENTS WITH RIGHT OF FIRST REFUSAL

Another option is a hybrid agreement with a right of first refusal. In this type of agreement, the business and the owners have shared purchase rights. If an owner departs the business and has an offer from a third party to purchase his or her interest, the business has the opportunity to purchase the departing owner's interest first at the price offered by the third party. If the company does not exercise its option to purchase the interest, then one or more remaining owners may purchase the interest. If neither the company nor the remaining owners purchase the interest, the departing owner may sell the interest to the third party.

Here's some typical right of first refusal language:

No owner ("Transferring Owner") may sell, transfer, or dispose of any portion of an ownership interest, for consideration or otherwise, unless the Transferring Owner notifies the company in writing of his or her intent to transfer the interest. Notice must include at a minimum (i) the name and the address of the proposed transferee and (ii) payment terms and price to be paid by the proposed transferee. Transferring Owner's notification will be deemed an offer to the company and the continuing owners of the interest proposed to be transferred. The company and the non-transferring owners then have an option, but not an obligation, to purchase the interest proposed for transfer ("Option to Purchase"), and may do so within 90 days after the date on which the company receives notice or becomes aware of the event triggering the

Option to Purchase. If the company and the non-transferring owners do not purchase the interest in accordance with the offer, the Transferring Owner may then transfer the interest to the proposed transferee within 30 days after the non-transferring owners' Option to Purchase ends.



With an entity purchase agreement, the buyer of the departing owner's interest is the business itself.

D. ONE PARTY PURCHASE AGREEMENTS

In this type of agreement, a sole owner of a business wants one person, such as a key employee, spouse, or other relative, to purchase the business when he or she dies, becomes disabled, or retires.

A one party purchase agreement provides that the owner will sell and the other party will buy the business at a price determined by the agreement. The price can be re-negotiated and amended periodically as the parties see fit.

A life insurance or disability insurance policy is a common and effective way to fund the one party purchase agreement. The eventual purchaser of the business is the owner and beneficiary of the policy. He or she typically pays the premium. Alternatively, the business can agree to pay the premium.

This type of agreement can also be structured with a right of first refusal giving the intended purchaser a right to meet any contending offers.

Buy-sell agreements typically incorporate one of three main methods for determining the price of an owner's interest: a formal appraisal by one or more appraisers; a formula; or a fixed price.

PART V.

METHODS OF SETTING A PRICE FOR THE BUYOUT

A. APPRAISAL

Naturally, departing and remaining owners in a company will have conflicting interests when it comes to the valuation process. The seller's goal is to secure the highest possible price for his or her buyout and the remaining owners, either individually or through the company itself, want the lowest possible price to buy out that owner. A solution to offset these competing interests is to hire one or more independent third party appraisers.

1. MULTIPLE APPRAISERS

Appraisers retained by a seller have a tendency to come in with a valuation on the high end while appraisers hired by a buyer have a tendency to come in with a valuation on the low end. One appraisal method to mitigate these tendencies is for the seller (the departing owner or his or her heirs) and the buyer (the company or remaining owners) to each hire a different appraiser and then average the appraisals. To ensure that the appraisals are comparable, the agreement can specify the qualifications and credentials the appraiser must hold, the date as of which the company should be valued, and the standard of value. Appraisers may use different standards of value: fair market value, fair value, investment value, intrinsic value or book value, although fair market value is the most common measure.

Despite these precautions, sometimes independent appraisers hired by different owners arrive at widely different figures making an average of the figures meaningless. Buy-sell agreements frequently provide for a third appraiser when the buyer's and seller's appraisals are far apart. More than 10 percent is a typical figure. The third appraiser can be someone who is mutually agreeable or is selected by the appraisers themselves. The third appraiser can do another appraisal that sets the price or is averaged with the one to which it is closest. Or the third appraiser can review the two appraisals and choose one or reconcile them.

