Buy-Sell Agreements

What every multi-owner business needs — and most do not have — Ament Law Group, P.C.

If you own a business with one or more other people and you do not have a buy-sell agreement, you are one unexpected event away from a crisis that could destroy the business, devastate your family, or force you into business with someone you never chose as a partner. This guide explains what a buy-sell agreement is, why every multi-owner business needs one, and what makes the difference between an agreement that works and one that fails when it matters most.

What a Buy-Sell Agreement Is

A buy-sell agreement — sometimes called a buyout agreement or business continuation agreement — is a legally binding contract among the owners of a business that governs what happens to an owner's interest when a defined trigger event occurs. It answers the question:

> "If something happens to one of us — death, disability, divorce, dispute, or departure — what happens to their ownership interest in the business, who buys it, at what price, and on what terms?"

Without a buy-sell agreement, these questions are answered by state law, probate courts, and whatever informal agreements the remaining owners and the departing owner's estate can negotiate under pressure — often in the middle of a family tragedy or a contentious dispute. The results are rarely good for anyone.

The Four Trigger Events — What the Agreement Must Cover

A well-drafted buy-sell agreement addresses all four of the major events that can force a change in ownership. Many agreements cover only one or two — and fail when the others occur.

1 Death

When an owner dies, their business interest passes to their estate and then to their heirs. The result: the surviving owners may be forced into business with a widow, widower, adult children, or — in the worst case — a court-appointed administrator who has no interest in or knowledge of the business. The buy-sell agreement specifies that the surviving owners (or the business itself) must purchase the deceased owner's interest at an agreed price, giving the estate liquidity and giving the surviving owners control.

2 Disability

An owner who cannot work but does not die creates a different problem. They are no longer contributing to the business, but they still own their share and are entitled to distributions. This can be financially devastating for a small business and deeply unfair to active owners. A buy-sell triggered by disability — typically after a defined period — allows the business to buy out the disabled owner's interest and move forward. The definition of disability in the agreement matters enormously.

3 Divorce

In many states, including Pennsylvania, a business interest may be marital property subject to equitable distribution in a divorce. Without a buy-sell agreement, a co-owner's spouse could receive a portion of the business interest — making someone who has never been involved in the business an involuntary co-owner. A properly drafted buy-sell agreement can require that a divorcing owner either buy out their own interest from the settlement or allow the business to purchase it, preventing outside interests from entering the ownership structure.

4 Departure — Voluntary or Involuntary

Owners leave businesses for many reasons: retirement, career change, relocation, disagreement with direction, or termination for cause. Each situation requires a mechanism for valuing and transferring the departing owner's interest. Without clear terms, voluntary departures become negotiation battles and involuntary departures become lawsuits. The buy-sell agreement defines the process, the price formula, and the terms before emotions are involved.

Valuation — The Most Important (and Most Disputed) Provision

How the purchase price is determined when a trigger event occurs is the most consequential provision in the agreement — and the one most likely to cause problems if not carefully drafted. There are three main approaches:

Fixed Price	Formula	Independent Appraisal
Owners agree on a specific value at the time the agreement is drafted and update it periodically. Simple to administer but becomes dangerously stale if not updated regularly. An agreement with a fixed price set five years ago is essentially worthless if the business has grown significantly.	The price is calculated by applying a formula to financial metrics — a multiple of revenue, EBITDA, or book value. More flexible than a fixed price, but formulas can produce results that no longer reflect the business's actual value as its nature or industry evolves.	An independent business valuator determines the price when a trigger event occurs. Most accurate and hardest to dispute, but can be slow and expensive — and may produce a value neither side expected. Often used as a tie-breaker between competing appraisals.

Practical reality: Most business owners dramatically underestimate the value of their business when the agreement is drafted — and dramatically overestimate it when they are the seller. The time to agree on valuation methodology is before a trigger event occurs, not during one.

Funding — How the Buyout Gets Paid

A buy-sell agreement without funding is largely aspirational. If a buyout obligation is triggered and the business or remaining owners cannot actually pay for it, the agreement fails. There are three primary funding mechanisms:

Life Insurance — The Most Common Solution

Each owner's life is insured for an amount that approximates their buyout value. When an owner dies, the policy pays out and provides immediate liquidity to fund the purchase. Life insurance funding is efficient, relatively straightforward, and keeps the business from having to liquidate assets or take on debt under pressure. Two structures: cross-purchase (owners insure each other) and entity-purchase (the business owns policies on the owners). Each has different tax and administrative implications. The right choice depends on the number of owners, entity type, and individual circumstances.

Disability Insurance and Cash

Life insurance addresses death. Disability buyouts are harder to fund because disability insurance for buyout purposes (as opposed to income replacement) is less common and can be expensive. Many agreements fund disability buyouts through installment payments over time — which works if the business is profitable but creates a significant burden if it is struggling. Some businesses maintain a sinking fund (cash reserves) for this purpose. The right approach depends on the business's cash position and the owners' relative risk tolerance.

The funding review problem: Most buy-sell agreements are drafted once and never revisited. A policy purchased when the business was worth significantly less will not fund a buyout at the business's current value. Insurance coverage and valuation should be reviewed every two to three years — or after any major change in business value.

Structure — Entity Type Changes How the Agreement Works

The structure of the buy-sell agreement interacts with the legal and tax structure of the business:

LLCs

Most LLC operating agreements contain some buyout provisions, but they are often inadequate — covering only voluntary departure and not death, disability, or divorce. A standalone buy-sell agreement (or thoroughly updated operating agreement) is typically needed.

S-Corporations

S-corp buy-sell agreements must account for the passive loss rules, the built-in gains tax on assets acquired during the S-election period, and the restriction that S-corps cannot have certain types of shareholders. A buyout that inadvertently violates S-corp eligibility rules can trigger a termination of the S-election with significant tax consequences.

Partnerships

Partnership buy-sell agreements must address the tax basis and capital account rules that govern how a departing partner's interest is treated. The difference between a "hot assets" sale and a non-hot assets sale has significant tax implications that should be built into the agreement's price and structure.

Warning Signs — When Your Existing Agreement May Not Protect You

If you have a buy-sell agreement, review it against these indicators:

- The agreement was drafted when the business was founded and has not been reviewed since
- The fixed price in the agreement has not been updated in more than two years
- The agreement does not address disability — only death
- The agreement does not address divorce, particularly in a community property or equitable distribution state
- The life insurance funding the agreement was purchased years ago and may no longer match the business's current value
- The agreement requires the business to fund a buyout but the business has no clear mechanism to pay
- The agreement was part of the operating agreement and was never separately reviewed by counsel
- One or more owners have gone through a divorce, death in the family, or significant change in personal circumstances since the agreement was signed

Where to start: A buy-sell agreement review is not a complex or expensive undertaking. But finding out that your agreement fails at the moment it is needed most is. If your business has multiple owners and you do not have a buy-sell agreement — or have not reviewed it in several years — that conversation should happen soon. Call (724) 733-3500 or visit ament.law.