

BUY-SELL PROVISIONS

If you have a business partner, an important question is what will happen to your ownership interest in the business when you die? Below I will discuss how to address this issue through the use of “buy-sell” provisions.

Who Needs Buy-Sell Provisions?

Buy-sell provisions are often utilized by people who own a business with one or more business partners. The most common situation is where two owners of a business each own one half of the business and the business is operated through either a corporation or a limited liability company. If one of the owners dies, in the absence of a buy-sell provision, the deceased owner’s interest in the company will pass to his or her spouse or other heirs.

The issue is that in this type of example, both of the business partners are working full time for the business and splitting the workload of operating the business. If one of them dies, then the remaining partner will have to carry 100% of the workload. In addition, the surviving partner may not want to have his old partner’s spouse or heirs involved in the company decision making process. For those reasons, and many others, business owners decide to use buy-sell provisions to allow them to buy out their business partner upon the death of the partner.

How Do Buy-Sell Provisions Work?

In a limited liability company or corporation, buy-sell provisions are found in the organizational documents. In a corporation, the most common place to find these provisions is in the shareholders agreement. A shareholders agreement is a separate agreement between the shareholders of a company that governs issues such as the transfer of shares by any of the shareholders. It will most often state that any shareholder cannot sell his/her shares without the consent of all the other shareholders. In addition, the shareholders agreement will address what happens to the shares of any shareholder upon the shareholder’s death. In a limited liability company, these types of provisions are found in the operating agreement.

The most important question is when are the buy-sell provisions triggered? The death of a shareholder is usually the main triggering event. In addition, the provisions can be triggered upon other events such as a shareholder’s disability, bankruptcy or if the shareholder is no longer an employee of the business. The reason for these trigger points is to provide for the shareholder’s interest to be cashed-out in the event that he or she is no longer able to commit his or her full time and attention to running the business.

Owners can decide to use some or all of these events as triggering events for the buy-sell provisions.

Once one of these triggering event occurs then the buy-sell provisions govern how that owner's shares are sold or continue to be held by his or her heirs. If a shareholder dies, then the deceased shareholder's heirs may not be able to gain ownership of the shares. Instead, there is a process put in place in the buy-sell provisions whereby the company will have a right to purchase the shares. If they are not bought by the company, then the remaining shareholders, if any, will typically have the right to buy the shares.

If both the company and the remaining shareholders do not want to buy the shares, the heirs of the deceased shareholder can continue to own the shares. However, usually the heirs of the deceased owner will not be able to use the deceased shareholder's voting rights to influence how the business is operated. Instead, they would be limited to passive ownership rights, that is only being able to receive their share of the profits of the company.

As the process described above indicates, the purchase of the deceased shareholder's interest need not be mandatory. The shareholders and the company have a right, but not a duty, to purchase the shares of the deceased shareholder. If the company and shareholders are unable or unwilling to purchase the ownerships interest, the heirs of the deceased shareholder can continue to own that interest, subject to the limitation mentioned above.

Funding the Purchase and Valuation Issues:

Funding the sale often plays an important part in these types of transactions. The reason the purchase of the deceased shareholders interest is optional is because the company and shareholders may not have enough money to fund the purchase of the interest. If the company's value is not too great, then the purchase can usually be funded through existing cash or life insurance. For example, if a company is worth \$2 million and has two owners that each own one half of the company, the company can buy a \$1 million life insurance policy fairly easily on each owner. When one owner dies, the company has \$1 million in cash to pay the heirs of the deceased for the value of his or her one half ownership interest in the company, leaving the company owned 100% by the surviving shareholder.

Problems arise, however, when the company is more valuable and life insurance alone cannot fund a buy out. For example, if a company that has two owners that own one half of a business worth \$10 million, upon the death of one owner, the company or remaining shareholder now has to pay \$5 million to fund a buy out. Since it may be difficult to get life insurance for that amount, there may not be enough cash in the company or in the surviving shareholder's bank account to pay such a large sum.

Consequently, the buy-sell provision will often allow the purchaser to pay the heirs part of the purchase price as a down payment with the balance paid over time.

Another important issue to address in the buy-sell provision is how to determine the value of the business. Upon the death of a shareholder, the value of the business needs to be determined in order to calculate the purchase price for the decedent's ownership interest. One way to address that is to have the shareholders agree on a value of the company each year. If the shareholders can agree on a value and actually perform this task each year, then this is an easy and inexpensive way to determine the value.

Another way to determine the value is through an appraisal process. In most buy-sell provisions, the company picks an appraiser and so do the heirs of the deceased shareholder. Once the two appraisals are completed, if they are close enough in value (within 20% or so), then the value of the company becomes the average of the two appraisals. If the two appraisals are widely divergent, then a neutral third appraisal can be done and that value will govern. In the context of the bankcard business, the buy-sell provision should call for valuation methods typically utilized in the industry (i.e. a multiple of monthly residual income) to be used in the appraisal process.

Buy-sell provisions are an important part of the documents that govern a company. These types of provisions should be drafted when you start up your company and updated regularly to ensure that they continue to reflect the desires of the owners for the disposition of their ownership interest in the event of an untimely death.

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