A current appraisal results in a more accurate valuation than a fixed price or formula agreements. Still, there are disadvantages with multiple appraisals. Notably, having multiple appraisers lengthens the process for valuation (sometimes close to a year from appraiser retention) during which time there is considerable uncertainty about the final price. Because the price is not set until the end of the process, the owners can't plan for what the price may be upon a trigger event.

Multiple appraisals can be expensive and significantly different results can lead to conflicts among owners that may end up in litigation.

2. SINGLE APPRAISER

Another option is to select one single appraiser and name the specific appraiser in the buy-sell agreement. The advantage with this method is that all parties have to approve of the appraiser, thereby avoiding the need to have multiple appraisers hired later to appease disagreeing owners. That single appraiser can then swiftly do the valuation. The owners can review it immediately to make sure they are satisfied with the methodology and result and can request adjustments if they are not.

The appraiser can then revisit the value annually or every other year, whatever makes the most sense for the owners. Owners often conclude that the certainty of maintaining up-to-date pricing is well worth the cost of the annual or biennial appraisal. Having a single, predetermined appraiser also avoids surprises with the process later when trigger events occur. The owners have had a chance to see and approve the valuation methods used by the appraiser. And they have been tracking the value of the company regularly. Selecting one mutually agreed upon appraiser also solidifies trust within the organization and mitigates disputes later on.

B. FORMULA

The owners can decide to hire an expert (e.g., accountant, lawyer, business appraiser, business broker) to develop a formula to determine the purchase price. Typical formulas apply a multiplier to some business metric such as book value, net income, revenue, or earnings. Two frequently used metrics are earnings before interest, taxes, depreciation, and amortization (EBITDA) and seller's discretionary earnings (SDE). SDE are the business's earnings before non-cash expenses, owner's compensation, interest expense and income, and non-recurring expenses. SDE is more likely to be used with small businesses that are managed by the owners. Sometimes an average of results of several different formula calculations is used.

The multiplier is typically a number between one and four and depends on various factors including the measurement to which it is being applied, the industry that the business is in, the business's tangible and intangible assets (e.g., goodwill, brand recognition), location, and future prospects.

Industry-wide multipliers are available online but must be adjusted for the unique characteristics of the business. Choosing the proper multiplier requires skill and judgment.

Some owners like the idea of a formula because it seems objective and transparent. A formula also makes the value calculation relatively simple. Once the formula is written into the buy-sell agreement (both in words and equations), your accountant can easily plug in the numbers and calculate the value. A disadvantage is that the formula can become stale if it is not revisited and revised periodically, which often does not happen. To reduce the risk of a stale formula resulting in an unrealistic valuation, you could add a provision to your buy-sell agreement requiring an appraisal if the formula has not been updated within a specified period or any owner disputes the valuation.

C. FIXED PRICE

In a fixed price valuation model, owners agree on a price for each owner's interest and agree to revisit that price periodically. Fixed price buy-sell agreements are seemingly straightforward. The method is simply that the owners come to terms on the value for the business or one or more owner's interests and include that price in the buy-sell agreement.

One downside, however, is that a fixed price is stagnant and will not reflect market changes, economic changes, industry changes, and regulatory changes. The fixed price also does not account for ownership changes and growth of the business. Although the buy-sell agreement may require that the owners meet annually to review the price and undergo another valuation, the annual revaluation often gets lost in the shuffle of the day-to-day management of the business.

Given that the fixed price will likely go stale, the risk can increase over time that one side of the deal is going to be shorted. Consequently, and particularly if the price was set at the outset of the business, a large discrepancy is likely to grow between the initial fixed price and the current fair market value of the business.

That discrepancy can cut both ways as far as creating an unfair advantage. If the updated fair market value is higher than the stale, fixed price in the buy-sell agreement, the company and/or the remaining owners would enjoy the benefit of the discrepancy when it came time to purchase the departing owner's interest. On the other hand, if the updated fair market value is significantly lower than the original fixed price, the selling owner would make out considerably better, leaving the company in a potentially debilitated position. A common occurrence when one side has received favorable terms and the other feels aggrieved is litigation. Dispute resolution only compounds the costs of the party who suffered because of the price discrepancy.

