A buy-sell agreement is a very important business document that needs to exist whenever several individuals come together to own a business. However, it is often neglected and only casually reviewed, despite the enormous consequences that a poorly considered agreement can have on you and your family. Here is what you need to know about buy-sell agreements:

What it is. A buy-sell agreement is a contract that determines when and at what price an owner's interest in a business is to be sold to the other owners. It will take effect upon the occurrence of certain events, often called "triggering events." These events trigger the terms of the buy-sell agreement.

What are the Trigger Events? A trigger event is the condition which causes one owner to sell his or her interest in the business, and the others to buy. While there can be many different types of triggers, there are a few particular ones that should be present in a well drafted buy-sell. The buy-sell should be triggered upon an owner's death, disability, and bankruptcy. It should also trigger if an owner wants to depart the company.

Why is it so important? The agreement essentially takes care of you, your family, the other owners, and the business. If you are disabled or die, you or your family will have less use of the business asset and a greater need for ready funds. This is especially true with closely-held businesses, as most money earned by the owners comes in the form of income and not dividend distributions. Failure to have a proper buy-sell agreement could mean you and your family are left in need of cash with no means to unload an asset which is earning you no income. On the other hand, the remaining owners of the business, and the business itself, will have no interest in running the business with someone not in on the original agreement. Failure to plan with a buy-sell could mean the other owners are stuck in a business relationship with someone they never intended to contract with, such as another owner's spouse or child.

Is the purchase by the other owner mandatory or permissive? In the event you die or become disabled, it is very important that the agreement requires the remaining owners to purchase your share of the business. Otherwise, the remaining owners can freeze either you or your family out of any profit generated by the business. This is especially true when you pass away, your family needs the funds from the sale of the business, but the remaining owners refuse to buy them out.

- Page Continued -

The agreement should set a price. The buy-sell agreement should set a price by which to determine the value of an owner's share. If this is not carefully drawn, remaining owners could undervalue your interest and purchase the interest at a reduced rate. This would give them a windfall at the expense of denying you or your family a fair share of the proceeds.

How should price be determined? The price of an owner's interest can be determined several different ways: Book value, share value (if available), a multiple of earnings, an appraisal, or it can simply be agreed upon. It should be noted that certain methods, such as book value, are generally not favored, and all methods can give drastically different values for the business. Thus it is important to make sure all owners agree on a method by which to value the company at the outset.

When should price be determined? The actual determination of the price can happen either at the time of the triggering event or at an earlier point in time. The disadvantage of waiting until the triggering event is none of the owners can be certain at what price the business will be set or that the price will be reasonably close to what they expect to pay or receive. An alternative is to set the price using the method of choice at an earlier date, before the agreement is triggered. This offers the advantage of each party knowing exactly what amount will be paid.

Revisit the agreement. The buy-sell agreement should be revisited occasionally, even annually if possible, to make sure it is still reasonable for the needs of the owner. This is especially true where a price for the equity interest has been agreed upon in advance. Using a price from when a business was just formed, and its economic future uncertain, could mean you or your family receive far less than your fair share of the business at a later date when the business has become successful.

Can the other owners afford to buy your interest? A buy-sell agreement is only so good as the ability of the remaining owners to buy the departing owner out. If they cannot generate the funds to make the purchase, then questions such as price and timing become irrelevant. Though there are several approaches to the problem, the most comment and efficient solution is to have the remaining owners or the business purchase life insurance on each other, so that when one owner passes away, the others have funds to buy the interest. You should be careful, though. Make sure that the other owners are required to use the funds to purchase the departing owner's share.