10 Key Items to Include in Your Buy-Sell Agreement

There are many items to address in creating an effective buy-sell agreement for your company. Here are 10 items to consider.

1. Determine the triggering events – Typically, a buy-sell agreement is needed for when there is a death, disability or retirement of a shareholder of the company. Also, in the case of multiple owner-employees, a clause is necessary for when someone is terminated for cause, such as committing a crime or an act that decreases the credibility of the company.

2. Setting the price – This can be one of the most difficult aspects of creating the buy-sell agreement. The value of a company is dependent on many factors and is very subjective.   To arrive at a formal value, the company may wish to engage a business valuation firm. A qualified business valuation expert will look at the value of the company from a discounted future cash flows, market price of comparable sales and replacement cost. However, this can be an expensive process, requiring regular updates.

More commonly in a small business, the shareholders derive a value to include in their agreement through a combining of traditional (but self-calculated) valuation methods, assistance from their accountant and attorney, and negotiation.

3. Considering tax effects – Each entity and each shareholder will have a different tax situation even compared to a similar business. If a trust owns the shares of an S-corporation, it would likely be beneficial for a shareholder to purchase shares directly from the other shareholder. If the company is a regular corporation, it will likely be tax advantageous for the company to redeem the shares directly. The company should work closely with their tax advisor and attorney to tailor the buy-sell agreement to mitigate unforeseen tax consequences.

4. Confirming participation – Obviously, if there are two or three owners, it can be assumed the other shareholder(s) will want to take on the additional ownership and ensure the continuity of the business.

There is always a possibility an owner would not be willing or able to take on the additional ownership. This is more common with minority ownership; such as when a key employee has been incentivized into the company. They may not have the expertise or desire to take on the responsibility. The owners need to address these issues of succession and willingness before it undertakes the creation of a buy-sell agreement.

5. Drag-a-long and tag-a-long – If there are minority owners, the majority owners will want to make sure the minority owners will not be an impediment to a sale of all or part of the company. A drag-a-long clause will require the minority owners to sell their interest along with the majority owners, therefore, not impeding any deals. Further, the minority owners will want to be protected in the event of a sale. A tag-a-long provision will require the minority owners to be treated under the same terms as the majority owners in the event of a sale of the business.

6. Shotgun clause – If an owner's departure from a business is contentious, a shotgun clause can be an effective way to avoid continued fighting or litigation. The clause allows a shareholder to offer a price to buy-out the other shareholder(s). In turn, the other shareholder(s) must accept the offer and sell their shares or they can purchase the shares of the offering shareholder. In practice this can also be initiated if the business is in decline; if the company is losing money and is losing value. There have been instances where a company on the verge of collapse has a shareholder offer to buy the other shareholders ownership for $1. It provides some tense moments as the shareholder has to make the decision to bail out or take control of the fledgling company.

7. Buy-out terms – The triggering event and price are important elements of buying back company shares. Equally important is how the remaining shareholder or the company will pay for the shares. The buy-sell agreement should outline the time required to perform on the share purchase, the initial payment amount, the term for the remaining payments, interest rate, remedies for non-performance, etc.

8. First right of refusal – Without the protective clause, the shareholders could find themselves business partners with unqualified and difficult shareholders. An existing shareholder could sell, gift or leave their shares of stock at the time of death to family members or others. A first right of refusal clause requires a shareholder to first offer their shares to the other shareholders or to the company.

9. Address funding – Depending on the health and financial position of the company, it may be very difficult for the remaining shareholder to pay for the company according to the terms of the buy-sell agreement. One shareholder may have liquid funds to exercise a purchase upon a triggering event and the other may not. In certain cases, that shareholder is compelled to put up assets as collateral, possibly their home. Ideally, each shareholder would obtain life/disability insurance, providing the company or remaining shareholders the funds necessary to buy out the departing shareholder.

10. Transparency – Once a shareholder departs, he/she needs some protection their buyout will be paid in the time required. The departing shareholder will want a certain level of access to the books and records of the company to have visibility to the assets, profitability and cash flow that will pay the buyout. This way the departing shareholder can see if any declines on needed cash flow are the result of external factors or due to remaining shareholder(s) using the company for personal expenditures or making large purchases.

Shareholders should work with their accountant, tax advisor and attorney to address the accounting, tax and legal effects of the provisions in the company's buy-sell agreement.

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