Fixed price buy-sell agreements are easily understandable. The nature of fixed price also makes the purchase easy to transact because no calculations have to be made and potentially argued over.

The risk of that price not being economically accurate or not reflecting the true state of the business, however, makes it hard to justify using. Nevertheless, if you decide to use a fixed price, you could add a provision to your buy-sell agreement requiring an appraisal if the price has not been updated for a specified period or any owner disputes the valuation.

PART VI.

BUYOUT FUNDING AND PAYMENT TERMS

A. FUNDING

There are numerous ways to fund a buy-sell agreement depending on initial capital, cash flow, number of owners, and other personal or financial factors. Here are the primary funding options:

1. THE BUYERS USE THEIR OWN MONEY WITH A SINGLE PAYMENT

Although ideal, this is the most unlikely means of purchase. The company may not have sufficient cash reserves to fund an entity purchase agreement. Owners of small businesses typically have their money working in the business and therefore need to look to other sources to fund a cross- purchase agreement.

2. INSTALLMENT PAYMENTS

Installment payments to the seller or the seller's heirs are a straightforward method that allows more cash flow for the business to operate. As with any commercial transaction, payment over the course of a longer term effectively delays completing the sale. That delay creates risk for the parties that the buyout will never materialize. At the same time, the seller or seller's heirs do not have large chunks of money to fund a retirement, satisfy debts, settle an estate, or invest in other opportunities. From the buyer's perspective, an installment sale makes payment easier. But the installment obligation can prevent the business from securing other loans to grow the business because credit may be negatively impacted. Moreover, the longer the term of the payments and greater the obligation, the more adverse the effect on the credit rating of the business will be.

3. LIFE INSURANCE

One of the most commonly used methods is to take out life insurance policies for each owner. The company can purchase the policies and pay the premiums for an entity purchase agreement or each owner can purchase a policy on the life of each other owner for a cross-purchase agreement. An advantage of funding a buyout with a life insurance policy is that it allows for a large lump sum payout, unlike an installment payment plan that can leave the purchase unsettled. A lump sum payout is particularly important on the death of an owner because of the often short notice to make the purchase and the need of the estate or heirs for cash. Life insurance policies also involve an independent third party, which mitigates some of the inevitable emotional strain between owners having to negotiate payment terms.

Premiums create a fixed cost for the buyer and subsequently can ease some of the concerns around funding being unpredictable. There are also tax advantages with the payout of a life insurance policy. A CPA or tax attorney can advise you on the details.

The life insurance policies can be term or whole life insurance. With a term policy, the premiums are often lower so may allow a business with little cash flow to operate more efficiently. A term policy provides coverage only for its term after which the policy expires without building up any cash value.

A whole life insurance policy, on the other hand, accumulates a guaranteed cash value that can be used to fund the buy-sell agreement for trigger events other than the insured's death. A comprehensive policy also can include riders for chronic illness, long-term disability, or long-term care.

There can be disadvantages to insurance funding, however. Owners with pre-existing conditions may require higher premiums or may be uninsurable, and, with a cross-purchase agreement, healthier, younger co-owners may have to pay disproportionately higher premiums for their older co-owners.

4. SINKING FUND

Owners can decide to extract a certain portion of business profits and allocate them to fund the buy-sell agreement. This method is generally referred to as a "sinking fund." The advantage is that a sinking fund is easy to administer. However, funding can be unpredictable depending on the growth of profits. Because it operates as a savings account, the fund gives the business the instant liquidity it needs to execute the buyout quickly. Obviously, without knowing when a trigger event may occur, there is always the risk of insufficient funding. A sinking fund can be a good option though when it is cost-prohibitive to insure a business owner, or for retirement purposes where the retiree can project a timeline for leaving the business.

