

Buy-Sell Agreements: A Risk Management Essential

Buy-sell agreements are critically important to a company's survival in the face of disaster or even the most long-foreseen ownership change. Unfortunately, owners often neglect to develop them early in a company's existence, and they become more difficult to settle as time goes on. Thus, you should create a buy-sell agreement as soon after starting a new business as possible. Or, if your company is already well-established, you need to immediately set aside time to create this risk management essential.

4 Key Elements

For any business entity, whether a corporation, partnership or limited liability company (LLC), buy-sell agreements serve a variety of purposes. For starters, they allow you to set the price and sale terms for departing owners while also determining who the company will — and won't — admit as a new owner. Plus, they can provide a ready market for the shares in the case of an owner's death or another ownership-change event. Here are four typically key elements of a buy-sell agreement:

1. **Triggering events.** Many people think of an owner's death as the primary triggering event, but it's certainly not the only one. Others may include disability, traditional retirement, divorce or bankruptcy, conviction of a crime or loss of a professional license, or owner disagreement. In short, you need to include any triggering event that would cause an owner to give up ownership or jeopardize his or her ability to own or even work for a company.
2. **Obligation to buy.** Also set forth in your buy-sell agreement the circumstances under which the business entity or remaining owners may buy a departing owner's share or stipulate a right of first refusal (without obligation) to buy the share. A business being obligated to buy a departing owner's interest is known as a "redemption agreement." If other owners are the ones who must buy, it's called a "cross-purchase agreement." Redemptions are more common in larger organizations, because they're less cumbersome — particularly if the agreement is funded by life insurance. (For more on this, see "Life Insurance: A Potential Funding Vehicle.") The cross-purchase option is more flexible, because acquisitions of the departing owner's interest needn't be proportional to existing ownership.
3. **Valuation provider and method.** Typically, a buy-sell agreement mandates that an independent and qualified business appraiser perform a valuation. Moreover, it should state guidelines for the appraiser, such as using fair market value. Fair market value is the price at which a willing seller would sell and a willing buyer would buy, each with reasonable knowledge of the relevant facts and without compulsion to sell or buy, respectively. It generally includes a discount for being a minority interest and for lack of marketability. Although this discount is favorable for estate tax purposes, it may mean the departing owner (or his or her family) gets a reduced value. Remember that you and your fellow owners must choose a valuation method at a time when no one yet knows who will be the first to depart. You may want to contact one of our valuation specialists at Beard Miller Company to discuss this subject in greater detail.
4. **Buyout terms.** Also address these in your buy-sell agreement. Which buy-out terms will apply usually depends on the applicable triggering event. For example, because life insurance can cover it, death typically prompts a lump-sum cash payment to the extent of available life insurance proceeds. An agreement will generally provide for payment of other buyouts over a period of years, so as to not create too large a burden on the business when an owner departs.

Many Difficult Issues

Without question, you face many difficult issues when crafting a buy-sell agreement. Nevertheless, the far greater peril is not facing the issues mentioned here, and others, either early in your company's existence or at some point well before an ownership change occurs. For help better understanding this critical task, please call us.

Sidebar: Life Insurance: A Potential Funding Vehicle

Among a company's funding options for a buy-sell agreement, life insurance stands out as a potential choice. When an owner dies, the coverage provides an immediate cash infusion to allow a lump-sum payout with no damage to the business. Life insurance proceeds generally are income tax-free to the beneficiary — whether an individual, business entity or separate entity. The only exception is the “transfer for value” rule, which asserts that proceeds will be taxable if a company transfers a corporate-owned policy to someone other than the insured or the insured's partner for valuable consideration.

The other side of the income tax equation, the trade-off, is that life insurance premiums for corporate-owned policies are not tax-deductible — even though a company is paying them to accomplish a business purpose. Because shareholders typically expect and hope that a company's value will rise over time, look for insurance flexible enough to follow a value increase by allowing additional future coverage regardless of changes in the insured individuals' medical histories.

In the case of a cross-purchase agreement (see the previous “Obligation to buy”), each owner will bear the life insurance costs as a nondeductible expense. Premium costs will vary — sometimes dramatically — by policy, depending on owners' respective ages, insurance ratings and ownership percentages. A policy generally can pay such insurance as additional compensation to each owner, “grossed up” because the premiums aren't deductible.

For example, it would take \$1,800 of gross compensation (if income taxes and payroll taxes are 45%) to equal a \$1,000 insurance cost. So beware that a 90% owner might end up paying most of his own eventual buyout's cost if the business covers the insurance premiums. Ultimately, when creating a buy-sell agreement, you must evaluate carefully whether it's really “fair” for the company to cover the entire cost.