WHY ARE BUY-SELL AGREEMENTS IMPORTANT?

The term “buy-sell agreement” means any legally enforceable arrangement by and among a business entity or its owners prescribing limitations on the ability to own and to transfer equity interests. It is the linchpin between a business succession plan and the estate plans of the owners in determining the future ownership and control of a business. The terms of a buy-sell agreement can be included in an operating agreement of a limited liability company, a partnership agreement for general and limited partnerships, or in a close corporation agreement for corporate entities.

Most often the terms of a buy-sell agreement are set forth in a separate written document by and among the shareholders of a corporation and the corporation itself. This article focuses on separate written buy-sell agreements involving corporations, even though many of the concepts apply to other types of business entities.

When entrepreneurs are forming a business entity, or a new investor becomes a shareholder, the parties are optimistic that they will all benefit from the financial success of the enterprise. Introducing the topics of death, disability, termination of employment, and other negative possibilities is comparable to negotiating a prenuptial agreement for a couple about to be wed. Unfortunate but foreseeable events need to be addressed as soon as possible before irreversible commitments are made.

A buy-sell agreement is an integral part of a shareholder’s personal estate plan. The creation of a market to liquidate an otherwise nonmarketable asset is crucial to many estate plans. The shareholder’s will and trust must contain directions to the fiduciary to comply with and to implement the terms of the agreement. These documents may also direct the fiduciary to accept the provisions of the agreement (such as the valuation methods) without the necessity or duty to inquire as to the validity of the data on which the sale is based or the process by which it is made.

Control and ownership

In discussing business succession planning, it is advisable to focus on three separate elements:

(1) Income
(2) Control
(3) Equity ownership

While a buy-sell agreement may indirectly affect the income from a business entity, the arrangement more directly affects control and equity ownership.

The company’s capital structure and organizational documents determine the control of the enterprise through the election of the board of directors. The managers of the business and perhaps the other shareholders, however, do not want family members who happen to inherit stock to be involved in the management of the business. The separation of control from the equity ownership of the business and the extraction of the value of the equity ownership of the business should be agreed on in writing by the shareholders.

Who is the purchaser?