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Strictly Business

A Business Law Blog for Entrepreneurs, Emerging Companies, and the Investment Management Industry.

ABOUT THE AUTHOR

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In his corporate practice, Mr. Davie has worked extensively with his clients on all aspects of their businesses, including company formation, business planning, mergers and acquisitions, vendor and customer contracts, corporate governance, debt and equity financings, and securities offerings. In addition, he has represented investment advisors, securities brokers, hedge funds, private equity funds, and real estate partnership syndicators in numerous private offerings of securities and in ongoing compliance. Prior to returning to private practice, Mr. Davie served as the general counsel to a private investment fund manager.

In his real estate practice, he has participated in property acquisitions, mortgage financings, and commercial leasing matters throughout the United States. He has represented developers, governmental entities, life insurance companies, banks, and owners of malls, shopping centers, industrial parks, and office towers. He has worked on a number of transactions involving the syndication of real estate partnerships, advising sponsors on both real estate and securities issues.

9 Reasons Why Your Business Needs a Buy-Sell Agreement

In any business with multiple owners, there is a good chance that at some point, one or more of those owners may no longer be affiliated with the company, whether by choice, death, bankruptcy, or divorce. It's important for business owners to plan for this in advance, so that when one of these situations occur, there is a preexisting agreement that sets out an orderly way to handle the situation. The best way to do this is with a buy-sell agreement. A buy-sell agreement is a contract between business owners that dictates who can buy a departing owner's share of the business and establishes a fair price for the owner's stake. The agreement may also provide procedures to resolve disagreements when a majority of the owners but not all of the owners decide to sell the business. Here are some reasons why you, as an entrepreneur, don't want to be in business with other people (even family) without a buy-sell agreement in place:

1. You should be able to choose your partners. When you made the decision to enter into business with your partners, hopefully you thought extensively about it and did some due diligence on them. It would be unfortunate to have that diligence and thought go to waste, because if you don't have a buy-sell agreement in place, your partner's stake in the business can be transferred to third-parties for a variety of reasons: your partner decides to sell, goes bankrupt and is forced to sell, dies, or gets divorced and his spouse ends up with some or all of his shares. In this event, you will have new partners that you never counted on having, and this may threaten your business's ability to continue on its current path.

2. If your partner decides he no longer wants to be involved in the business, you have a way of obtaining his stake in the company so that he can't continue to influence the business after he is no longer involved. Buy-sell agreements often provide that if an owner-employee were to become no longer employed by the company, that owner-employee must sell his stake back to the company or the other owners. Also, since buy-sell agreements provide a mechanism for determining a fair price in the departing partner's stake, he will be unable to extort an unreasonably high sum on his way out.

3. If you want to leave the business and no longer want to own stock in the company, you have a way of fixing the fair price in your stake. Again, since a buy-sell agreement sets out a method of determining the fair price of the stake of the departing owner, you can eliminate potential lawsuits and disputes by agreeing in advance what is fair. This can be of benefit to

you if you are the one leaving the company. Be careful though; if the valuation method is not well thought out, you could end up being unable to get a fair price on your stake in the company on your way out.

4. It could reduce your estate tax burden. The valuation method contained in a buy-sell agreement is set not only for purposes of an eventual sale, but also for estate tax valuation purposes. Privately owned businesses are difficult to value. An owner's idea of a business's worth at his death may be much lower than the IRS's. However, if you have a buy-sell agreement in place, as long as such agreement is a bona fide arms length transaction, you can use the method contained in that agreement as evidence as to how the business should be valued. But if no process for valuing the business has been put into place, the IRS will be free to determine its own value.

5. It lets the partners set expectations as to the transferability of interests in the company. Even when a partner does not want to leave the company, he still may want to sell part of his stake in the company to partially "cash out" for any number of reasons. Putting in place a buy-sell agreement can give the remaining partners a right of first refusal or other protections to give them more control over ownership changes in the company. In the least, the mere process of writing a buy-sell agreement is beneficial because it gives the partners a chance to discuss and decide these issues at a time when there is often a surplus of good will.

6. It can prevent minority shareholders from vetoing a sale of the business. If a buy-sell agreement contains a drag along clause, then a majority of owners can force the entire business to be sold. Without this, it is possible that even a 1% owner could hold up an entire deal, possibly to extort the other owners for a greater portion of the sales proceeds.

7. It can protect minority shareholders from being cheated out of the proceeds of a sale of the business. Along with point 6 above, if a buy-sell agreement contains a tag along clause, then upon the sale of the business, the minority owners will be entitled to the same price per share as the majority owners. This prevents majority shareholders from conspiring with a buyer of the business and extracting a control premium from the buyer to the detriment of the minority shareholders.

8. The time when someone leaves a company is not the time to be negotiating the fair value of a business. Often partings are awkward and sometimes downright unpleasant. Emotions may run high, precluding a careful and thoughtful discussion of how to resolve disagreements. Instead, you should set the mechanism for calculating the value while spirits are high.

9. It can protect your family. One of the most likely reasons why you may need to leave your company or transfer your stake is upon your death or disability. At this point, you will not be capable of negotiating on behalf of your family. Your family will need and deserves to be paid the fair value for your interest. If there is no buy-sell agreement in place, the surviving owners may be reluctant to pay a fair amount for your stake and are likely to at least negotiate against your family members. A buy-sell agreement provides a pre-agreed method of making sure the work you put into your business takes care of the people you care about most.

Buy-sell agreements are a crucial part of business planning for any venture which is owned by multiple parties. They can be used for corporations, limited liability companies, and partnerships. Drafting one should not be put off, because if you don't put one in place at the outset, you are unlikely to do so until issues arise. You should consult an attorney with experience in business and corporate matters for more information.

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