

Does Your Business Have A Buy-Sell Agreement?

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One of the most important documents every business with multiple owners should have is a buy-sell agreement. In a corporation, this will be a separate agreement; in a partnership or LLC, it will normally be a part of the partnership or operating agreement.

A buy-sell agreement is a legal document whose purpose is to control who can buy an owner's interest, when they can buy it, and what the terms of payment and price will be.

The transition of an owner's interest in a business will happen upon the occurrence of any one of several "triggering" events. The most common "triggering events" include the death, disability, or retirement of one of the owners. Other events could include a voluntary or forced termination of an owner's involvement with the business such as through a divorce or bankruptcy involving one of the owners.

Often, a business will try to protect or fund for these events through the use of insurance policies. The scope of this article, however, is intended to only review what a buy-sell agreement is and not get into the details of funding mechanisms.

The provisions of the agreement generally handle the transfer in one of two ways. The agreement can be a cross purchase type of arrangement or it can be an entity purchase arrangement.

In a **cross purchase agreement**, the other owners agree to buy the departing owner's interest. This type of arrangement **works best if the number of owners is very small**. In an **entity purchase agreement**, the corporation, partnership, or LLC redeems the owner's interest. This type of arrangement **works well if there are a larger number of owners**.

One of the primary purposes of a buy-sell agreement is to control who can be an owner of a departing owner's interest in a business. In a cross purchase agreement, it will be one or all of the other owners who will buy the interest. In an entity purchase type, the end result is essentially the same except that the outgoing owner's interest is retired by the business leaving the remaining owners owning all of the business. *There may be different tax consequences to the departing owner as well as the business but this is considered to be outside the intended scope of this article. Feel free to contact us if you would like more details on this.*

Other control features include limitations on transfers of owner interests. The agreement will contain provisions restricting transfers of owner interests to outside parties such as family members and unrelated third parties. The provisions for transfers to family members are typically more liberal than transfers to



strangers. In order to give a departing owner some ability to get a fair value for his or her interest, a provision called a “**right of first refusal**” is often included which allows the departing owner to seek out other interested parties to purchase the interest but still gives the remaining owners the right to purchase the interest at the same price and terms as an outsider would be willing to pay.

The final aspect of a buy-sell agreement is **agreeing on the method to be used to value the business**. By coming to agreement on a specific way to value the business in advance, the owners will avoid considerable turmoil that is possible when a triggering event happens and the owners find out that there are many different approaches to valuation that can yield significantly different prices for the business. Examples of methods used to value a business are:

1. **Fixed price** – The parties agree to a price in advance. Very often this is an annually set price that is agreed to by all parties and a signed addendum to the buy-sell agreement is prepared each year. One of the problems that occurs with this approach is that the shareholders will forget to do this annual update and suddenly a triggering event happens and the latest agreed upon value is several years old and not relevant anymore.
2. **Formula** - In this approach, the owners come up with a formula such as, for example, one times revenues, five times earnings, or two times book value. This has the advantage of being easy but it is unlikely that a formula will be an accurate reflection of the value of the business through time.
3. **Appraised value** – If this method is adopted, the owners agree to have a formal business appraisal performed and use this value for the transition of the owner's interest. The appraisal can be done annually or less frequently for a smaller business. If done less frequently, the business may want to have a provision stating that a valuation will be done as of the end of the month preceding a triggering event. This process can be a single appraisal whereby the parties agree that the value determined by a designated qualified appraiser is binding. It can also be a multiple appraiser process where both the buying and selling parties get an appraisal done. In this process there needs to be some sort of reconciling provision to deal with the potential disparity between opposing valuers. For example, the appraisals could be averaged as long as the two valuations are within 10% of each other or a third valuator could be hired to render a determinative value or pick one of the original two appraised values.

Once the above issues have been resolved, the terms of payment should be agreed upon. The agreement can state that the price can be paid in a lump sum, over time based on a set number of years and interest rate, or perhaps even paid from some type of insurance proceeds as in the case of death or disability.

Since a buy-sell agreement is a formal legal document, it makes sense to plan this out properly with the advice of your business advisors. When the time is right, we would be happy to meet with you and your attorney to plan out what would be the best course of action for you and your business.