5. BORROWING FUNDS

When the time comes to buy out an owner, the buyers can always apply for a loan. Much like the installment payment plan, this can be advantageous for situations where the business has minimal cash flow, but aside from negatively affecting credit, interest costs and carrying debt may prohibit growth of the business.

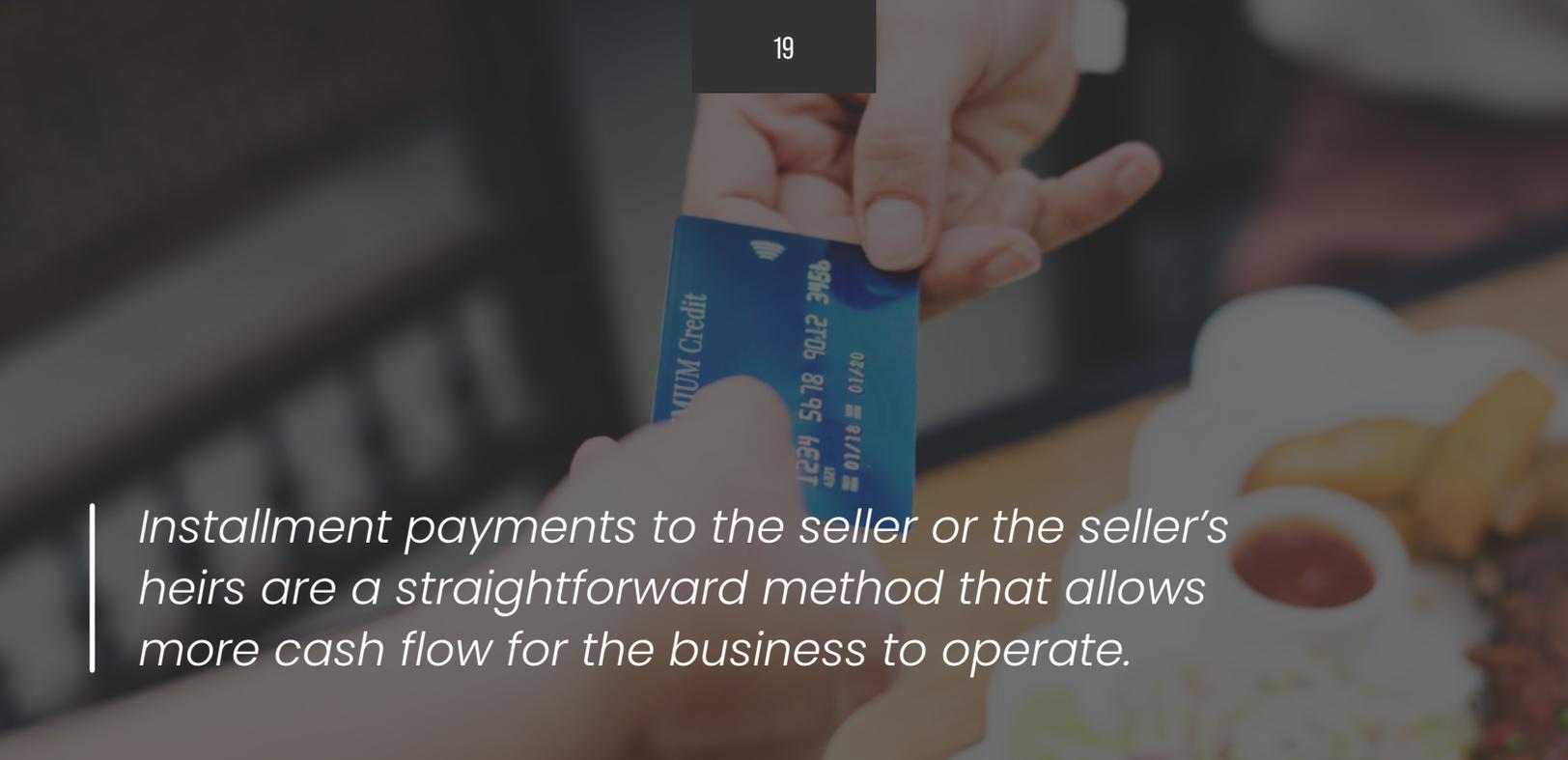
B. PAYMENT TERMS

The terms for paying the purchase price to the departing owner can vary and may be negotiated depending on the price and the buyer's choice of funding options. In an entity purchase agreement, for example, installment payments based on profits or a promissory note can function as payment terms.

The typical options for payment terms in the buy-sell agreement are as follows:

1. FULL CASH PAYMENT IN A LUMP SUM

For example, the buyer will make full cash payment for the seller's ownership interest to the seller within 30 days of the date the company/buyer provides a notice of intent to purchase. The parties can negotiate the timeframe for payment if administrative demands require it (e.g. by lengthening it 60 days).



Installment payments to the seller or the seller's heirs are a straightforward method that allows more cash flow for the business to operate.

2. MONTHLY INSTALLMENTS OF PRINCIPAL AND INTEREST

The buyer pays the seller the purchase price for the ownership interest in equal installments over a term (e.g. 60 months). That price includes interest added to the amount of each installment computed at an annual rate of (e.g. whatever the negotiated percent is) and compounded annually on the unpaid continuing balance of the purchase price for the ownership interest. Then the parties will set the payment schedule according to whatever is feasible for the buyer and whatever gives the seller assurance the buyer will be able to meet the full purchase price. For example, there may be a "down payment" and subsequently the buyer will make monthly or quarterly payments until the full purchase price, together with any interest owed, is paid.

3. CUSTOMIZED SCHEDULE FOR PAYMENT

The buyer and the seller negotiate a schedule that does not involve regular payments, but rather relies on the buyer paying the seller the purchase price for the ownership interest according to customized terms. For example, additional payments may be tied to milestones such as a particular product going to market or the company hitting certain revenue goals.

