Why You Need A BUY-SELL AGREEMENT

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A buy-sell agreement is a "must-have" anytime a person goes in on a business with a partner. Failing to have one means failing to protect your family and yourself.

(1) Fallout From Not Having a Buy-Sell Agreement

Failure to have a buy-sell agreement can lead to one of any number of unpleasant outcomes. If your partner passes away before you, the new co-owner of the business will very likely be their spouse or child. It is probable this is not something you would have agreed to had you thought about it. If you and your old partner were equal decision makers, the new kid also gets equal input on the direction of the business. And, if you think you are safe because you still have control of the business no matter whom your partner is, you should know that minority shareholders bring their own headaches and legal problems.

All of this is bad, but it can get worse if you die first. Without a buy-sell agreement, there is no guarantee that your former partner will treat your family fairly. Your partner could buy your part of the business for far less than it is worth at a time when your family may need the money. This is especially true when most of your net-worth is wrapped up in the business, and your spouse and kids desperately need the cash, not the business. Worse still, though, is maybe your partner doesn't buy your family out at a discount, maybe he doesn't buy them out at all. If you have a minority interest, your partner could leave your family with an asset over which they have no control. The partner continues to run the business and draw a salary, but makes sure that no dividends are paid out and that the company never buys back your shares or units. Of course, you may be thinking that your partner is a good person and would never do that, but consider: there are a lot of lawsuits out there between co-owners, and no one ever went into business with an enemy.

(2) How Does a Buy-Sell Agreement Work?

A buy-sell agreement is essentially an "if-then" statement. If a certain condition occurs, then the buy-sell agreement is "triggered" and one is forced to buy another owner out, or phrased another way, one owner is forced to sell to the other. Different ways of saying the same thing: one owner has to buy and one has to sell.

(3) The Three Goals of a Buy-Sell Agreement

You will be doing well by your buy-sell agreement, and thus yourself, if you keep these three objectives in mind:

- One, you want it structured so no one gets stuck with a partner they do not want . . .
- Two, you want everyone to get their fair share at the end of the day . . .
- Three, you want to keep the courts out of the issue . . .

(4) When Should the Buy-Sell Take Effect?

The triggering conditions are very important and should be carefully thought out. Again, these conditions "cause" the buy-sell to take effect. These conditions can be anything a person can think of, but there are some usual suspects that should appear in every buy-sell.

- Death: The remaining partner is required to buy the deceased partner's shares. This way, the deceased partner's family receives the sale proceeds and the remaining partner does not have to enter into a business with the family.

- Disability: With most closely-held businesses, owners earn money not through dividend payments but a salary. If an owner ever becomes disabled and is no longer able to work, then he or she is also no longer able to draw a salary. This can be devastating for both the owner and the family. With a buy-sell, the owner is ensured payment for the value of his part of the business.

- Divorce: This prevents the scenario, admittedly rare, in which a divorcing spouse receives part of a business to the chagrin of the other owner.

- Disagreement: Occasionally, owners that previously got along swimmingly can become dead locked, hurting the business and requiring court intervention in the absence of a buy-sell. By forcing a sale during an irreconcilable disagreement, a court that may dissolve the business does not have to get involved.

- Bankruptcy: This protects the remaining partners from losing the business during another partner's bankruptcy, when creditors are circling and desperate.

There are more trigger conditions, naturally, but if you include these, your buy-sell will be off to a good start.

(5) How is the Value of Your Business Determined?

Equally as important as the conditions triggering the buy-sell is how the value of the business is to be decided. The goal, again, no matter the exiting partner and the remaining partner, is that everyone receives their fair share; no owner pays too much or receives too little. As a practice point, most owners like to think of book value, or assets minus liabilities, as the value of the business, and this is almost never the case.

There are many different ways to determine the value to be used in the buy-sell agreement. There is the "fixed-price" method, in which the owners come together and agree on the value of the business for the purpose of the buy-sell agreement. This is perhaps the easiest to do, but it is likely to be the most inaccurate and not in-tune with the actual value of the business. Furthermore, it is often years out of date because the owners never return to reevaluate the value of the business, though they should.

A "formula agreement" may also be used. Intuitively enough, a formula is used to determine the value at the time the buy-sell agreement is activated. This is beneficial since it is not static and reflects changes in the business' value better. However, it is still difficult to choose the "correct" formula, which is always open to debate, and the method used when the business is starting might not work as well years down the road when the business is substantially profitable.

The last method that can be used to determine value is the "process method." This involves picking an appraiser, either ahead of time and listing it in the agreement, or at the time the buy-sell is triggered, to determine the value of the business. This has the advantage of being the most accurate method in light of a business' circumstances, but owners should be cautioned that it offers the least amount of predictability as to what the value of the business will be at the end of the day.

(6) But Wait, How Do We Pay For It All?

Having a perfect, legally enforceable buy-sell agreement means little to nothing, however, unless a more practical question is also addressed in your buy-sell: how do the remaining owners buy out the exiting owner? If they cannot afford to buy out the shares or units, then no one is really better off. When you address this question, you are said to be "funding" the buy-sell.

Cash is one means of funding the agreement. It is reliable and certain. However, most closely-held businesses and partners do not have abundant pools of cash at hand to buy out a half or quarter owner at a moment's notice.

A promissory note, which essentially amounts to payments over time with interest, is another means of making the purchase. The buying owner makes payment to the exiting owner over time, usually making those payments from the profits of the business. This is easier on the purchasing owner, but shifts risk to the exiting owner. If the business ever becomes insolvent, the purchasing owner may no longer be able to make payments on the note, leaving the exiting owner or his family high and dry.

The last method used to fund a buy-sell agreement is life insurance on each owner's life. The advantage here is that it ensures there is a lump sum of cash when an owner passes. However, there are two catches. First, it really only handles the buy-sell agreement when the triggering condition is death. Two, it requires advanced planning. You need to do this well ahead of time when the owners are insurable. But that shouldn't be an issue, because you are reading this now.

If you take the above the advice into account, you will have a well put-together and effective buy-sell. At the end of the day, you are working together to make the buy-sell that is:

Understandable	Predictable
Reasonable and Fair	Helpful in Transferring Wealth

Remember, you need to act today if you want to protect your business and also make sure you are not leaving yourself and your family out in the cold.

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