BEGINNING THE END THE RIGHT WAY: EQUITY BUYOUT AGREEMENTS

Every story has a beginning and an end. So too, do the relationships of owners in closely held businesses. When a business is organized or expands ownership ranks, the owners need to consider what will be done when the relationship has run its course and it becomes necessary or desirable for the company and/or the owners remaining with the company ("Buying Owners" or "BOs") to buy out a member of the ownership team (a "Selling Owner" or "SO"). There are several basic questions to address and, when those questions are answered, to document -- (i) What sort of events should trigger a buyout? (ii) When should such buyout be mandatory (and if so, for whom?) or optional? (iii) How should the buyout price be determined? and (iv) How should buyout funds be obtained?

Triggering Events. A change in ownership status may be dictated by (i) 'life' events such as an SO's death, disability, divorce or conventional retirement, (ii) an SO's wish to "cash-out" all or a portion of the SO's interest or (iii) disagreements among the ownership team. When an SO leaves the company in a 'life' event situation, companies will usually not want to have estate executors, ex-spouses or family members succeeding to SO interests and able to access company records or vote on company affairs. In other cases, SOs simply wish to monetize all or a portion of their interests and use the sale proceeds for personal purposes such as retirement, children's education or investing in other ventures. In such situations, companies will not want interests falling into the hands of competitors or other potentially hostile persons. Finally, when involuntary termination or business disagreement is involved, it can get especially thorny. In light of the usually strong feelings (and occasional litigation) associated with these hostile situations, the company or the BOs will probably want to reclaim the interests and not deal with someone motivated by a desire for retribution. Anticipated third party interest in purchasing the company may call for some variation of these techniques.

Mandatory vs Optional. Three basic mandatory purchase techniques are (i) company (or BO) 'call' or right to purchase, and corresponding requirement of the SO to sell; on occasion, this is embodied in a so-called 'right of first refusal' or ability to buy if there is a desire to sell to a third party; (ii) SO 'put' or right to require the company (or BO(s)) to buy; and (c) mutual commitment to buy and sell under specified circumstances. Of course, parties are always free to negotiate voluntary deals in accordance with individual needs and preferences. With many of the events described in this article, it is highly unlikely that the parties can come to terms on a voluntary transaction. Typically, some sort of mandatory transaction is called for in cases where animosity is likely, such as a divorce or involuntary termination. That is, a company will want to be able to force a repurchase of interest from a terminated employee or one going through a divorce involving potential transfer of the interest pursuant to a decree or settlement. SOs not leaving on their own terms will often want to require a buyout.

Price Determination. Again, while parties are always free to negotiate a price, the likelihood of acrimony trumping rationality in an exit situation, makes it essential that a default mechanism be prescribed in advance. For unvested interests, the buyback price is usually de minimis. For vested interests, such mechanisms consist of an appraisal by an

objective third party or a formula based upon what is reasonable in the particular industry. All concerned should be mindful of tax consequences. If an appraisal is desired, parties need to specify how the independent appraiser(s) are determined and paid and required background. A specific firm can be identified in the original agreement. Buyout formulae can be based on multiples or percentage of sales or earnings/cash flow (EBITDA) for one or a number of years, balance sheet book value, or simply a dollar amount per percentage point, or a combination of metrics.

A minority interest in a closely-held business is almost always highly illiquid and, consequently, subject to a discount to its 'inherent' value. Accordingly, prudent employee-owners will often want a commitment to have their interests purchased at a fairly determined price in the event of an involuntary termination. A similar discount would likely apply in connection with a normal retirement although the company may not have the same motivation as it would with a termination. Companies will often bargain for a further discount in the event of a termination for cause.

Source of Funds. Unless companies and BOs are likely to keep cash on hand for buyouts, business owners should prescribe a method to fund buyouts. For buyouts upon death, term or whole life insurance owned by the company is often quite helpful. Some companies maintain a standby line of credit to fund buyouts. In other cases, subject to tax considerations, companies may periodically put aside funds out of earnings to cover anticipated buyout obligations.

Our corporate partners are pleased to work with you to determine which techniques make the most sense now and as your business grows.

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