



A Professional Corporation

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## RE: Buy-Sell Agreements

Dear Business Owners:

This letter is intended to address the various options you need to consider in preparing a Buy-Sell agreement. The two of you should consider these ideas before we meet to discuss the final details.

In general, the Buy-Sell Agreement is like a Pre-Nuptial Agreement. Things are good between you now, but we want to put on paper what will happen if something goes wrong.

**1. When will the Buy-Sell be triggered?** What events do you want to cause any of you to be forced to sell your shares, or to at least have to offer your shares up for sale? The most common choices are:

A. **Death:** In the event that one of you dies, you probably want the survivor to be forced to buy your interests from your estate. From the deceased owner's perspective, this protects your family from the other owners taking advantage of them by forcing them out for less than fair value or unfairly operating the entity. From the surviving owner's perspective, this forces the survivor's heirs to sell the ownership rather than having to live with them as co-owners.

B. **Disability:** A permanent disability which prevents one of you from carrying on your duties is much like a death from a business point of view. The surviving owner would not want to continue with the disabled owner's guardian or power of attorney as a co-owner.

C. **Desire to Sell:** You could face a situation in which one of you wants out for whatever reason - health, stress, fear of losing what you've built, etc. If one of you wants to sell out and the other does not, what are the rules with regard to the selling owner? It is common to force the selling owner to give an option to the other owners before they can sell the interests in the open market.

D. Divorce/ Bankruptcy: If one of you ends up in a situation where a court has potential jurisdiction over the ownership of your interests, should the Buy-Sell be triggered? It is common to treat such an event like an option granted to the other owner so that they are given the right to prevent having the court allow for an unknown new co-owner.

E. Termination of Employment: If one of you quits working for the business, but doesn't want to sell, should the non-working employee be forced to offer their interests for sale? This is not as bad as wanting to sell out, but they have stopped adding value to the businesses. It is not as excusable as a permanent disability, which is outside of their control. This may not be a big deal because the other partner can compensate by just taking more salary and/or hiring the help needed. This trigger is used in about half of the Buy-Sell Agreements we prepare.

F. Other: Because this is a contractual agreement, you can put in additional triggers. If you wanted to say that wearing green shoes is cause to force one of you to sell out, you have that right. The most common triggers are those listed above, though sometimes we see one based on professional designation. So if a lawyer loses his right to practice law, he would be forced to sell out.

**2. How will the Buy-Sell be triggered?** What actually happens when a trigger occurs? There are three main answers:

A. Forced Sale/Forced Purchase: In the event of Death, you probably want to force the heirs to sell and you probably want to force the survivor to purchase. If you don't force the survivor to purchase, they would have the ability to keep the heirs on as co-owners and the heirs would be subject to the survivor's control as operator of the business. The same thinking could be applied to disability.

B. Forced Option to Sell/ Optional Purchase: In the event of all the other triggering events, you probably want to make the owner causing the trigger to be forced to offer their shares to the other owner and/or the entity itself. However, it wouldn't be right in such circumstances to force the purchase by the remaining owner. For instance, if Indiana outlawed your business, the value would drop dramatically. We don't want to benefit the owner who decided to bail out first.

C. Forced Liquidation: You could agree that if one of you wants to walk away, it causes a forced liquidation of the entity and you split what is left after the liquidation.

**3. How will we value the entity?** This is one of the most difficult questions in any Buy-Sell agreement. There are several approaches:

A. Fair Market Value (FMV) as a Going Concern: This is the value of the business appraised as if it were going to continue in business. This is really what the business is worth just prior to the trigger and should be worth to the survivor, so it is a common approach.

B. FMV in an Orderly Liquidation: This assumes that the business will be shut down and liquidated, even if that will not actually occur. This usually results in a lower value than the previous option.

C. FMV in an Immediate Liquidation: This is the "fire sale" and results in an even lower valuation.

D. Industry Formula: Many industries have a well known formula for the values. For instance, a flower shop is almost always worth 80% of annual sales plus inventory on hand. If we can find a formula for your business, that could be a simple method to value the company.

E. Agreed Upon Formula: You might agree to your own formula based on your experience. Formulas are nice in that you can always tell what the business is valued at and you won't have to hire appraisers to value the business.

F. Book Value: This method simply appraises the business based on the balance sheet. Given the business you are in, I doubt this would result in a fair value.

G. Modified Book Value: Like an agreed upon formula, you can also agree upon a fair modification of book value. You might agree to take book value but to add in a fixed value for contracts or other assets.

H. Agreed Upon Amounts: Another method is to just agree upon the proper value from time to time, usually annually. You can take into account where the industry is headed and all other pertinent factors. This is very common in businesses which are difficult to value and where the value does not vary greatly within a given year.

I. Modification Based on Trigger: Many people decide that the value the departing owner gets should differ based on the type of event. If you decide to walk away, you only get 80% of the price you would have received had you died.

**4. How will the purchase price be paid?** This could be the most important question. We want to come up with a method of payment which completes the purchase without creating a cash flow problem for the remaining owners. Some common method:

A. Insurance: This is the easy answer for death, and sometimes disability. Because they are insurable events, we can purchase insurance and turn it over to the heirs of the deceased owner. Any remaining balance is usually small and will not create a cash flow problem.

B. Installment Sale: The most common approach is to set a payment schedule with interest, usually over 5 to 10 years. You want to pick a payment schedule which can realistically be met by the remaining owners. The payout schedule might differ based on the triggering event. For instance, you might get paid over 5 years for becoming disabled, but paid over 10 years if you walk away.

C. Borrowing Base: You could require the remaining owner to pay over five years, but they have to immediately pay that amount which they would receive by borrowing against the assets up to X% of the appraised value. This probably won't add much in your type of business, but it would for the real estate entity.

D. Installment Sale Modified by Cash Flow: You could put payment deferrals based on the actual cash flow of the business. This is intended to keep the remaining owners out of trouble while making the payments. The problem is that the remaining owners usually have such control over the cash flow that they can manipulate this power, so they must be drafted very carefully.

The Buy-Sell Agreement writes down the rules so that if you or your representatives are not getting along, we have the rules to follow. But remember that you both can always agree to ignore the Buy-Sell Agreement and do whatever you agree to with regard to any particular event.

Please consider these items from both sides of each issue. You don't know if you'll be the owner causing the trigger or if you'll be the remaining owner. Also, please try to think through the various "what ifs" that could occur. You know your business and your situation better than I do, so you are in a better position to think about what might come up. We want to address all those "what ifs" now.

If you give this some thought, we should be able to decide the main details of the agreement at a meeting or perhaps even over the phone. Please call with any comments or questions. Thank you.