A Pre-Nup for Your Business: The Buy-Sell Agreement

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A business partnership is in many ways like a marriage. The partners, who sometimes have very different personalities and points of view, must work together to run their business, which takes patience, understanding, and a lot of compromise. Like a marriage, the business partnership starts out with the best intentions, as the partners are often "in love" with each other and with the idea of building their company together. In fact, business partners might actually spend more time with one another than they do their spouses.

As with a marriage, though, the "honeymoon" may eventually end and the partners may find it best that they part ways. When this happens, conflict can result as the partners try to decide how they will split the assets and liabilities of the business. If one (or more) partner wants to continue the business, they will need to decide what will happen to the departing partner's ownership interest. Just as many couples set out the mechanics of divorce beforehand with a prenuptial agreement, so should the partners set out the terms of a business break-up with a properly structured buy-sell agreement.

A buy-sell agreement provides for the mandatory purchase of a departing partner's ownership interest in a company by certain persons in certain circumstances. It can be a stand-alone document or incorporated in the company's operating or partnership agreement. The terms should include a definition of the events triggering the buy-sell, a list of persons allowed to purchase the departing partner's ownership interest, the method for valuing that interest, and the details of the closing of the purchase.

The buy-sell provisions may be triggered by several events. The most common are a business owner's death, divorce, insolvency, retirement, or desire to leave the business. The agreement should define each of these events so that it is clear when it has occurred. It should also require the departing partner (or his estate) to give notice of the occurrence of a triggering event to the company and the other partners and define the time period for giving such notice.

Upon the happening of a triggering event, certain people or entities will either be obligated or given the first option to purchase the departing partner's ownership interest in the business. This is typically the remaining business partners or the business itself. In this way, the buy-sell prevents ownership from being transferred to an outsider without the owners' consent and centralizes control of the company, which is often desirable in small businesses. This is particularly important if the departing partner owned a majority interest in the business. Most business owners would not want just anyone becoming a majority owner of their company without their consent.

Perhaps the thing most apt to cause conflict and litigation in a business break-up is the value of the departing owner's interest. Anyone with an accounting background or business finance knowledge knows that there are many different ways to value a company. It could be appraised fair market value or book value, just to name a few, and there are different ways of calculating each of those. Therefore, a good buy-sell agreement should set forth the valuation method to be used, what metrics to include when calculating the value, and who is responsible for making the calculation. The agreement may also set forth an alternate calculation if one of the parties is dissatisfied with the result of the first method.

Finally, the buy-sell agreement will spell out the terms of the closing of the deal. It will state whether the purchase price is to be paid entirely in cash, entirely by financing, or a combination of both. Financing terms will be set forth, if applicable. Funding details for the purchase can vary in complexity, depending upon the unique situation of each company. The closing details will also include various dates and deadlines that must be met. As with any contract, the buy-sell agreement should also include provisions for modifying and terminating the agreement.

No matter how happy a business relationship might be, partners should consider executing a buy-sell agreement to protect themselves and their business in the event of unforeseen circumstances or an ugly "break-up." Business owners should seek the advice and assistance of knowledgeable accountants, attorneys, and business consultants when drafting their buy-sell agreement, as the terms can have significant tax consequences and legal ramifications which should be discussed and understood before entering into the agreement. With careful discussion and planning, however, a buy-sell agreement can ensure that your company continues operating successfully despite the erosion of relationships between business partners.

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