BUY-SELL AGREEMENTS
General Overview
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The Buy-Sell (also known as buyout) Agreement is an agreement among business owners to purchase or sell a business interest after a specific event, at a determinable price and on predetermined terms. The purchase or sale may be required or optional. The agreement may give purchase or sale rights to one party or to all of the parties or to the company.

A Buy-Sell Agreement can be between shareholders of a corporation, members of an LLC, partners of a partnership, or key employees and the owner(s).

Purposes of the Buy-Sell Agreement

The Buy-Sell Agreement has several primary purposes. First, owners of a small business often wish to limit who can become a new co-owner. For example, they may not want spouses or children of their fellow co-owners to become owners. Without a Buy-Sell Agreement, this type of transfer could occur, for example, if a co-owner dies or gets divorced. Thus, the Buy-Sell Agreement includes a general prohibition on the sale or transfer of ownership interests, except under the specific circumstances specified in the agreement.

Second, owners of a small business may wish to "create a market" for the sale or transfer of their ownership interests. This is particularly important in a small business which may not have a market for the purchase of all or a portion of the business. In the absence of a Buy-Sell Agreement, owners may find that they have limited or no opportunity to sell upon events such as retirement or disability. Therefore, the Buy-Sell Agreement can provide a mechanism for the purchase of the interest of an owner who retires, dies, becomes disabled, or simply wishes to sell to someone else.

One important issue is whether a purchase by the company or other owner is a requirement or an option. For example, if the sale or transfer results from death, the other owners (or the company) in the Buy-Sell Agreement can agree to be obligated to purchase the ownership interest. In contrast, the agreement may state that if an owner simply wants to withdraw or goes through personal bankruptcy, the other owners may have the option to purchase the owner's interests. The obligation or option to purchase may be given to either the company or the other owners. Alternatively, the approach can be taken that a decision will be made at the time of the event as to who purchases the interests.

Owners should carefully consider if it is prudent to obligate themselves in the agreement to purchase another owner’s interests. It may be best to evaluate the circumstances at the time of the business changing event and make the purchase decision at that time.

Third, the Buy-Sell Agreement specifies the mechanism for determining the purchase price. It also sets forth terms for how the purchase price will be paid. Owners often believe that they can resolve these issues as the circumstances arise. However, they may discover to their dismay at a later point, that "selling" owners do not have the same perspective of fair price or terms of payment as owners who wish to remain.

Funding of the payment of the purchase price of a departing owner is handled by several methods. For death and disability, the most common is requiring either the owners or the company to purchase life and disability buyout insurance. For other situations, the Buy-Sell Agreement generally allows the remaining owners to pay over a period of time on an installment basis.

Finally, the Buy-Sell Agreement can peg the value of the business for taxing the estate upon an owner's death.

Types of Buy-Sell Agreements

1. **Cross Purchase.** This type of agreement involves the business owners entering into an agreement among themselves in which the remaining owners may buy the interest of the departing owner. The agreement may also define the percentage interest each remaining owner can purchase.

2. **Redemption.** This type of agreement the business purchases the interest of the departing owner. If the business is the corporation, this entity agreement is sometimes referred to as a stock redemption agreement.

3. **Hybrid (Wait and See).** This type of agreement allows flexibility in that it is not decided until an owner's interests are to be transferred whether the remaining owners or the business purchases the interest of the departing owner. A frequent issue addressed is the order of who can purchase first: the company or the other owners.

Valuing the Business

A very important aspect of the Buy-Sell Agreement is to establish the method of valuing the business in order to determine the purchase price of the owner's interest. If the purchase price cannot be determined from the agreement, it will not be enforceable.

A Buy-Sell Agreement may use one of the following methods to determine the purchase price of an owner's interest:

1. **Book Value Method.** The owners agree on the value of the company based on the company's assets minus its liabilities. This method is most appropriate in the early stages of a company.

2. **Multiple of Book Value Method**. If a small business has been up and running successfully for several years, its real value is probably greater than its book value. This formula goes beyond measuring the book value of the company's tangible assets to take into account "intangible assets". These intangibles may include assets such as goodwill, mailing lists, and trade names.

3. **Capitalization of Earnings**. This method may be used for a new business without a significant track record. It attempts to value a business by estimating an acceptable rate of return on an owner's investment. The first step is to determine the company's annual earnings by subtracting the cost of doing business from gross revenue. The next step is to multiply the annual earnings by an agreed upon multiplier usually between 2 and 10. Often, the multiplier is based on industry standard.

4. **Appraisal Method**. The selling owner and the company mutually select an appraiser to value the company. If they cannot agree, each party selects an appraiser (and pays the cost thereof). In that case, the value of the company is the average of the two appraisals unless the difference between the two appraisals is more than an agreed percentage, generally around 15%. If the difference is too great, the two appraisers select a third appraiser (the cost is split) and the value determined by the third appraiser is the tie-breaking value.

5. **Fixed Price Method.** This method fixes a dollar value for the business. If this method is used, periodic reviews are essential in order to ensure that the dollar amount reflects the actual value of the company.

Funding the Buy-Sell Agreement

Where does the money come from to purchase the business interest? There are really only three ways to fund the purchase of an ownership interest: insurance, savings (personal or from the company), and installment purchases. Most of the time, a combination of these funding techniques is employed.

Note that insurance premiums on policies purchased for these purposes are not deductible. Additionally, the use of insurance in a cross-purchase situation with more than a few owners can get complicated. If you have five owners, you need 20 policies! Or else you might get an escrow agent to hold one policy on each of the five, and each owner could contribute to the payment of premiums on policies on the four other owners. In the case of multiple owners, it often makes sense for the company to pay for the life insurance policies on the owners.

The following are the methods by which to fund the purchase:

1. Personal Funds of Owners

2. Company Funds
   a. Sinking Fund (accumulated earnings)
   b. Borrowed Funds

3. Life Insurance

4. Combination of the above

Payment Terms

Because payment terms can have a great effect on the success of a buyout, the Buy-Sell Agreement will want to have a payment plan that is fair to both buyer and seller.

The choice of payment terms will depend upon where the funds to purchase an owner's interest come from. If the buyout is to be funded with life and/or disability buyout insurance, the buyout can be either fully or partially funded as soon as insurance proceeds are paid.

Examples of typical payment terms are as follows:

1. **Lump Sum Cash Payment**. This method requires the buyer to pay the full amount of the purchase price in cash within a specified period of time.
2. **Equal Installment Payments.** The purchase price is paid in equal installments, plus interest over a specified period of time. This method has no down payment.
3. **Down Payment Plus Installment Payments.** This method requires an initial cash down payment followed by periodic installment payments until the full amount plus interest is paid. A down payment of 25% to two-thirds of the purchase price is often required, followed by installment payment for three to five years.
4. **Customized Schedule of Installment Payments.** In this method, the Buy Sell Agreement specifies a custom schedule of installment payments. For example, payments may be four times per year for four years.
5. **Interest Only Installment Payments.** Period payments of interest only are paid. Payment of the purchase price is delayed to a later date. Note that this method is rarely used and may only be viable in a new business between immediate family members.