PART VII.

WHEN TO ADOPT A BUY-SELL AGREEMENT

If you are just launching your business, now is the time to put your buy-sell agreement in place. If your business has been operating a while, now is also the time to put your buy-sell agreement in place. The sooner you do it, the better because people are less emotional about hypothetical situations than situations they are living through.

Before a trigger event occurs, all owners can imagine themselves as both departing and remaining with the business and so will want an agreement that is fair to both sides. Once a trigger event occurs or is imminent, the owners' interests diverge. The seller wants the highest possible price and quick payment. The buyers want to pay the lowest possible price and often want a longer payout period. Negotiations can become contentious and an agreement elusive. Protracted negotiations followed by litigation can spell the death of the business. Relationships among co-owners, who formerly may have been good friends or even family, can be destroyed.

As part of the formation of any business, documents are prepared that govern the business. These may include a partnership agreement, operating agreement for an LLC, or articles of incorporation and bylaws for a corporation. A buy-sell agreement can be included in the initial documents during formation of the business. The buy-sell agreement then appears less personal and more of an administrative matter. If you and your co-owners are not exactly sure what your expectations are yet, a basic buy-sell agreement can be included that can be amended as the business matures.

If your governing documents are already in place, they can be amended to include your buy-sell agreement or a separate agreement can be executed and then referenced in your governing documents. You'll want to make sure that your buy-sell agreement does not conflict with any provisions in your existing documents. After preparing your buy-sell agreement, your attorney should review all your documents for consistency.

Once you have your buy-sell agreement, you and your co-owners should review it every year or every other year and amend it if need be to make sure the pricing mechanism and payment terms are still appropriate. Many business owners execute buy-sell agreements early on and then never look at them again until a trigger event occurs. Often the agreement is woefully out of date putting one side or the other at a serious disadvantage.