Buy-Sell Agreements: An Important Tool for Small Business Planning

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Buy-sell agreements are an important part of planning for subcontractors as well as other small businesses. A buy-sell agreement controls when and how owners of a company may sell their interests in the company to each other and to third parties. Buy-sell agreements can be used with corporations, LLCs, and partnerships. In the case of LLCs and partnerships, buy-sell provisions are sometimes included in the company's operating agreement or partnership agreement rather than in a separate agreement.

Buy-Sell Agreements Can Serve Many Purposes

For many subcontractors, the owners of the business are also the people responsible for running its day-to-day operations. In these types of businesses, the dynamic among the owners is important and allowing an outsider to become an owner of the business could destroy that dynamic. This is particularly true for the many subcontractors that are family-owned businesses. Buy-sell agreements often restrict the business owners from selling their interests in the company to third parties without the agreement of the other owners in order to prevent this from happening.

Many small business owners find themselves wanting to gradually allow employees to buy into the company for a number of reasons. Granting an employee an interest in the company can motivate the employee to work harder because it gives the employee a personal stake in the business. However, that purpose can be defeated if an employee is able to resign his or her employment and remain an owner of the business. A buy-sell agreement can avoid this situation by requiring that the employee sell his or her interest if his or her employment is terminated.

Buy-sell agreements can also protect the business from changes in the owners' lives that could otherwise impact the company. In many states, a married owner who gets a divorce can create headaches because the spouse may have a right to some or all of the interest in the company as part of the divorce proceedings. Similarly, if an owner files for bankruptcy, the owner's creditors may be able to go after the owner's interest in the company. And when an owner dies, the owner's interest becomes part of the owner's estate and is subject to distribution under the owner's will or, if there is no will, under state law. A buy-sell agreement can protect the company in all of these situations by preventing ex-spouses, creditors, and heirs from becoming owners of the business.

Buy-Sell Agreements Can Help Keep Outsiders from Becoming Owners

Most buy-sell agreements contain certain common provisions. For example, almost all buy-sell agreements contain some restrictions on owners selling their ownership interests to outsiders. These restrictions can take several different forms. One option is an outright restriction on transferring the interest without consent from the other owners. Alternatively, the agreement can include a right of first refusal where an owner who wishes to sell must first notify the other owners of the proposed sale and provide them (or the company) the opportunity to purchase the owner's interest on the same terms, or even at a price determined by a valuation method in the agreement. This latter approach can make it easier for a dissatisfied owner to leave the company, but it also creates risk if the other owners are unwilling or unable to buy the outgoing owner's interest.

Determining How to Value Your Company is an Important First Step

Buy-sell agreements also frequently contain provisions governing the terms for the sale of an owner's interest in the company to other owners. For example, the buy-sell agreement usually provides a method for valuing the owner's interest. This is often one of the most controversial and important provisions in the agreement and requires careful consideration. Valuation provisions generally contain a mechanism for determining the value of the company and, therefore, the selling owner's interest. Some buy-sell agreements contain a simple formula to be used to determine the value of the company. For example, it is common for buy-sell agreements to value the company based upon the company's most recent year EBITDA (earnings before interest, taxes, depreciation, and amortization) times a multiplier. However, there are disadvantages to this approach. If a company has a particularly good or bad year, the EBITDA approach can result in the company being under- or over-valued. EBITDA can also be manipulated and does not take into account unusual, one-time circumstances. However, having a set formula that is clearly stated in the agreement can avoid disputes over the correct value of the company.

Another approach is to have a valuation of the company prepared each year by the company's accountant. This approach can reduce the risk of

a good or bad year skewing the value and avoid the risk of an owner "gaming" the valuation calculation. However, annual valuations can be expensive, and disputes can arise over the identity of the appraiser and errors in the appraiser's calculation.

A third approach is to have a valuation prepared when an event occurs that triggers the buy-sell agreement. Some buy-sell agreements have provisions providing a procedure for the departing owner and the other owners to have separate valuations prepared when the buy-sell agreement is triggered, with the value of the company being equal to the average of the two. If the two valuations are very far apart, a third, independent appraiser might be retained to provide a "tie-breaker" valuation. This approach is more expensive and time-consuming, but it also minimizes the risk of an error in the valuation affecting the valuation of the company.

Careful Consideration of Payment Terms Is Critical

Once you determine how your company will be valued, the next step is to decide upon payment terms. One common approach is to provide for the purchase price to be paid in equal monthly installments over a period of years, with or without a down payment. Sometimes the installment payments are interest-only, with a deadline to make the full principal payment at the end. Other times, it may make sense to require the full payment in a lump sum. If the payments are going to be funded using distributions from the company, it may make sense to allow a temporary forbearance if the company's financial performance does not meet certain specified metrics. Whatever payment terms are selected, it is important that they be reasonable so that the purchasing owner can satisfy them.

Trigger Events Determine When Your Buy-Sell Agreement Takes Effect

Another critical part of preparing a buy-sell agreement is determining what events will trigger the buy-sell process. Buy-sell agreements often include a provision allowing an owner who wishes to leave the company to voluntarily invoke the buy-sell process, but these agreements also usually include a number of involuntary triggers. As discussed above, divorce and bankruptcy are common triggers to prevent ex-spouses and creditors from obtaining an interest in the company. In the case of an owner's death, it is common for a company to take out life insurance policies on its owners and then provide for the proceeds from that policy to be used to buy out the owner's interest. Other common triggers include resignation or termination of employment, disability, and an attempted impermissible transfer. Of course, these provisions may not always be appropriate depending upon the succession plans for the company. For example, it may be appropriate for a major owner's interest to pass to his children upon his death to preserve the family's interest in the company. As with all provisions of a buy-sell agreement, the triggers used must be carefully selected to ensure that they meet the company's needs and goals.

Buy-Sell Agreements Must be the Product of Careful Consideration and Ongoing Reevaluation

There are many different considerations that go into a buy-sell agreement. A buy-sell agreement should be the product of careful discussion and consideration of the company's values, goals, and plans for the future. A subcontractor should never try to prepare a buy-sell agreement without input from its legal counsel and accountant to ensure that the agreement is carefully drafted, the consequences of the agreement are understood, and the agreement meets the needs of the company. A poorly drafted buy-sell agreement, or one that is wrong for the company, can be worse than having no buy-sell agreement at all and can generate costly litigation.

Moreover, a buy-sell agreement is not a one-time task. The agreement should be the subject of periodic review and reevaluation to determine whether it still makes sense for the company as its needs change. If you do not have a buy-sell agreement in place, now is a great time to begin thinking about one. If you do have an agreement already, you should re-evaluate it at least yearly to make sure that it still makes sense for your company. While updating your buy-sell agreement regularly may seem like an unnecessary headache, ensuring that your agreement aligns with your company's goals and needs as you grow can prevent expensive litigation or costly unexpected consequences later on.

About the Author

Joseph M. Kanfer is a partner at Woolford Kanfer Law, P.C., with experience litigating a wide range of complex business, construction, and other disputes in both state and federal courts. He has also argued cases before the Superior Court of Pennsylvania, the Commonwealth Court of Pennsylvania, and the United States Court of Appeals for the Third Circuit. Woolford Law provides a wide range of legal services to its diverse client-base, which includes general contractors, subcontractors, homebuilders, real estate developers, municipalities, design professionals, health care professionals, manufacturers, distribution companies, professional services firms, retailers, and communications firms. Click here for more information on Woolford Kanfer Law PC.