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Why Would I Need A Buy-Sell Agreement?

Many of our clients are business owners. Although these businesses tend to be successful, we have found that many of the owners do not have clearly defined succession plans. This month, we will look at one of the best ways to outline a succession plan, especially when partners or family members are involved in a business.

Tom and Julie met as project managers for a Fortune 500 company. After a couple of years of collaboration, they decided they could accomplish more and make more money in their own business. They've worked out most of the details about their individual roles, financial contributions, how they were going to raise capital, and even who else they might invite to join their venture. Their attorney advised that they also give some thought to a "buy-sell agreement" – a term that was new to both of them.

When they learned that it was an agreement for the eventual disposition of their business, they decided they had plenty of time to worry about that later – maybe 10 or 20 years from now. Fortunately, their attorney was able to explain why a buy-sell agreement should be part of the start-up documents, and they saw the wisdom of making it a priority.

A Buy-Sell Agreement is a written agreement among the owners of a business in which each owner agrees what will happen to their shares in the business upon the occurrence of a specified event (death, disability, termination of employment, etc.). Often the shareholders will agree that the shares will be sold to the surviving owners at a specific price. Each owner commits to buy the shares of their departing co-owner upon the occurrence of a specified event.

There are several reasons a good buy-sell agreement is important to you:

A valid buy-sell agreement protects you and your family.

If you retire or become disabled, you created a market for your shares at an agreed upon price.

If you die while owning the business, a buy-sell agreement can guarantee your heirs a buyer and a predetermined price.

A buy-sell agreement negotiated between you and an unrelated successor provides a valuation that you can generally rely on for other tax purposes.

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Buy-Sell Agreements can be funded (often with life insurance) or unfunded (usually with promises to pay). Funding a Buy-Sell Agreement with life insurance is the most practical method to fund a buy-sell as long as the owners are insurable. With life insurance, the heirs receive cash and walk away, and the surviving owner gets the deceased owner's shares immediately. Unfunded Buy-Sell Agreements are usually better than no agreement, but the odds of the heirs ever getting paid are substantially reduced. Quite often the earnings of the company going forward are not sufficient to pay off the heirs.

There are three basic different types of buy-sell agreements:

Cross-Purchase Agreement: A cross-purchase agreement allows the remaining co-owners to purchase the interest of a departing owner. Each co-owner must have sufficient capital to make the purchase. For the death of an owner, each owner generally acquires a life insurance policy on the lives of each other owner, and the death benefits received are required to be used to purchase the deceased owner's interest.

Entity (or Redemption) Purchase Agreement: An entity purchase agreement requires the business to purchase the interest of a departing owner. After the purchase, the remaining owners would be the only owners of the entity. It is also common to fund the purchase with a life insurance policy purchased by the business.

Hybrid Agreement: A hybrid agreement provides the remaining owners and the business itself to purchase the interest of a departing owner. With a hybrid agreement, it is possible to give the individual owners the right to acquire the interest, but not the obligation. If the owners decline, the business would be obligated to acquire the interest of the departing owner. Alternatively, the agreement may allow for both the remaining owners and the company to purchase the departing owner's interest. Therefore the hybrid agreement has characteristics of both the cross-purchase and the entity-redemption agreement and is the most flexible.

How to Value the Company

The valuation section of a buy-sell agreement is very important because it defines how the value of the owner's interest will be valued when there is a change in ownership. Changes will inevitably occur. Partners or shareholders of closely-held companies will decide to part voluntarily or an event such as death will trigger the buy-sell agreement. If this section of the agreement is skipped, it will lead to increased costs and time to determine the value of the interest at the time of the change.

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The method of valuation should be clearly defined. A method should be selected that determines fair value at the time of the triggering event. Vague language for a formula that establishes a range of prices, rather than a firm price should be avoided. The reason is that two valuation professionals using vague language may calculate two very different values, either of which is within "the range." If a company has only one owner, it's up to that owner to find a successor and enter into a buy-sell agreement. Sometimes the successor will come from the next generation of the family.

When there is no related heir apparent and no co-owners, finding a successor can be difficult. A key employee might be designated. Or the owner of a successful medium-sized company or professional practice might actually acquire a smaller firm headed by a younger individual, in the hope that the prime mover behind the acquired entity will someday take over the larger firm. In any event, a buy-sell agreement should be in place between the current owner and the designated successor.

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