Business Planning

Buy-Sell Agreements: Why every business with multiple owners should have one.

By Eva Stark, JD, LL.M.

Many closely held businesses are owned by two or more co-owners. Individuals who co-own businesses may have known each other for years and are generally comfortable and successful in working with each other. But as they focus on day-to-day business operations, the tendency is to neglect important long-term planning such as establishing and funding a buy-sell agreement.

What is a buy-sell agreement?

A buy-sell agreement is a formal, written understanding among co-owners of a business detailing how ownership and control of the business can be transferred. It can help ensure that potentially undesirable and disruptive outsiders can be prevented from having ownership or voting rights in the business. A buy-sell agreement can additionally benefit a departing owner (or his or her estate or heirs) by providing a market for the sale of the departing owner's business interest where no market would otherwise exist.

Why is a buy-sell agreement important?

In the absence of a buy-sell agreement, a business owner is generally free to transfer his or her business interest to virtually anyone during lifetime or at death. A court also could award a co-owner's business interest to a creditor or ex-spouse upon divorce without the consent of the other co-owners. If such an event occurs, the remaining co-owners would then have to contend with running the business with the new co-owner. Depending on the entity type, ownership structure and state law, this new co-owner also may hold significant voting power or control, lack necessary skills or work ethic, be significantly disruptive, and threaten the future success of the business along with the livelihood of the remaining owners and their families.

A departing owner's family also may be negatively impacted in the absence of a buy-sell agreement. An interest in a closely held business is typically very difficult to sell. Without a funded buy-sell agreement, a deceased or permanently disabled owner's family may continue to have a substantial portion of their wealth tied up in the closely-held business in which they may desire no participation. Their livelihood will depend on the future success of the business—an often undesirable result.

What are some of the key provisions of a buy-sell agreement?

BUY-SELL METHOD

Most buy-sell agreements will incorporate one of three buy-sell methods: cross-purchase method, entity purchase method (stock redemption in case of a corporation) or a hybrid method. Under the cross-purchase method, business owners agree to purchase a departing owner's interest directly from the departing owner (or his/her estate). Under the entity purchase method, the business agrees to purchase the departing owner's interest. Under a hybrid method, the combination of first two methods may be utilized. For example, the agreement may provide that the business may elect to purchase the departing owner's interest, and to the extent it does not, the remaining owners will purchase it.

TRIGGERING EVENTS

A buy-sell agreement also will define a list of "triggering events" that give the remaining owners or the business the right to purchase an owner's interest. Triggering events typically include voluntary transfers, such as a contemplated sale by an owner to a third party, as well as involuntary transfers, such as transfers at death or transfers to a creditor (by judgment, divorce, bankruptcy or any other method). If the business's operations require that each owner actively participate in the business, triggering events may additionally include an owner's disability, retirement, loss of a professional license, or failure to remain "active" in the business by failing to provide services to the company or its clients. Such a provision may be critical for a business that is a professional practice but may be less important for a manager-managed real estate investment company, for example.

PURCHASE PRICE

The buy-sell agreement typically outlines how the purchase price is to be determined following a triggering event. The method for determining the buyout price and whether discounts may be utilized may vary depending on the specific triggering event and whether it is voluntary or involuntary.

For example, many buy-sell agreements provide that the remaining owners or the company will match the price and terms of a third party offer if a voluntary sale to a third party is contemplated, or pay fair market value (FMV) for an owner's interest upon death. The same agreements, however, may provide that only book value will be paid or the FMV will be discounted by a number of percentage points in the event of an involuntary transfer—such as a transfer to a creditor—which may offer additional protection for the remaining owners. However, when different values are used for different triggering events, it will be important to ensure that the IRS will respect such valuations. Where an owner can dispose of his or her interest during life for a different price than what is provided in the buy-sell agreement in the event of death, the IRS may not respect such valuation for estate tax purposes and may re-calculate the value (usually to the taxpayer's detriment).

Many buy-sell agreements also establish a procedure for determining the FMV of a business interest. For example, the document may provide that the owners will execute a certificate of agreed value on an annual basis on which buyout prices are to be based. The owners may also agree that the FMV is to be determined by one or more qualified appraisers.

Where qualified appraisers are utilized, the documents often provide that the qualified appraiser will be selected jointly by the departing owner and the remaining owners; or if an agreement cannot be reached, a qualified appraiser will be selected by each owner and the two appraisers' valuations are reconciled by a pre-selected method.

For example, the agreement may provide that if the values determined by the buyer's appraiser and the seller's appraiser vary by less than a certain number of percentage points based on the lower of the two appraisals, the appraisals are to be averaged; and if they vary by more than the set number of percentage points, the two appraisers are to select a third appraiser whose valuation will be final.

PAYMENT TERMS

Some buy-sell agreements require the payment for an owner's interest in cash (or by matching the terms of a third-party offer). This is an attractive solution for business owners who do not want their families' security dependent on the future success of the business. Other buy-sell agreements provide for installment payments over a certain number of years, with interest and the business interest offered up as security. Yet others utilize a combination of the two by requiring cash payments to the extent of insurance proceeds with note payments for the rest. Payment terms can also vary depending on whether the buyout was triggered by a voluntary or involuntary transfer.

How are buy-sell agreements typically funded?

Life insurance has become a popular funding mechanism for buy-sell agreements. For many business owners, it is likely to be one of the more cost-efficient funding mechanisms.

With life insurance, funding automatically becomes available when it is needed the most to carry out a buyout—upon an owner's death. Where permanent life insurance is used, cash values may often be accessed to make a buyout more feasible in the event of an owner's retirement, disability or upon the occurrence of other triggering events. (Policy cash values are typically accessed through policy loans that accrue interest and reduce death benefits.)

Where life insurance is used, it will be important to ensure that policy ownership matches the buy-sell method used. To fund a cross-purchase agreement, each owner will generally purchase life insurance on the life of every other owner. To fund an entity-purchase, the business will typically purchase a policy on the life of each owner.

ARE THERE ADDITIONAL METHODS OF FUNDING A BUY-SELL AGREEMENT?

The co-owners and/or the business also could establish some type of sinking fund for a buyout. However, there is no guarantee that sufficient funds will be accumulated by the time a triggering event occurs. Additionally, sinking funds must generally be kept in conservative, low-return investments at significant opportunity cost.

Loans also could be an option. With loans, interest is an additional cost. There also is no guarantee that a remaining owner or the business will qualify for the desired loan amount at an affordable interest rate when the need for a loan arises. Some buy-sell agreements provide for payments over time in the event of an owner's death. This can be a significant drag on the cash flows of a business or the remaining owners while making the deceased owner's family dependent on the future success of the business. Whatever funding method is selected, business owners should periodically review what funding is in place and ascertain whether it corresponds with changes in the value of the business as well as changes in business needs or personal circumstances of the owners.

Conclusion

A buy-sell agreement is a critical tool for the long-term success of a business with two or more co-owners because it can help ensure that ownership and control of the business is kept out of the hands of potentially disruptive successor co-owners.

It also can create a market for the sale of a deceased owner's interest where no market would otherwise exist.

There are many ways to structure a buy-sell agreement and clients should consult with their attorneys and other professional advisors to determine the best buy-sell method and provisions considering their particular circumstances.

Of course, a buy-sell agreement also may only be as good as the ability to carry it out. As a result, it is important to ensure that sufficient funding is always in place. Business owners should periodically review their buy-sell agreements and available funding with their professional advisors to ensure that their existing agreement and funding meets their changing needs.

Eva Stark, JD, LL.M.

Eva joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.