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Best in Law: Does Your Business Need a 'Prenup?'

BB&K Partner D. Brian Reider Writes in *The Press-Enterprise* How These Agreements Can Impact How a Business Relationship Ends: Smoothly or Contentiously

By D. Brian Reider

You are likely familiar with the news stories of this celebrity or that being involved in divorce proceedings where the language of a "prenup" is of great importance. You probably also know that the term is short for "prenuptial," and refers to a contract entered into before marriage, with the intention that it govern who owns what assets, and how they will be divided upon divorce.

But have you considered that, on much the same reasoning, business owners should also have their own form of a "prenup"?

In fact, anytime two or more people come together to form a business, be it a partnership, limited liability company or a corporation, they are in effect "getting married," and should also be thinking of having an agreement that will govern when the time comes for one or more of them to no longer be involved in the business.
Typically called a "buy-sell agreement," or just a "buy-sell," such agreements are often the difference between a business relationship ending smoothly, or ending in contentious and expensive litigation.

While their exact details will vary depending on the circumstances of a particular business relationship, almost every buy-sell involves the same general questions. First, what future events will trigger the provisions of the buy-sell? Most commonly, these will include at least the death, disability, divorce, bankruptcy, retirement or withdrawal of an owner. Whenever any of the trigger events occur, a process starts that gives either, or both, the company and the other owners the right to buy part or all of the ownership interest of the withdrawing owner.

Second, the buy-sell governs what the withdrawing owner (or their heirs) will be paid for their ownership interest. Again, multiple methods can be used. Some owners like to meet annually and agree upon the value of the company, and

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therefore the value of their ownership interests. Others prefer to apply preset accounting formulas and protocols, such as book value, liquidation value or discounted cash flow formulas. Still others also look to apply minority or marketability discounts. These are discounts which may reduce the value of an ownership interest because it is not a controlling interest or because, for some other reason, a buyer would not pay full price for the interest. There are also those who prefer to have one or more neutral business appraisers set the value at the time the trigger event occurs.

Regardless of the method used for valuation, once the value is set, then the questions are: who buys the interest, and is the purchase mandatory or optional? The variations include the business itself buying back the interest (if it legally can), or for the other owner or owners to buy the interest. There may also be the possibility of only a part of the withdrawing owner's interest being purchased.

Depending on the value of the withdrawing owner's interest, another vexing problem can often be to decide how the purchase is to be funded. Here, there are most commonly three approaches. The easiest is an outright cash purchase, but that is often not practical because of the amount involved. In many cases, the owners agree to pay for the withdrawing owner's interest by financing it with a down payment, and then installment payments being made over a fixed number of years. Finally, where the parties are insurable, life insurance can be purchased by either the company or the owners that will fund the purchase, at least on the death of the withdrawing owner (but this leaves many scenarios where such life insurance would not be available).

When a trigger event occurs, if all of the processes have been agreed to in advance, the buy-sell can then be mechanically applied to accomplish the buyout in an orderly fashion. The business can continue without interruption and excessively negative cash-flow consequences. The discussions about a buy-sell can be difficult, and absolutely need the involvement of competent counsel, an accountant and perhaps other financial advisers.

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