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Buy and Sell Agreements

Many businesses, especially partnerships and corporations with a small number of shareholders, use contractual arrangements to control what happens if one owner dies or becomes disabled, wants to sell his/her interest or to handle a situation where the owners wish to go separate ways.

This article describes some of the issues associated with this type of arrangement, called a buy/sell agreement. If your business has multiple owners, you may want to consult an attorney and have an agreement drafted.

Generally, a buy/sell agreement can be used to prevent the disruption of the business when there is a forced change in ownership. It can be used to identify how ownership can pass, how the business should be valued and may even include details on how the funding of a buyout may be established. Three of the main benefits of having a buy/sell agreement in place are:

- It can provide for the stable continuance of the business.
- It can provide a valuation process.
- It can help solve estate-planning issues for the owners.

Continuance of the business
When a major owner of a business dies, becomes disabled or retires, having a plan in place can avoid the chaos often found in such a situation. A buy/sell agreement may provide for the remaining owner(s) to buy the departing owner's interest. It could also provide for the business (if a corporation) to buy back the ownership, or it could provide for the ownership to be sold outright. Imagine the situation where a partner dies and all of a sudden one of his children decides to start taking an active role in the business with very little training or experience. Having an agreement in place can prevent this potential disaster.

Valuation
Most small businesses are hard to value. Without the presence of a major owner, they can be even more difficult to value. Many buy/sell agreements include some form of valuation model that can be used as part of the process of passing ownership. It may be a flat dollar value, some multiple of earnings or cash flow, an appraisal method to be used or some other formula driven method. Buy/sell agreements can also be drafted to create a situation where the value is based what one owner is willing to pay the other owner for his interest. In such an arrangement, Partner A could offer to buyout the Partner B for $XX. Either Partner B accepts the offer of $XX or must sell his interest to Partner A for the same $XX.

Estate planning issues

Many business owners face difficulty in creating effective estate plans. Three of the issues that cause the most difficulty are what happens to the owner's ownership interest in the business, how the interest should be valued for estate tax purposes and if there funds available to pay any estate taxes that may be due. A contractual buy/sell agreement can set the rules for the transfer of interest in the business. If the agreement has a valuation method included, that method may become the basis for valuing the business for estate purposes. The IRS doesn't have to accept the valuation method, but often does if the method is reasonable. Finally, if there is a sale process set out in the buy/sell agreement, that process may also include details on the new owner paying for the interest and therefore providing money to pay any estate tax that may be due.

Summary

If your business has multiple owners, you should probably have some form of contractual buy/sell agreement in place. Being prepared for the unexpected is good business. The process of creating the agreement will also probably result in the owners having frank discussions about the future of the business and that too is good business. Given the permanent nature and importance of a buy/sell agreement, using a qualified attorney is also a good idea.