Legal

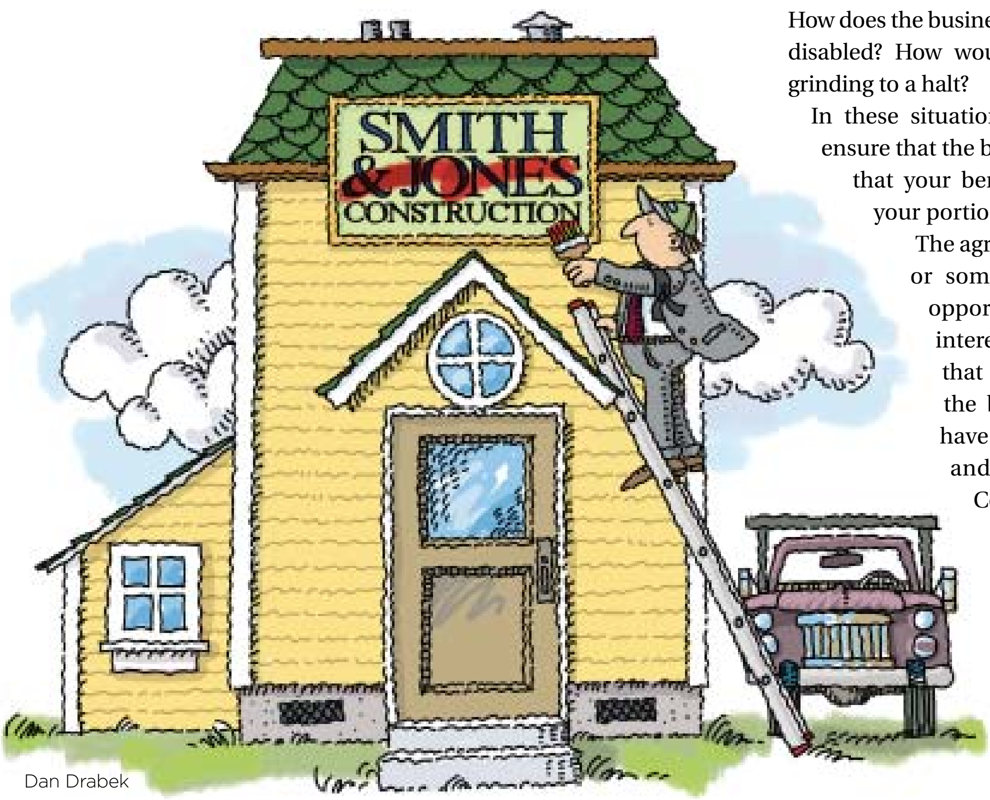
Plan Ahead With a Buy-Sell Agreement

by Kevin M. Veler

Most contractors are so immersed in the day-to-day issues of running a company they fail to protect themselves against events that could cost them or their families the business. For example, what happens if you as the owner suddenly die or become disabled? What happens if your business partner dies, becomes disabled, or goes through a nasty divorce? What if you have a serious falling-out with your partner and want to sell the business or buy him out?

Or, on a more positive note, how do you keep your most valuable employees from leaving to go out on their own?

One way to deal with these questions is to answer them in advance, which is what happens when you sign a buy-sell agreement with a co-owner, employee, or someone else. This agreement — either among the owners of a business or between an owner and someone who would like to own the business, such as an employee or another contractor — spells out the circumstances under which ownership interests may be purchased or sold.



Dan Drabek

Why Bother?

The agreement could provide a mechanism for one owner to force another owner to sell out. Or it could make it possible for one owner to force another owner to buy him out; he would do this by making an offer to sell that, according to the agreement, could not be refused.

For your key employees, the benefit is clear: They could gain ownership yet avoid being forced to partner with someone you chose to sell or transfer your interest to.

The agreement can be optional rather than required, such as having "a right of first refusal" if the owner wants to sell. A good buy-sell agreement should cover a variety of situations, including the ones listed below.

Someone Dies

How does the business get handled if you die or become disabled? How would you keep the company from grinding to a halt?

