# Top Mistakes In Buy-Sell Agreements

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*The buy-sell agreement arguably is the most important legal agreement for closely-held entities. Whether you are the client's business attorney or the estate planning attorney advising the owner of a small business, understanding what can go wrong with buy-sell agreements will help you better serve your clients.*

## FAILURE TO COORDINATE

Many times, business owners think seriously about buy-sell agreements only after they've already entered into other agreements that can impact the effectiveness of the buy-sell. Examples include articles of incorporation/organization or partnership agreement, bylaws/operating agreements, loans or security agreements, franchise agreements, and leases. Buy-sell agreements must be coordinated with these other agreements. For example, a buy-sell agreement could conflict with the client's plan of distribution in her estate planning documents. Sometimes, the effectiveness of the buy-sell may require the consent of third parties, which is common in financing arrangement or franchise agreements. Local law may provide that another document, such as articles of incorporation, takes precedence over the buysell agreement if the two are inconsistent.

## IMPROPER SELECTION OF FORM OF BUY-SELL AGREEMENT

Many attorneys are aware that buy-sell agreements essentially take three forms: redemption (where the entity purchases the interest), cross-purchases (where one or more persons buy the entity interests) and hybrids (a mix of the two). Selection of the wrong form will create unintended and unwanted results. For example, I recently handled the case of a cross-purchase agreement with a Texas Shoot-Out provision that involved five equal shareholders where four shareholders wanted to buy out the fifth. Coordinating the rights and options, and the timing required to exercise them, for the four shareholders was like crossing a legal and tactical minefield.

## IMPROPER SELECTION OF BUY-SELL AGREEMENT TRIGGERING EVENTS

The number of potential triggering events that can be considered in a buy-sell agreement is limited only by the parties' goals and situation. A buy-sell agreement that does not cover reasonably foreseeable and appropriate triggering events may well have drastic unintended consequences. For example, buy-sells are not just about death; they might also have to consider the divorce or disability of a shareholder. Warning a business owner that he might otherwise end up owning the business with his partner's ex-wife has moti-

vated many a business owner to engage in buy-sell planning. The circumstance I warn clients about the most is the absentee shareholder. If a shareholder who is expected to work in the business stops contributing his time and energy, are there provisions in the buy-sell to buy out his interest so he cannot continue to coast on the efforts of the other working shareholders?

## FAILURE TO TAILOR THE ASSOCIATED RIGHTS AND OBLIGATIONS FOLLOWING OCCURRENCE OF A TRIGGERING EVENT

Similar to triggering events, the selection of what happens on occurrence of a triggering event should be tailored to the goals and circumstances of the client. For example, involuntary termination of employment may require a mandatory buyout while voluntary termination may trigger only an option to buy out the employee who is leaving. This can provide a disincentive to fire a shareholder/employee while also preventing a cash flow crisis if a disgruntled shareholder decides to leave and open up a competing business. (Assuming the buy-sell does not have an applicable and enforceable non-compete provision, which it probably should). Even when the termination is voluntary, there may be different obligations depending on whether the employee is retiring after a certain age or leaving this business before retirement age.

## INFLEXIBLE COOKIE CUTTER VALUATION

Valuation can be a major source of contention in every buy-sell. One of the most troublesome valuation provisions I have seen is tying the valuation to some agreement of the owners to be made in the future or according to a schedule (such as annually). First, your typical business owner is not a very good judge of the value of his or her business. Even worse, in my opinion, most shareholders do not keep to the schedule of agreeing upon a value, so you may have a valuation that is years old, if you have one at all.

Formula valuations can have value, as long as the formula is tied to the realities of the business. A formula based on book value may not mean much where most of the business value is in goodwill. Even tying the

valuation to an appraisal must carefully consider who chooses the appraiser. Some buy-sells use the “three appraisal” method where each side picks an appraiser and the two appraisers pick a third, all of whom appraise the interest. This can get rather costly for many small businesses. For some clients it might be sufficient to have one appraiser selected by two appraisers selected by each party. But this would not fit very well if there is a potential that there will be more than one buyer or seller.

## FUNDING A BUYOUT

Even if everybody is in agreement on when a buyout might be mandatory or optional and how to value the interest that will be purchased, payment issues must still be addressed. How will the seller be paid? How does this affect the future viability of the business? The business or shareholders may be able to purchase life insurance for a death-triggering event. Notably, I have yet to hear that any insurer is offering divorce insurance, or “I just don’t want to work here anymore” insurance. Carefully consider whether payment will be

in a lump sum or over time, and whether the option to split off assets might be available to satisfy a payment obligation. Where there is life insurance, make sure that the death benefit, policy owners, and beneficiaries are all properly aligned.

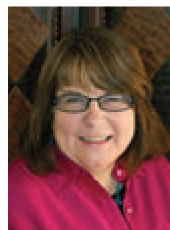
## LOW EASY TERMS

You and the client have decided that an obligation to purchase an interest will be paid out over time. While many buy-sell agreements contain installment payout plans for payments of purchase price, very few buy-sell agreements provide much detail or flexibility as to the amount of installment payouts. Was any analysis done prior to picking the installment payout period? Does the agreement contain any system for adjusting payments to reflect changed circumstances after the triggering event occurs? One common problem that I see in this respect is a buy-out obligation that comes before an earlier buy-out obligation is fully paid out. The entity or remaining shareholders may be able to pay when an owner dies, for example. But what if one of the remaining shareholders dies soon after?

## FAILURE TO CONSIDER RELATED PROPERTIES OR ENTITIES

It is one thing to provide for sale of ownership interests and quite another to consider related property. Related property can include life insurance policies on the life of a selling owner, interests in affiliated entities, or interests in land or other property co-owned by some or all of the remaining owners (such as property where the business operates). It can also include intellectual property, leases or other contractual rights or obligations. Relationships, needs and interests that were aligned may no longer mesh after a sale. For example, a former business entity owner may care a lot more about how much the entity pays in rent for the property that he or she continues to co-own after a sale. Failure to address these continuing relationships at the time of the buy-sell agreement can negatively impact operations down the road. It may not be necessary or advisable to solve all of these issues within the buy-sell agreement. For example, it may be that all that is needed is a lease that ensures that the entity will pay then fair market value rent.

In my practice, I've seen several buy-sell agreements "mature." I have been surprised by how many times the business owners mutually agree to terms that are different from what is in the buy-sell agreement. Does that mean the buy-sell agreement was a failure or a waste of time? On the contrary, these business owners were able to reach a mutually acceptable settlement because they knew that the buy-sell agreement would dictate the result if they could not agree. In my view, we succeed as legal advisors when we maximize the chances that everyone will walk away satisfied. It's an added bonus that you will not be dragged into a protracted dispute that may require you to devote uncompensated time and energy or worse, to contact your malpractice insurer.



ABOUT THE AUTHOR

*Karen Brady has been practicing estate and business planning in Arvada, Colorado since 1990. She is a member of the board of directors of Words Beyond Bars, a non-profit focusing on the power of reading for prison inmates. She likes to geocache and spends many a weekend transporting shelter dogs and cats to better homes.*