



SMALL BUSINESS & NONPROFIT CLINIC

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**Buy-Sell Agreements: The Basics**

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*I. Introduction*

When a group of people join together and decide to start a small business, they are typically excited and optimistic. Unfortunately, these new business owners cannot predict what the future holds. At some point, a business owner may decide to leave the business, either voluntarily or involuntarily. If this situation does arise, a buy-sell agreement can prevent the disruption of a small business.

*II. What is a buy-sell agreement?*

A buy-sell agreement is like a “premarital agreement” for business owners. While a premarital agreement governs the division of property if a couple divorces, a buy-sell agreement will determine what will happen to a business owner’s share if the owner divorces herself from the business. The main purpose of a buy-sell agreement is to limit a business owner’s ability to transfer her share of the business. A buy-sell agreement is also used to set a price for the departing owner’s share and determine how

the owner will be paid for her share. A buy-sell agreement can be included in the governing document for the business, such as the bylaws for a corporation or the operating agreement for a limited liability company. A buy-sell agreement can also be a separate document.

### *III. Why does a business need a buy-sell agreement?*

If a small business does not have a buy-sell agreement, several problems could arise:

- An owner can transfer her share of the business without the consent of the other owners, thus allowing a stranger to come in and acquire an ownership interest in the business; or
- When a business owner decides to sell her share of the business, disputes could arise over how much the owner's share is worth; or
- A disagreement could also arise concerning how the departing business owner will be paid for her share.

Even if a business is owned by one person, a buy-sell agreement is still necessary. A single-owner business may decide to take on additional owners at some point. Even if a business does not take on additional owners, the sole owner should still plan for what will happen to her business if something should happen to her.

### *IV. What needs to be included in a buy-sell agreement?*

Every buy-sell agreement should contain several provisions. The buy-sell agreement should restrict an owner's ability to transfer her ownership interest. One way to do this is to give the other business owner's the first option to purchase the departing

owner's share. This will prevent the dilemma discussed above where a stranger is able to come along and acquire an ownership interest in the business.

The buy-sell agreement should also specify that the value of an owner's share is based on her ownership interest in the business. Since an owner's interest in the business may change over time, the buy-sell agreement should not list what each owner's share is. Instead, the business owners should keep a capital account. A capital account lists the funds and assets invested in a business by each owner. The buy-sell agreement should state that the capital account will be used to determine an owner's interest in the business if the time comes to buy her out.

A buy-sell agreement should also contain a list of trigger events. A trigger event is an event that may result in a buyout of a business owner's share. Common trigger events include death, disability, divorce, deadlock, bankruptcy and expulsion of a business owner. The buy-sell agreement should include a list of trigger events and whether a buyout of the owner's share is optional or mandatory for each event listed.

A buy-sell agreement should also include a way to value the departing owner's share of the business. There are numerous ways to value a business. The owners should get together and come to an agreement over which method is best for their particular business. It would be wise to seek the assistance of an accountant when determining which valuation method to use. The method that the owners agree to should be listed in the agreement to prevent future disputes over the value of a departing owner's share.

In addition to stating the value of a departing owner's share, the buy-sell agreement should also state the payment method for the departing owner's share. The business may not have enough money to pay the full price of the departing owner's share

all at once. Therefore, the business should set up a payment plan that is both affordable for the business and fair for the departing owner.

#### *V. Conclusion*

Clearly, a buy-sell agreement is essential for any small business. Therefore, small business owners should seek competent legal counsel to draft a buy-sell agreement for their business. It's difficult to predict what the future might hold, but it is much easier to plan for problems that may arise.