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The good, bad, ugly of buy/sell agreements for business owners

By **JAMES RAPP***

CLINT Eastwood's spaghetti western, "The Good, the Bad & the Ugly," holds many lessons about people and busines relationships. The standoff at Sad Hill cemetery presents the realities faced when business arrangements end — ones that may be avoided in advance by a thoughtfully crafted buy/sell agreement.

Friends, family, foes

When business relationships begin, a common rejoinder to a suggestion of a buy/sell agreement is that it's not needed. "We are friends (or family); we can work things out without an agreement." Or, "We will get to that once we get the business going."

Together in business, the best of friends and the closest of family may become the fiercest of adversaries over time. Throw in marriages, divorces, varying work ethics, talented and not-so-talented family in the business, perceptions of each other's importance or contributions, competitive challenges, interlopers wanting part of the business, capital needs, differences in business vision, outside interests and retirement planning, along with others, and these can doom relationships and, with them, an otherwise successful business.

How will things resolve themselves? A buy/sell agreement answers this question.

Heading to Sad Hill

As the trio of Eastwood's character Blondie (the good), Lee Van Cleef's Angel Eyes (the bad) and Eli Wallach's Tuco (the ugly) face off at Sad Hill, it's easy to forget that Blondie and Tuco were business partners — but did they remain so?

Their money-making scheme involved Blondie repeatedly turning Tuco in for a bounty and, as Tuco was about to be hanged, severing the noose by shooting it. After setting Tuco free, the two would escape on horseback to share the reward.

They eventually have a falling out, even to the point of Tuco trying to force Blondie to hang himself. Each holds separate secrets to the location of a large gold stash at Sad Hill, though, so they again join forces. They share information of the gold's location — or do they? However, Tuco then steals a horse, abandons Blondie and heads to Sad Hill, but Blondie still arrives, to Tuco's surprise, only to be joined by interloper Angel Eyes, who is also in search of the gold. A three-way gunfight follows.

Business owners may head to their own Sad Hill. No doubt, owners have disagreements. Some differences are able to be resolved. Some disagreements, though, may fester and run far deeper, leading to a level of distrust, disdain and animosity that makes working together impractical, or maybe even impossible.

While differences may focus on the business, conflict may embroil personal relationships as well. A trusted advisor, attorney, accountant or mutual friend may be able to bridge the gap. Other times, it may take bringing in an outsider to assume management or foster a buyout, a sale or some other resolution to bring closure. Absent this, owners might resort to a costly and generally unsatisfactory judicial resolution.

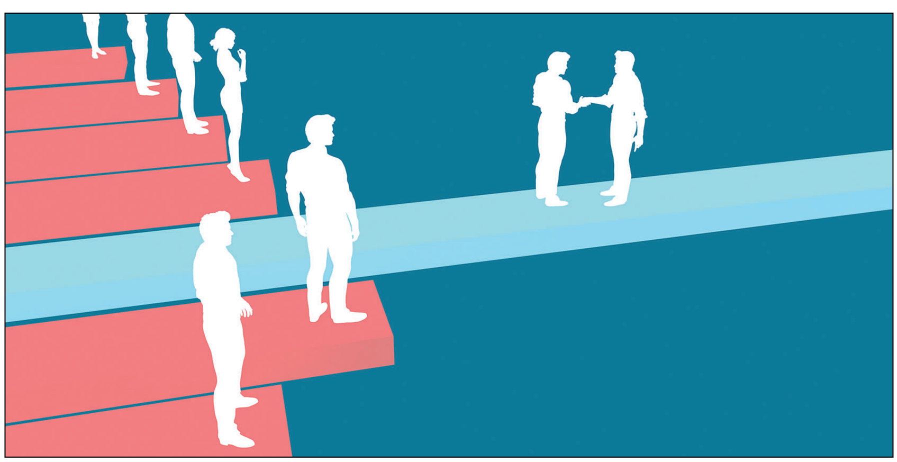
Planning to disengage

It is as important to plan for how business owners might eventually disengage as it is to plan for starting and continuing a business. The common vehicle is an upfront buy/sell agreement. This agreement restricts the transfer of ownership interests and establishes rights, circumstances, obligations and terms for permitted or required transfers.

Even if a business is long-standing, planning is important. It is never too late for an agreement — so long as unresolvable dysfunction has not already set in!

Here are some considerations in preparing a buy/sell agreement:

- **What transfers are prohibited or allowed?** Most agreements prohibit any transfer, whether voluntary or involuntary, unless approved by the other owners. Exceptions may be made for transfers to other owners, family members or key employees.
- **What circumstances trigger a buy/sell?** Common triggering events are death, permanent disability, termination of employment, retirement, creditor claims and bankruptcy. Divorce also might be a triggering event.
- **How are third-party offers addressed?** When an owner receives an offer and wishes to accept, other owners may be allowed to match the offer — essentially a right of first refusal. Other business arrangements flatly prohibit a sale to outsiders, even if an offer is received.
- **Does the business or another owner(s) have the purchase right?** Agreements may extend the right to purchase to the business or the other owners or both. A common arrangement gives the business a priority right, which, if not exercised, defaults to the other owners. Priorities may be set among owners, sometimes favoring the business founder but usually exercised based on ownership.
- **Are purchase rights optional or mandatory?** Purchase rights may be optional or mandatory. Optional rights



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aren't required to be exercised. Mandatory purchase rights must be exercised. Mandatory purchases often are required when there is a death or employment is terminated at the initiative of the business.

