BUY-SELL Agreements—FAQ

http://www.nolo.com/legal-encyclopedia/buy-sell-agreement-faq-29037.html

When does a business need a buy-sell agreement?

Every co-owned business needs a buy-sell, or buyout, agreement the moment the business is formed or as soon after that as possible. A buy-sell, or buyout, agreement, protects business owners when a co-owner wants to leave the company (and protects the owner who's leaving). If a co-owner wants out of the business, wants to retire, wants to sell his shares to someone else, goes through a divorce, or passes away, a buyout agreement acts as a sort of "premarital agreement" to protect everyone's interests, setting the price and terms for a buyout. Every day that value is added to a business without a plan for future transition, it increases the owners' financial risk.

A buy-sell agreement is used for buying and selling businesses, right?

No. Despite the name, buy-sell agreements have little to do with buying and selling companies. Instead, they are binding contracts between co-owners that control when owners can sell their interest, who can buy an owner's interest, and what price will be paid. These agreements come into play when an owner retires, goes bankrupt, becomes disabled, gets divorced, or dies -- in other words, a buy-sell agreement is a sort of prenuptial agreement between business co-owners. Mainly these agreements guide buyouts between the owners themselves; that's why we like to call them buyout agreements.

If a co-owner of a business gets divorced, can the former spouse ask the divorce court for part ownership in the business?

In some states, yes, and the former spouse can succeed in getting it, too. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), all earnings during marriage and all property acquired with those earnings are considered community property, owned equally by husband and wife. When property is divided during a divorce, each spouse can claim a right to all community property.

Even in non-community property states, a spouse could argue for a partial interest in the business, because marital property laws require property to be divided equitably during divorce.

To avoid this prospect, a good buyout or buy-sell agreement requires the former spouse of a divorced owner to sell any interest received in a divorce settlement back to the company or the other co-owners, according to a valuation method provided in the agreement.

Can a co-owner's personal bankruptcy affect the business?

In the worst case scenario, a bankruptcy trustee could liquidate the business (sell all of its assets) and take half to pay the bankrupt owner's debts. To prevent a business from getting tied up in bankruptcy court, the owners can sign a buy-sell or buyout agreement that requires a co-owner who faces bankruptcy to notify other co-owners before filing. Under the terms of this agreement, this becomes an automatic offer to sell the bankrupt owner's interest back to the other owners. The buyout money goes to the bankruptcy trustee and the business can proceed without difficulties

What's the best way to value a company when an owner is being bought out?

You can hire a professional appraiser or use a valuation formula to come up with a price using financial statements from one or more years. But the problem is that valuing a business at the time of sale usually results in co-owners seizing on different valuation formulas, which can produce very different results. For that reason, it helps for the owners to agree on a way to value the company in advance in a buy-sell or buyout agreement. This gives owners the chance to discuss and vote on how a reasonable price for the company should be calculated. The fact that a sound method was agreed to beforehand can go a long way to reducing conflict when the time for a buyout comes.

What happens if a company needs to, but can't afford to, buy out one of its owners?

Requiring an immediate 100% lump-sum cash payout can prevent even the most successful company from buying back an owner's interest. That's why having flexible payment terms built into a buy-sell or buyout agreement, signed in advance, can help. For instance, a buyout agreement can provide for a down payment of 1/4 to 1/3 of the buyout price followed by installment payments for three to five years at a reasonable rate of interest.

Can a buy-sell agreement be used to avoid estate taxes?

Buy-sell, or buyout, agreements have been used successfully to lower estate taxes in intergenerational businesses -- businesses where at least one co-owner plans to leave the interest to heirs who will remain active in the business. This can help a family business owner pass the business on to children or other relatives without burdening them with unnecessary estate taxes caused by an aggressive value of the business. The key for estate planning is choosing a conservative price or valuation formula for the business in the buy-sell or buyout agreement. The result can be to legally set the value of the ownership interest at an amount considerably lower than its sales value at the time of death.

For more information on buyout agreeements, see *Business Buyout Agreements: A Step-by-Step Guide for Co-Owners*, by Bethany Laurence & Anthony Mancuso (Nolo).