

FARALLON LAW GROUP NEWSLETTER (AUGUST, 2010)

Planning for Business Succession: The Buy-Sell Agreement

Many business owners overlook a critical element of business planning that can save both money and frustration down the road: the buy-sell agreement. When you implement a buy-sell agreement, you and your partners prepare for events that have been the downfall of many successful small businesses; namely, the death, disability, divorce, bankruptcy or retirement of one of the owners. A buy-sell agreement is put in place among all the active owners of the business and sets forth, among other things: (a) the events triggering a buyout, (b) the means of determining the buy-out price, and (c) a prohibition on transfers of ownership interests without giving the other owners a right of first refusal to purchase the ownership.

➤ **Events Triggering a Buyout.** Typically, the events that trigger a buyout of ownership interests are:

- The owner dies or becomes disabled such that he/she cannot continue to carry out his/her duties;
- A divorce judgment or settlement in which an owner's ex-spouse receives an ownership interest in the company;
- A bankruptcy filing; or
- The retirement of an owner.

➤ **Determining Buy-Out Price.** To prevent spending considerable time, energy and money in negotiating the price of the selling owner's ownership interests, the buy-sell agreement specifies how it will be valued. Some owners elect to set a fixed price on the business as a whole, and the price of ownership interests is calculated as a pro rata portion. Another approach is to specify the valuation method and process for appraising the business at the time of a triggering event in order to determine the applicable price. This approach may require an outside appraiser or it may use a customary accounting formula appropriate for the industry in which the business operates (such as average EBITDA for several prior years with a multiplier).

➤ **Insurance Proceeds as Liquidity.** To provide liquidity to purchase the ownership interests of a deceased or disabled owner, the buy-sell agreement will typically call for either the owners to purchase life or disability insurance on one another (a cross-purchase buy-sell agreement) or the business itself to purchase insurance on each owner (an entity-purchase buy-sell agreement).

Cross-purchase agreements. In these types of buy-sell agreements, each owner agrees to purchase an insurance policy on the other owners and acts as both holder and beneficiary of the policies. Upon the death or disability of an owner, the other owners use the insurance proceeds to purchase their ownership interests. These agreements are especially suitable for small businesses with few owners. The plan becomes more difficult to administer as the number of owners increases. Another related disadvantage of cross purchase agreements is that age or other insurability factors can create a disparity in premiums. Younger or healthier owners may incur higher premiums to cover older and less healthy owners.

Entity-purchase agreements. Here, the business holds policies on each of the owners. When an owner dies or becomes disabled, the business buys their ownership interest in the business with the insurance proceeds. After the ownership redemption is accomplished and the ownership purchased by the business, each owner holds a greater percentage of ownership. A key advantage of using entity purchase agreements is administrative ease – it is much simpler to administer for multiple owners. Another advantage is that the business will bear the premium differences. One disadvantage is that the insurance proceeds may be taxable to the beneficiaries of the deceased in which case a higher policy amount may be desired.

Please feel free to contact Mario Kashou or Boris Lieberman at 415-255-2450 if you have questions about buy-sell agreements or other business succession matters.

This Newsletter is intended as a general guide to law issues and developments. It does not contain a general legal analysis or constitute a legal opinion of Farallon Law Group LLP or any member of the firm on the legal issues described. It is recommended that readers not rely on this general guide in structuring individual transactions but that professional advice be sought in connection with individual transactions.