The Importance of Having a Strong Buy-Sell Agreement

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What is a buy-sell agreement? Simply put, it is an agreement that identifies what will happen to a business co-owner's portion of the business in the event of death, disability, retirement, or another situation that has an impact on business ownership.

- A buy-sell agreement can limit the transfer of a business to a pool of mutually agreed-upon parties.
- It can set a price or provide a method for determining a price for a percentage of the business.
- A buy-sell agreement can also stipulate what terms, if any, such an ownership transfer will entail.

Ready for retirement

Consider the following scenario. You and your business partner have had a very successful relationship over the past dozen years. The business has been operating smoothly and you are both enjoying the benefits of ownership that your hard work has brought about. Today, your partner mentions to you in passing that he has sold his portion of the business to his nephew for $1 million and he is moving to Florida to take up kite surfing.

Without a buy-sell agreement, there is little you can do. You may have never met your partner's nephew and likely have no idea what changes he may want to make to the business. If you had a buy-sell agreement with your partner, you could have been the only available buyer for his ownership interest or you may at least have had a first right of refusal.

The $1 million price tag for your partner's ownership interest also means little to you. There is no guarantee that anyone else would pay that price for your shares, and you do not know if the nephew borrowed money from your partner or if the equipment owned by the business now has a $1 million lien against it.

In a buy-sell agreement, the partners agree beforehand on a manner of setting the price to be paid for each other's share of the business. Some strategies involve basing the value on the book value of the assets owned, some specify that the business must be appraised and the value of the partner's interest be determined, and others simply state a fixed dollar or other amount regardless of the business' actual value (possibly updated annually).

Unexpected death of a partner

What if, instead of kite surfing, your partner suddenly passed away? Could you afford to buy his or her ownership interest from the estate? What price would you pay? Would you need to pay it in cash or would the estate accept terms? If so, at what interest rate? Or, what if his or her spouse wanted to step in and run the business?
A buy-sell agreement can include the answers to all these questions so that there are no surprises down the line. An insurance policy could also be obtained to fund such a purchase should the unthinkable happen. One reason businesses fail is undercapitalization caused by not having enough cash on hand to pay bills.

The following is an all-too-common scenario for small partnerships without either a buy/ sell agreement or life insurance to fund the purchase: One partner passes away suddenly, and that half of the business remains owned by the estate. Typically the heirs of an estate are not happy with their indirect ownership of an interest in the business, and the remaining partner is also not excited about having to meet with a committee any time money needs to be spent. The remaining partner would prefer to buy the ownership interest from the estate but typically needs to borrow money to do it. When the debt to buy out the estate's ownership interest is secured by the business' assets, the remaining partner often realizes that the value of the remaining half is less than the amount paid to the estate due to the addition of the new loan to the books. This is especially true when one includes the expense of hiring a replacement employee to cover those duties previously performed by the other partner to the new debt payments that were not part of the previous capital structure.

In the worst case scenario, the amount paid to the estate causes such a financial burden to the business, that any hiccup in customer payments or supplier deliveries could have a devastating effect on the future of the business.

A sound business practice

A business can run into many potential problems. A strong buy-sell agreement helps navigate around many of the more serious ones, but it still takes the cooperation of all the owners and their professional advisors to make sure things keep running smoothly, even if one of them opts for kite surfing.

If you have questions about buy-sell agreements, please contact any member of Yeo & Yeo's Manufacturing Services team.

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