• **What are the payment terms?** Establishing payment terms may be important to allow the business to viably continue, although a lump sum may be appropriate, especially if funded by insurance or called for by a third-party offer. Also, consider the cash flow requirements of multiple buyouts.

• **Will life insurance fund a buyout?** Life insurance may fund a buyout. Death benefits, of course, would immediately provide funds, but cash value policies may be useful if death is not the triggering event.

• **What are the tax consequences of a buy/sell arrangement?** Every effort should be made to make the buy/sell agreement as tax efficient as possible. Get the advice of a tax professional.

• **Should spouses sign off on the agreement?** When an owner is married or has a domestic partner, consider having them confirm knowledge of and a commitment to honor the agreement's terms. This avoids a claim that they were unaware of the agreement or that the agreement violates spousal rights under state law.

Valuation of ownership

A critically important provision to include is how to value the ownership interest. A good practice is to prepare a sample valuation based on the valuation method agreed upon in order to avoid misunderstandings as to what the agreement will financially mean in practice. Kinks in the valuation method may be addressed.

Many agreements value a business based on "book value," without giving it much more thought. Book value is simply assets over liabilities. True book value does not value assets at fair market value but is simply original cost less depreciation. This seldom reflects the owners' ideas of value.

An "adjusted" book value readjusts asset value to fair market, which avoids the problem. Where readjusted, however, it's important to exclude items — often custom equipment and life insurance death benefits — that should not be considered in the valuation. Agreement on who will value items also may be helpful.

Because the book value is, at best, a tally of the net asset value, other methods may be more appropriate. Valuation firms may be retained to determine the value, but — to adapt the statement popularized by Mark Twain that "there are three kinds of lies: lies, damned lies and statistics" to "there are lies, damned lies and appraisals" — owners would be wise to use the information provided by such a firm to define the manner in which valuation is to be made when required and make certain that there is agreement on the method used. Some businesses are valued based on revenue, multiples of earnings or cash flow, among other formulas. Discounting may be a consideration in some circumstances.

Owners may stipulate a value. This may be especially useful for a startup where the value is fixed for a time and there is significant debt. It also may be appropriate where there is life insurance aimed at providing a minimum buyout, regardless of value. Long term, an agreed value usually will become stale and default to a formula called for after a period of time.

In valuing a business, recognize that one doesn't know if they will be the goose or the gander — the seller or buyer! The goal should be to allow the business to remain viable. Don't necessarily expect full value. The aim should be an equitable valuation and not necessarily what could be obtained on a market sale.

Overlooked considerations

There are some provisions that do not frequently appear in buy/sell agreements but are worth considering.

One of the unfortunate circumstances seldom addressed is owner wrongdoing. Employee theft costs businesses billions annually. Theft isn't always just employees. Theft or other criminal conduct involving an owner should trigger a right to buy out the interest of that owner and reduce the amount paid for any ownership interest held.

While employees often are subject to non-compete covenants and nondisclosure agreements, owners usually are not. An owner has some ill-defined common law obligations to a business. It is advisable to expressly include these obligations when an owner's interest is acquired.

The 'shootout' option

When there are two or only a few owners, a "shootout" option may be worth considering. This is helpful when the reason for initiating the process is not some objective event such as death but instead may best be described as irreconcilable differences. As in divorce, the owners simply no longer get along or no longer want to be in business together for ill-defined reasons.

The shootout option allows any owner to declare irreconcilable differences. The other owner or owners are afforded the option to either cause the business to be sold or liquidated or, instead, to call for an auction among the owners.

If the business is sold or liquidated, the parties either would have included the manner or method or would agree on it, with any disagreements resolved through arbitration.

The auction alternative would allow the owner declaring irreconcilable differences and the non-declaring owner or owners to bid for the interest of the other or others, with the high bid prevailing. All shares would be sold or purchased, with the business ownership passing to either the owner declaring irreconcilable differences or the other non-declaring owner or owners.

Importantly, too, if the shootout is planned upfront, the process is largely self-executing so that family, friends, business advisors and others really do not meaningfully affect the fairness of the process. A shootout is just that.

The shootout has incentives and disincentives. An owner typically will be hesitant to make a declaration and then to defer to the other owner or owners to decide the method for resolution. The owners may be reluctant to start a shootout if they lack financial ammunition. All or some parties likely would want the business to continue.

Importantly, the auction avoids questions of valuation. No one will likely pay more than what the business is worth or much less than what it could be sold or liquidated for. In practice, the method is quite effective and, if nothing else, motivates a resolution and brings closure.

Honor at Sad Hill

Distrust continued among the trio at Sad Hill. Blondie had given Tuco a fake name for the grave where the gold was buried. Before they separated for a decisive gunfight, Blondie agreed to write the name of the grave where the gold was actually located on a stone. Staring each other down and finally drawing, Angel Eyes is killed by Blondie, and only then did Tuco realize the gun had been unloaded by Blondie the night before.

The gold is recovered from an adjoining grave marked "Unknown." Blondie, still cautious, forces Tuco to put a hangman's noose around his neck and to stand perilously on an unsteady grave marker, riding off with half of the gold. From a distance, Blondie severs the rope with a rifle shot, leaving Tuco alive with his share of the gold but tied up and cursing Blondie.

So, there was honor at Sad Hill. Blondie and Tuco shared the gold, but that grave marker easily could have given way before the rifle shot freed Tuco. Similarly, business owners might well have a sense of honor, but as business relationships deteriorate, the owners move perilously close to an irreversible business breakdown and failure. A buy/sell agreement provides a better option. ■