BUY-SELL AGREEMENTS

for Closely Held and Family Business Owners

by Z. Christopher Mercer, ASA, CFA, ABAR

CHECKLIST FOR SHAREHOLDER PROMISSORY NOTES

Checklist for Shareholder Promissory Notes in Buy-Sell Agreements

Potential Areas for Agreement	Comment	Company Perspectives	Selling Shareholder Perspectives
Term of Note	Typical terms range from two years on the low side to as many as ten years.	Longer terms tend to be preferable to assure flexibility and ability to pay with least impact on the business.	Shorter terms tend to be preferable in order to complete transaction and eliminate credit exposure to the company.
Form of Note	The form of the note can range from interest-only, to amortizing over the term with equal payments, to equal payments of principal each year (or quarter or month), together with interest.	Interest-only provides the most flexibility to companies and defers payment as long as possible.	Amortizing notes - equal stream of payments Equal payments of principal each period - declining stream of payments Interest-only is riskiest and defers payment of principal to maturity. If credit exposure is not an issue, longer deferral of principal payments extends payment of capital gains with installment sale treatment of the note.
Down Payment	The down payment can range from nothing down, to a set percentage of the total price at closing, to requiring that the first payment of an amortizing note be paid at closing.	Low down payments provide the greatest flexibility to companies.	Larger down payments provide current liquidity for selling shareholders and minimize future risk of credit exposure to the company.
Payment Schedule	Payment schedules can range from monthly to quarterly to annually.	Monthly payments are generally considered to be too frequent by most companies. Annual payments provide the greatest flexibility.	Sellers often prefer monthly payments for predictability, but will often agree on quarterly payments.
Interest Rate: Level	The interest rate on the loan is an important element and requires careful consideration. The manner in which the interest rate is set should be clearly stated in terms that will be clear in the future.	Companies tend to desire a relatively low interest rate to minimize cash flow requirements.	Sellers need to have a reasonable (market) rate to assure a risk-adjusted return on the note while awaiting repayment of principal. Below market rates reduce the present value of the purchase price.
Interest Rate: Floating or Fixed	Depends on company and shareholder tolerance to interest rate exposure during term of notes. With a floating rate and a regular amortization, the amortization schedule must be recalculated as rates change. If the rate is based on the *Wall Street Journal* prime rate as of, say, the trigger date, the agreement must be clear if the rate is fixed at that level or repriced periodically. Unclear language creates big problems.	Many companies will tend to desire to fix the interest rate to eliminate exposure to rising rates over the term of notes.	Sellers need to consider the risk of interest rate exposure with floating rates relative to the consistency assured by fixed rate notes.

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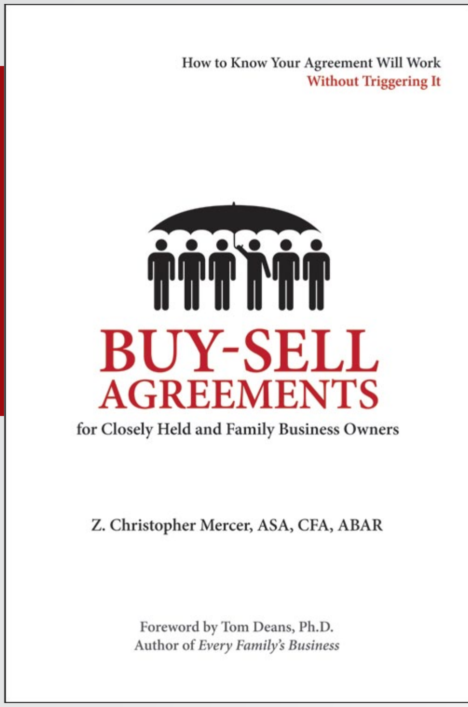
Priority in Company's Capital Structure	Must specify position in capital structure. If this element is not specified, it will likely assure that shareholder notes are effectively subordinated debt, i.e., subordinated to all other lenders and other creditors.	Companies tend to want notes to be unsecured and at the bottom of the capital structure. A shareholder note without other protections or security is favorable financing and tantamount to subordinated debt.	Many agreements give no thought of subordination to other creditors. If a seller note is effectively subordinated to all other creditors, then the interest rate should reflect its relative risk in relationship to other borrowings. The effect of an inadequate interest rate relative to risk is to devalue the note relative to its par value. Sellers may desire that future incremental financings be subordinated to their notes or else company will need to pre-pay.
Security	The question for consideration is whether the shareholder note will be secured in any fashion by the general assets of the company, by specific assets owned by the company, or by stock in the company.	Companies tend to prefer that shareholder notes not be secured. Having them unsecured provides maximum flexibility for future financings.	Sellers will want to have security for their notes. At the very least, the shares that have been sold can be the security. Since remaining shareholders benefit from the company's purchase of shares under the agreement, a portion of their shares could be held as collateral. Certainly, shareholders desire to be assured that future financings of the company will be subordinated to their debt.
Prepayment: Right or Obligation	Prepayment can be an issue under a number of circumstances and is one that should be covered in buy-sell agreements.	A company may desire the right to prepay a note to assure flexibility regarding cash flow and future financings. Companies prefer that there be no prepayment penalty.	Prepayment can be beneficial to sellers in that they achieve liquidity earlier than planned. However, if the prepayment terminates a note with an attractive interest rate (relatively high) and the rate cannot be replaced in the markets, prepayment may be unfavorable. Sellers will want mandatory prepayment if the company is sold or engages in a substantial recapitalization that could jeopardize a note's creditworthiness.
Events of Default / Rights of Holder / Ability of Company to Cure	Surprisingly, many buy-sell agreements do not discuss events of default regarding shareholder notes at all.	If events of default, such as the failure to make a payment, are considered, the company will want the right to cure the default within a short period of time.	In the event of default not timely cured, sellers may want the ability to accelerate the note such that it is due in full.
Other Terms per Counsel	As recommended and agreed to by owners and the company.		



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