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More Reasons for a Well-Crafted Buy-Sell Agreement

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Buy-sell agreements establish and protect rights among shareholders that do not otherwise exist in the company.

Through a buy-sell agreement, a minority shareholder may attain more control over his or her destiny than is normally provided through voting rights. These safeguards may include placing limits on the sale or purchase of the stock of the majority owner(s), establishing valuation of all owners' stock, giving minority owners the right to sell their stock if certain events occur, and other important items.

An example of the type of right that a buy-sell agreement can establish is providing the owner of a minority interest the right to serve on the board of directors. Obviously, this can be an important right because a minority shareholder might not otherwise be able to garner sufficient votes to be elected to the board.

A second example is requiring the corporation and remaining shareholders to do their best to obtain the release of the departing shareholder from any personally guaranteed indebtedness, as well as to release any personal collateral used for a corporate debt when the owner of that collateral sells his or her interest in the company.

Recall Tom Gardner from the hypothetical case study we discussed last issue. As a minority owner, he was unable to buy control of the company and was unable to prevent a new majority owner from exercising total control over the company. A buy-sell agreement could have prevented that.

An intangible benefit lies in the process of designing the buy-sell agreement.

All too often when there are joint owners of a business, they do not sit down together to discuss business issues. In order to draft a buy-sell agreement, a meeting of all owners is essential. In doing so, they address major questions affecting their relationship such as: What happens if one of the owners dies? What happens if the owners don't get along? What happens if one wants to retire before the other? Obtaining answers to these important questions requires owners to discuss their ideas about the future of the business.

For an example of this, let's look at the hypothetical case study of John and Steve, both equal partners in a manufacturing business.

John and Steve had a poor relationship and they were certain each had opposing views on the future of the business in terms of both growth and their respective desires to remain in the business. They each also had their own ideas about their own importance to the business.

During meetings with their advisory team, they soon learned there were many reasons for their company's success. Although one owner was the "money man" and the other was more active in the business, they learned that both were equally concerned with the long-term future of the company. This recognition allowed them and their advisors to draft a complete buy-sell agreement for their mutual benefit.

The process took almost a year. During that time, the owners met periodically with their advisors to review business goals and aspirations. Increasingly, they found themselves in agreement, not just in matters contained in the buy-sell agreement, but also with respect to operational ideas. Those bases of agreement soon broadened into a consensus on how the business should proceed if one of them were no longer with it.

As a result of this process, their business became more vibrant and more directed. The owners became more committed than ever and, not coincidentally, the company's profitability and value increased steadily.

A buy-sell agreement establishes a market for an owner's stock at an agreed-upon price.

Without an agreement, there's no market for stock in a closely held business, even if you're a controlling owner. Your ability to sell your interest will be limited unless you can require your co-owner to also sell—most buyers want to own 100 percent of a company and don't want the potential "excess baggage" of a co-owner not of their choosing. Otherwise, if you have not made firm arrangements for the sale of your stock, the buy-sell agreement is the only means of disposing of your ownership interest at a fair price. The agreement can obligate the other owners to purchase your stock, thus creating a market if you must sell your stock due to unforeseen events such as death or disability.