

TouchStone Nugget

Partnership Buy-Sell Agreements

What happens to a business when a partner suddenly leaves? Moreover, what happens if a partner unexpectedly dies or becomes disabled? If the remaining partner or partners are not prepared for any of these events, the business could be financially devastated. To ensure that partners are prepared to deal with these disruptive situations, consider creating a buy-sell agreement as a formal part of your business records.

As with all legal documents, an attorney should be involved minimally in a review capacity, if not in fact with its preparation. Potentially, multiple attorneys could be involved to protect the specific interests of their respective client, i.e., each partner.

A buy-sell agreement is a critical component of a partnership. Whenever there is more than one owner in a business, a written buy-sell agreement should be in place. It provides a sensible transition plan if a partner dies, retires or becomes disabled. In most cases, a buy-sell agreement is created amongst all of the partners, although, at times, the interests of certain partners may take precedence over those of others.

For example, when an older partner takes on a much younger partner, the primary focus of the agreement would be on planning for the death, retirement or disability of the older partner. Particular emphasis would be placed on addressing funding issues when one of these events occurs.

Major Events

Obviously, the terms of a buy-sell agreement will vary, depending on the specific circumstances of the partnership, but typical agreements cover the three major event triggers: death, disability and retirement. Each event will require a different funding solution.

Death of a Partner. The death of a partner is always difficult to deal with because of the sudden void created by deceased absence. From a funding standpoint, the event is the least difficult to provide for though life insurance. Partners purchase life insurance on each other. A partner with a very small interest may only need life insurance on the majority partner. The surviving partner(s) can cost-effectively fund the purchase of the deceased partner's business interest through life insurance. Adequate life insurance provides immediate cash flow to the deceased partner's estate. The policy may also supplement cash flow to the business to offset the loss of the partner. It enables partnership interests to be transferred without creating a financial crisis for the business.

Disability or Retirement of a Partner A disability that prevents a partner from actively contributing to the business, either permanently or for an extended time, that partner's interest in the business will become available for purchase by the remaining partner(s).

Similarly, a partner's interest will need to be purchased upon his retirement. A properly structured buy-sell agreement should include provisions for buying out a partner's interests under both situations. For disability buy-out purposes, the agreement should:

- Clearly define the term "permanently disabled."
- State how long the disabling condition must last before the buy-out is triggered.
- Purchase "disability lump-sum insurance" as a funding source.

Disability buy-out insurance differs from regular disability insurance in that it pays a lump-sum benefit when a partner becomes "permanently disabled." Regular Disability coverage provides income to a temporarily disabled partner as a monthly benefit.

For retirement and disability buy-out purposes, the agreement should provide a formula for valuing each partner's interest in the business. How the buy-out will be funded should give particular focus to financing arrangements.

Financing the Buy-Out

Typically, the remaining partners will not have sufficient independent resources to buy-out the retiring or disabled partner's interest. Therefore, when a partner retires or becomes permanently disabled (without insurance), the remaining partners generally must finance the buy-out over a period of years, likely with the seller holding a promissory note for an agreed upon amount. This section of the buy-sell agreement should state the term of the payment period (i.e., five or ten years), payment frequency (i.e., monthly or yearly) and the effective interest rate applied to the unpaid balance.

Buying partners usually rely on the cash flow of the business to cover their buy-out payments. Insufficient cash flow to support the cost of running the business and the buy-out payments may trigger a financial crisis. The selling partner can alleviate a problem with a flexible payment plan, perhaps by extending the payment period or reducing the interest rate. The selling partner will often rely heavily on the buy-out proceeds to facilitate his exit, particularly in a disability situation. Extending payment terms or a lower rate the seller simply transfers the financial crisis from the business to himself. Early planning is the best way to avoid potential funding problems in a buy-out. Here are a few suggestions.

Make sure the buy-sell agreement is flexible to permit the partners to modify financing terms, if necessary, on the retirement of a partner.

Purchase a sufficient amount of life and buy-out disability insurance coverage on each partner (assuming they're insurable at a reasonable cost). If permanent life insurance is part of the buy-sell arrangement, it may be possible to use the accumulated cash-value to partially fund the buy-out obligation upon disability or retirement, although it generally won't provide all of the cash needed.

Purchasing disability buy-out insurance requires language in the agreement that matches the terms and conditions of the policy. Should the policy state that a partner must be disabled for two years before benefits are paid. Be sure to have comparable language in the agreement that defines permanently disabled after two years.

If a new partner will be brought in to replace a retiring partner, then begin looking for that new partner several years ahead of the anticipated retirement date. The agreement should outline conditions and criteria that a new partner should satisfy to be consider as a buy-in applicant

Appraisal or Business Valuations

A major component of a buy-sell agreement concerns a determination of the business' value. One key discussion should focus on the scope of the process to determine the value of the business. If the business is comprised primarily of personal property and real property (tangible assets), in addition to the cash flow from the business, certainly an appraisal of the business is appropriate including a business valuation. Possibly with some service oriented businesses, with minimal tangible assets, a business valuation alone may be sufficient to establish the agreed upon worth or value of the business.

The valuation formula or methodology to be used will also be an important consideration and should be specified in the agreement. There are multiple approaches and multiple methods within each approach to be considered. The formula or method used may vary depending on the dynamics of each business. If the partnership owns the physical property on which the business is situated, then it may be a good idea to have that property owned by a separate entity. The property could then be leased to the partnership, which operates the business. A separate buy-sell agreement or clause in the primary agreement would be needed to deal solely with the real estate.

Pre-determine Initial Value. Although the parties can include a value in the initial agreement, that value is typically updated each year to account for changes in performance that would affect the value of the business. A drawback to this method is that the parties may have to spend a great deal of time agreeing on the upfront value as well as agreeing to annual adjustments in value.

Book Value. A company's book value is the net difference between total assets and total liabilities or total equity. A problem with this approach is that book value does not account for a company's earning potential. In addition, it only reflects the original cost of the company's assets, less any depreciation.

Earnings Multiple. This method attempts to value the company in a manner similar to the approach by a potential buyer. While it is a much better reflection of ongoing value than book value, the approach may not be appropriate for certain types of companies, such as a start-up with high initial costs that result in low initial earnings.

Appraisal. Under this approach, an independent appraiser determines the fair market value of the interests held or being repurchased. The advantage of this methodology is that the shareholders do not need to negotiate a value up front, but rather allow an independent third party to determine the value. As noted above, an appraisal is most appropriate when significant tangible assets are held by the business. The buy-sell agreement should specify how the appraiser would be selected, who will pay for the appraisal. The agreement should specify if any discount should be applied or reflected in the valuation method for stock held or repurchased. Such discounts are applied for lack of marketability (a non-public company) or a discount applied to a minority shareholder interest.

Because there are multiple valuation methods, an important aspect of this provision in the buy-sell agreement will be the recognition of state law regarding the Court's preferred approach to valuing a business. With state legal precedence in mind, there should be no surprises should the matter of a business valuation become an issue in a Court of Law.

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