Making the Breakup Much Easier

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Aaron Lee Fineman for The New York Times
HAPPY OUTCOME Steve Hindy of the Brooklyn Brewery had the option of buying out his partner when the partner decided to leave.

MICHAEL AYOUB was an experienced chef and restaurateur when a Brooklyn business owner enlisted his help in 1988 to turn around a struggling catering company. In exchange for his sweat equity, Mr. Ayoub would acquire a one-third interest and be an equal partner with the founder and his daughter.
The next 10 years were a “lovefest,” Mr. Ayoub said, during which they opened two successful restaurants in Park Slope. But as competition intensified, the partners disagreed about strategies. Father and daughter ousted Mr. Ayoub in 2001.

When he tried to cash out, they argued that the business had hit hard times and wasn’t worth anything. (Both restaurants have since closed.) Mr. Ayoub, 51, who now owns Fornino, an upscale pizzeria in the Williamsburg section of Brooklyn, said he walked away from the feud with just enough to pay his lawyer.

Such tangles and many others can be avoided with a buy-sell agreement — basically a business prenup or a postnup, depending on when owners draw it up. In a buy-sell, partners (the process is the same for corporations and limited liability companies) decide what will happen to their interest in the company if events like death, divorce and personal bankruptcy occur.

A buy-sell can prevent an assortment of evils, like becoming unwilling partners with an owner’s heirs, or leaving a surviving spouse illiquid because the remaining owners refuse to buy the survivor’s inherited shares. By requiring a sale under certain circumstances, known as trigger events, and specifying the terms beforehand, the buy-sell avoids conflict and protects everyone, said Louis A. Mezzullo, author of “An Estate Planner’s Guide to Buy-Sell Agreements for the Closely Held Business.”

The best time to arrange the details, which can require 20 pages or more, is before you begin a venture, said Robert E. Gregg, a lawyer with Squire, Sanders & Dempsey in Tysons Corner, Va. Still, Mr. Gregg, who has worked with many start-ups, said there was generally no harm in waiting six months or so until you’re sure the business is workable. Either way, there are issues to sort out.

What events should you include? While some, like leaving the company, starting a competing business or offering shares to an outsider may seem obvious, others could require considerable soul-searching. For example, if a founding partner retires, the remaining owners may feel torn between a desire to reward past work and not wanting that person to get a free ride while they keep pouring themselves into the company.

Who can — or must — buy the business interest when one party wants out? In what’s called a cross-purchase agreement, the option or obligation belongs to the remaining owners. Alternatively, you can use a redemption agreement, which designates the company as the buyer. A hybrid approach typically gives an owner the right of first refusal, with the company next in line if the owner doesn’t exercise it.

When owners’ interests are divided unequally — say, one is a majority shareholder — you may also want to incorporate what’s known as a tag-along provision. Then, if a 90 percent owner sells to Microsoft, for example, the deal must include the 10 percent shareholder too.

The co-founders of the Brooklyn Brewery, also in Williamsburg, relied on their cross-purchase agreement when one of them, Tom Potter, 52, sold 50 percent of the voting stock in 2003 for an undisclosed sum and went to work for a nonprofit. Steve Hindy, 59, the other owner, who held the remaining voting stock, had the option to buy out Mr. Potter. But he chose not to do so because he approved of the buyer: David Ottaway, a longtime friend and one of the first investors in the company when it started in 1988.

How can you value the interests being sold? There are many ways to approach this. If you name a set amount, you’ll need to update it annually to reflect changes in the company, the industry or the economy, said Samuel A. Donaldson, a professor at the University of Washington School of Law in Seattle. A more practical solution is to describe a process for determining the value, whether it is according to a formula or through an appraisal of the company’s fair market value.

It is also possible to vary the purchase price depending on the triggering event, said Charles A. Redd, a lawyer with Sonnenschein Nath & Rosenthal in St. Louis. For instance, you might make it just a fraction of the fair market value when an owner defects to another company, but 100 percent of that value when an owner dies.

What are the payment terms and financing? A lump-sum payout is often associated with life insurance that is used to finance a buyout when an owner dies, Mr. Redd said. You’ll need fewer policies if the company buys a policy for every owner, rather than if they insure one another individually, he said. The alternative is an installment sale, with payments plus interest over a defined period. These arrangements are common in buyouts where the owners don’t anticipate a ready source of cash, which could happen if one owner gets divorced or wants to quit the business, Professor Donaldson said. The legal bill to prepare a buy-sell agreement can cost $2,500 to $15,000, depending on complexity. If your budget is tight, you can rely on the free buy-sell agreement that many life insurance companies offer policy buyers, but it will probably cover only an owner’s death, not other trigger events.

You may be able to save by using a self-help book like “Business Buyout Agreements: A Step-by-Step Guide for Co-Owners,” by Bethany Laurence and Anthony Mancuso, and asking your lawyer to review your draft.

Whatever the price tag, a buy-sell agreement affords peace of mind that some people think money can’t buy. As Mr. Potter, formerly of Brooklyn Brewery, put it in an e-mail message: “Having the ultimate dispute resolution available in case of irreconcilable differences not only keeps you from coming to blows, but makes it less likely that you feel the need to split up in the first place.”

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