BUY-SELL AGREEMENTS ARE A PRESCRIPTION FOR CONTINUED BUSINESS HEALTH

Successful co-business owners usually have business plans that set out a road map for continued successful business operations. However, such road maps often do not address how to continue the business in the face of disasters such as the death, disability, divorce, or bankruptcy of one of the co-business owners. In the same way that good fences make good neighbors, a good disaster plan makes it more likely that the business will survive and also serves the interests of all co-business owners. It does not matter whether the business is established as an informal partnership, a corporation, a limited liability company, or any other type of entity. A buy-sell agreement is an important part of any business plan.

Buy-sell agreements should be structured to achieve both the business and personal/estate planning objectives of the owners. On the business side of things, buy-sell agreements will provide for the continuing control of the business by one or more of the owners and set a price for the buy-out. If one owner dies and the business interest is inherited by a surviving spouse, the new co-business owners may find that their interests have become adverse. The surviving spouse may favor the distribution of all business profits and be unwilling to contribute additional equity to support expansion. This tension could develop exactly when the business needs to retain funds in order to hire one or more employees to replace the efforts of the deceased owner.

From a personal/estate planning point of view, a buy-sell agreement can be used to provide some liquidity for the owner's estate. Under many circumstances, the price established under the buy-sell agreement can be used to determine the estate tax value of a deceased owner's interest in the business. This can avoid lengthy and expensive disputes with the IRS regarding the estate tax due on closely held business interests. A buy-sell agreement can also cover the disability of an owner as well as establishing procedures if one of the owners desires to retire or leave the business.

Because valuation of closely held businesses is so difficult, buy-sell agreements often provide a specific mechanism or formula. Some agreements provide that the owners will agree to a pre-determined price that approximates fair market value on an annual basis. Unfortunately, with the press of other business matters it is all too easy to neglect that annual process. Another method is to provide a formula such as multiplying net earnings by an appropriate factor. Such a formula might take into consideration net earnings for the past five years weighted toward the most recent years times a factor of 7.5 to establish a value. Book value or net asset value can also be considered in the formula. A pure book value or net asset value approach may misstate the value particularly after the business has been in existence for a significant period of time.

Another popular approach is to provide for an independent professional appraisal under particular guidelines or rules set forth in the buy-sell agreement. While this approach provides an up to date valuation, it is sometimes expensive and time consuming to implement.

There is no right formula or mechanism for all situations and this is something that needs to be carefully considered by the co-owners. Buy-sell agreements may be in place for many years before they are applied and the formula should be periodically reviewed to make sure that it will still yield a fair and reasonable result.

Another important issue in buy-sell agreements is funding. The agreement will do no one any good if the purchaser is not able to finance the purchase. In some cases, a buy-sell agreement will provide for payment over time. In other cases, life insurance or disability insurance is used to fund the agreement.

Still another use for a buy-sell agreement is when minority owners depart and cease employment with the business. Often times the remaining owners will not want a minority interest owner reviewing management and financial decisions particularly if that person has now gone to work for a competitor. Even minority share owners will generally have reasonable access to the financial records of the business.

Buy-sell agreements are flexible enough to be structured to meet the needs of almost any business arrangement. Unfortunately, some co-business owners ignore this essential part of a business plan in hopes that their co-owners "will do the right thing" whatever happens. However, different business financial and personal interests under various circumstances may lead to definitional problems with "the right thing." It is a better prescription for continued business health to set out the road map and ground rules before the disaster occurs.