

Business Strategies for “What if” Situations

By Nathan Sachs



What If I Have a Co-Owner or Partner?

AS A BUSINESS OWNER, if you have a co-owner or a partner, then you must also have a buy/sell agreement. This agreement spells out exactly what will happen in the case of certain “triggering events” with the ownership of the business. Most business owners think first of death as a triggering event, but there are several others. Other triggering events are disability, divorce, bankruptcy, the transfer of stock to a third party, retirement, termination, and even how to handle disagreements between owners.

The agreement should dictate what happens to ownership interests in the event of a “triggering event.” Who is going to buy the ownership interest, for how much, and in what way? This agreement also should include a formula or set price to determine the cost of the buyout. It will also dictate who cannot buy ownership interest. Typically, before you sell your interest to a third party, you have to offer it to your co-owner or partner.

This document should be drafted by a competent attorney. It is often recommended that each owner have their own attorney involved in the process in case there is a dispute in the future.

The agreement can be either a cross-purchase, an entity purchase, or stock redemption plan. In a cross-purchase agreement, the other stockholder or partner will be purchasing the stock. In an entity or stock redemption agreement, the entity itself will be purchasing the stock - i.e., the corporation.

By determining a purchasing price prior to the triggering event, you avoid any hassles in the future. Everybody agrees beforehand what the business is worth and for how much the ownership will be sold. The agreement will also detail exactly the terms of the buyout.

There is another advantage of a having a properly drafted buy/sell agreement. The value of the business can be pegged for estate tax purposes, thus preventing the IRS from arbitrarily assigning a value. The IRS will look for certain provisions in the agreement. First, the estate of the deceased owner must be

obligated to sell. The co-owner or partner must have first right of refusal to buy the ownership interest in the case of a living buyout. Lastly, the agreement must be an “arm’s length” transaction; the price of the ownership interest must be deemed reasonable.

The agreement should provide for funding the buyout. With proper funding, of what value is the agreement really? There are four ways to do this.

Method number one is plain old cash. Whoever is going to do the buying, either the co-owner or entity, must accumulate enough cash to fund the agreement. Since no one really knows for sure when a “triggering event” will occur, timing is a real issue here. Will there be enough time to accumulate the cash?

The second method is borrowing the money. There are several concerns here. Will the buyer be able to obtain a loan? The loan must be paid back, plus the interest. This can put a real strain on cash flow.

The third method is known as the installment method. This is a very simple method. The purchase price will be paid out in the future in installments. This can be a real drain on the future cash flow of the business. If the business fails, the installment payments can stop.

The last method is the use of life insurance. All of the above methods are viable in the event of most triggering events except death. Only life insurance can guarantee that the money will be there when an owner dies.

The buy/sell agreement is the most important agreement a business owner can have. Not doing one jeopardizes the future of the business as well as the future of the business owner’s family. ■

Nathan S. Sachs, CLU, ChFC, CFBS, is founder and owner of Scottsdale-based Blueprints for Tomorrow™, a business advisory firm. Sachs can be reached at (480) 596-1525 or via email at natesachs@blueprintsfortomorrow.com.