

# The Importance of a Buy-Sell Agreement for Business Owners

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If you are the owner of a business that does not have a buy-sell agreement in place, or you have not reviewed your buy-sell agreement recently, it may be time to sit down with your Lathrop GPM attorney. Buy-sell agreements can be complex because they may address various issues including tax issues, valuation methodology, incapacity, death, bankruptcy, transfer restrictions, and management. Because of the wide spectrum of areas to address, it is important to retain an attorney with significant experience in this highly specialized area.

The following is an overview of a buy-sell agreement and provides further discussion around key considerations and common issues to consider in drafting and implementing a buy-sell agreement.

## What is a Buy-Sell Agreement and Who Needs a Buy-Sell Agreement?

- A buy-sell agreement is a written contract between two or more owners of a business, or among owners of the business and the business itself. The agreement sets out rules and expectations about what will happen in the event of certain triggering events.
- A buy-sell agreement helps ensure that the ownership and management of the company continue on in a manner that is in the best interests of the business and is fair to the owners by clearly defining what happens under different triggering events.
- Generally, any multi-owner business that would like a clearly defined plan regarding the transfer of ownership and management should have a buy-sell agreement in place.

## How does a Buy-Sell Agreement Benefit Business Owners?

A buy-sell agreement can provide the following benefits to the owners:

- Keeps ownership away from unfavorable owners (e.g., a spouse of a divorcing owner or heirs after the death of an owner).
- Ensures a reliable process for how a business interest will be sold or transferred upon certain triggering events.
- Establishes a consistent and fair method to value the interest of the selling or transferring owner, which may be relevant for estate tax purposes.

- Includes methods to purchase an owner's interest including how the purchase will be funded.
- Implements structure and creates provisions to remove owners under certain circumstances and other provisions to ensure continuity of business operations.

Buyout of Ownership. A buy-sell agreement typically provides for certain triggering events that can result in a buyout of an owner's interest. In general, the business interests are not transferable except in the manner described in the buy-sell agreement. Any attempted transfer that does not comply with the terms of the buy-sell agreement is generally void.

The following are common triggering events:

- Voluntary Transfer (e.g., choose to sell, gift, or retire);
- Involuntary Transfer (e.g., divorce, incapacity, or bankruptcy); and
- Termination of employment.

Purchaser in the Event of a Buyout. If a buyout is triggered, who buys the ownership interest the other owners or the business?

Optional or Mandatory Buyouts. Should a buyout be optional or mandatory? The answer to this question may vary depending on the triggering event and/or additional circumstances that can be specified in the buy-sell agreement.

Purchase Price. What will be the purchase price and how will the purchase price be determined? Some common methods for determining a purchase price include:

- *Fair Market Value Determined by Appraisal.* Fair market value is consistent with estate tax reporting and the income tax basis adjustment after an owner's death. Appraisals can be more neutral—they do not favor the buyer or the seller of the business interest. But, appraisals take time and involve expense.
- *Agreed Upon Fixed Price.* Generally, even if this method is utilized, another method (e.g., appraisal or formula) should be used if the owners have not agreed to a value during some period of time (e.g., 12 months) prior to the triggering event.
- *Formula.* The purchase price may be based on a formula using the assets of the business or the net income during prior years, which can vary depending on the industry of the business.

Payment Terms. What will be the payment terms? Often, a buyout is paid with a down payment and a promissory note for the balance, secured by the ownership interest being sold. If the buyout is triggered on an owner's death, then the payment terms should provide adequate cash to pay the estate taxes that may be due nine months after that owner's date of death.

Funding of Buyouts. If the business will be the purchaser, how will the purchase be funded? A buy-sell agreement should carefully consider how the purchase will be funded in the occurrence of a triggering

event. A bank loan to fund a buyout by the business may limit the cash flow of the business and its borrowing power for operations or expansion. If there is insurance on an owner's life, then the proceeds can be applied towards the purchase price after the owner's death.

#### Common Buyout Funding Options.

- *Insurance policy.* Life or disability insurance proceeds could be utilized to fund the buyout of the owner's interest.
- *Installment note.* Payments spread over a period of time can help the remaining owners or the business afford the buyout.
- *Cash.* Reserve cash in the business or held by the owners is the quickest and easiest way to fund a buyout.
- *Sale or Distribution of Business Assets.* Selling or distributing assets that are not essential to the ongoing operations of the business can generate needed liquidity.
- *Bank Loan.* Drawing on a line of credit or borrowing against other assets could provide another source of liquidity necessary to fund a buyout.
- *Employee Stock Ownership Plan.* Selling to an employee stock ownership plan creates beneficial ownership for the employees while also providing potential tax advantages.

Put and Call Rights. Are put and/or call rights appropriate? A put right is an owner's right to force the business or another owner to purchase an interest. A call right is a business's or other owner's right to force an owner to sell the owner's interest to sell an interest.

Right of First Refusal. In the event of a proposed transaction involving the sale or transfer of an interest in the business to a third-party, should the business or the remaining owner(s) have a right of first refusal to purchase the interest? If so, should the purchase price be the price agreed to by the third-party in a proposed sale transaction, the price applicable to other buyouts under the buy-sell agreement, the lesser of the two amounts, or another method of valuation.

Estate Planning/Family Transfers. Transfers to trusts or to family members for estate planning purposes or related entities should be considered and discussed further depending on the circumstances. Generally, it makes sense to allow transfers from an owner to an owner's revocable trust so long as the owner remains the trustee of the revocable trust.

Succession Planning. In most situations the implementation of a buy-sell agreement is not the same as creating a comprehensive business succession plan that involves the long-term continuation and transfer of the control of the business. Often a buy-sell agreement is more of a contingency plan that provides clear governance regarding the methods to exit the business after the occurrence of a triggering event.



Overall, the best advice to a business owner is specifically tailored to the needs and circumstances of the owner, the owner's family, and the owner's business and in order to develop a buy-sell agreement that is comprehensive, structured, and balanced. Therefore, it is of the utmost importance for business owners to retain experienced counsel to assist with planning and implementing a buy-sell agreement and reviewing it periodically to ensure that the agreement continues to accomplish the desired objectives as circumstances and tax laws change.

If you have questions or would like to discuss this topic further, please reach out to Matt Scheidker.