In these situations, the intent of a buy-sell is to ensure that the business continues and, most of all, that your beneficiaries receive a fair price for your portion.

The agreement could offer a key employee or someone else of your choosing the opportunity to step up and acquire your interest. At minimum, it should provide that there is someone around to close the business so your family does not have to deal with unfulfilled contracts and other issues (see "Death of a Contractor," 9/03).

Life insurance. If there are co-owners, the company could pay for life insurance that would enable the surviving owner to purchase the interest of the owner who died. The policy wouldn't necessarily have to cover the entire amount; it could be a down payment that allowed the surviving partner to fund the rest of the purchase with future cash flow.

Dispute Between Co-owners

A buy-sell can be the business version of a "prenuptial agreement." It could be a prearranged buyout to get you out of certain situations, establish a price, and set the term for payment. Such an agreement can be helpful if you have a falling-out with your partner or if one of you decides to leave the business, for whatever reason.

Court-ordered transfer. If your partner gets divorced or goes through a personal bankruptcy, the courts could transfer his interest to someone you don't want to be in business with. Do you really want to be partners with your partner's ex, the ex's new spouse, or someone to whom your partner owes money?

A buy-sell agreement can ensure that in the event of a court-ordered transfer you have the right to buy the stock for a certain amount. You might not be able to come up with cash on such short notice, so the agreement could allow you to pay for the stock over a certain period of years.

Employee "Options"

Some owners will give employees an interest in the business. Before doing this, it's important to sign a buy-sell that spells out what happens if the employee quits or you fire him. There needs to be a way for you to buy back his interest. As with a divorce, the time to negotiate this is up-front and not after things have soured.

A buy-sell could also allow a key employee to buy out the owner at some future point in time. Such an agreement could help the owner hang on to a valuable employee who otherwise might be tempted to go out on his own. This key employee could look forward to becoming an owner rather than worrying about finding a new job when the current owner bows out. Since it's unlikely the

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employee could pay cash, the agreement might allow him to purchase a portion of the business each year for a fixed price.

Exit strategy. There are numerous other reasons for having an agreement that controls the sale of an interest in your business. You may want to be able to buy out or sell to your co-owner because you are tired of being in business with him. One of you may be ready to retire or may simply want to move on to something else. When this happens, the person who plans to stay in the business needs to have some say about who ends up with his partner's share.

Valuation

One of the most critical aspects of a buy-sell agreement is how you decide to value the business. You can hope that you and your partner will agree on what the business is worth, but odds are the person who is selling will think it's more valuable than the buyer does.

How do you handle this? Well, the agreement could provide that you can formally offer (in writing) to buy out your partner at a price you establish. To protect against lowball offers, the provision could also state that if you offer to purchase for, say, $10 a share, you are also agreeing to sell your interest for $10 a share. This ensures that the offer will be fair and that one party can buy out the other.

Co-owners could also agree to have the business appraised by some outside party, or they could decide that it should be valued at some multiple of past earnings. But whatever valuation method you choose, it's easier to agree on it in advance than to negotiate it in the middle of a dispute.

Funding

Most buy-sell agreements also identify funding for the buyout. A purchase could be funded with assets from the business, but this approach might drain the company to the point where it would be unable to survive. Proper funding helps insure that cash will be available to carry out the terms of the agreement.

There are several more sensible methods that may be used, either independently or in combination, to fund a purchase/sale. The buyer could pay cash, borrow money from a bank, or sign a promissory note to the owner. The note could require fixed installment payments or periodic payments based on future profits. Life insurance on one of the owners is a very popular option because it ensures that beneficiaries will receive the agreed-upon price (the amount of the policy) for the business.

Don't Try This at Home

Because of all the possible variations and options involved, buy-sell agreements are too complex to draft without professional advice. At the very least, you need to talk to an attorney who has experience with these types of agreements — but it also helps to bring in an accountant to make sure the agreement doesn't trigger dire tax consequences.

And if insurance is going to fund the deal, you should work with an agent who is familiar with buy-sell agreements.

Kevin M. Veler *is an Atlanta attorney with more than 20 years of experience representing companies in construction, real estate, and general business transactions.*