



Buy-Sell Agreements



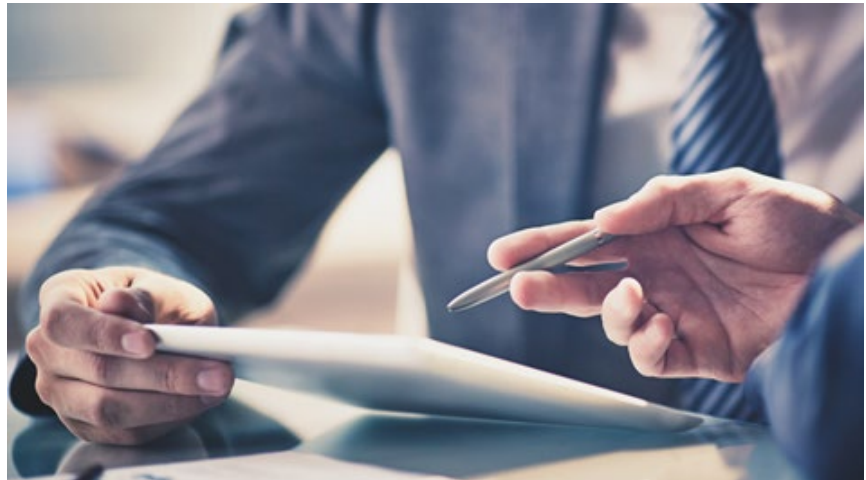
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Buy-Sell Agreements



A buy-sell agreement is a legally binding document signed by owners of property (typically a business) placing certain restrictions on the transfer of property and requiring specified actions upon specified events.

Advantages of Buy-Sell Agreements

- A properly arranged buy-sell agreement protects business and remaining owners from inactive, uninformed, and potentially dissident shareholders and helps consolidate control in the hands of the agreed upon group. It also keeps ownership out of the hands of unexpected outsiders such as a co-owner's creditor, a trustee in bankruptcy or ex-spouse.
- Active owner-workers can be sure that their incomes from the active business will be commensurate with their increased responsibilities and workloads, and their efforts will not go to someone who adds no value to the business.
- A buy-sell agreement will help fix the value of each owner's business interest. It can also help avoid costly, time consuming, and aggravating litigation with both other owners and the IRS.
- A binding agreement between the owners provides a market at a reasonable and fair price for what otherwise might be an unmarketable interest. To the extent the agreement is

properly funded, estate liquidity problems created by the inclusion of the business in the gross estate are eliminated.

- From the viewpoint of the heirs of a deceased business owner, a buy-sell severs their dependency on the surviving owners and the economic fortunes of a business that has lost a key person.
- The agreement is useful only to the extent adequately funded on the date of the “triggering event.”
- The agreement must meet the requirements of complex tax and other laws, and thus it may be complicated and expensive to have drafted.
- A buy-sell agreement is only as good as the price (preferably price setting formula) is fair to all parties. This means such agreements must be revisited and thoroughly reviewed at least every three years.

DIS-Advantages of Buy-Sell Agreements

When the Buy-Out Takes Place

No one knows whether the buy-out will occur:

- At a voluntary withdrawal of an owner prior to retirement
- At normal retirement age, as planned
- The owner has become disabled and can no longer work
- An owner can no longer contribute capital as required
- Because the owner has died or is terminally ill
- The owner’s stock would be involuntarily transferred (*such as to a creditor or ex-spouse*)

What is certain is that one of these events will occur!

So ideally, the buyer’s obligation will be funded in a manner that is easy for the parties to understand, is low cost, is easily administered, and will not adversely affecting the working capital or credit position of the business or professional practice.

**Buy-Sell Agreement
Mistakes**

Prudent business owners establish buy-sell agreements if there are partners or shareholders in the business, and sometimes even in a one-owner business. With a buy-sell agreement, the owners agree that if one owner leaves the business because of death, retirement, disability, or other triggering events, the remaining owner(s) will buy out that owner or the owner's estate.

Too often, however, business owners use canned buy-sell agreements, with little thought given as to how the contract best fits their particular needs.

Failure to Fund

One of the most common mistakes business owners make is failing to properly fund a buy-sell agreement. Let's say two partners, each owning half the business, agree to buy the other out in the event of death or other triggering event. However, how is the remaining owner going to pay for the other half of the business?

Few owners will have the cash, and banks will be reluctant to loan, especially if the business is still young and unproven. Bankers will question how the business, having just lost a key person, can service the debt of a new loan.

A new partner could be brought in, but the remaining owner may not want the new partner. The most common solution, though not the only one, is for a life insurance policy to be taken out on each partner or shareholder in the amount of the value of the interest of the owner.

There are many different methods of structuring the policies (ownership of the policies by the business can have severe tax consequences, for example), so business owners should work with a qualified financial advisor.

Determining Purchase Price

This may seem an easy question in the beginning, when the owners mutually agree on the value of the business. However, what happens several years down the road? What is an acceptable evaluation to the Internal Revenue Service? If the owners have not re-valued the business each year, there could be serious disputes. If one owner leaves in a way that is detrimental to the business (such as taking clients), should the departing owner receive a smaller price for his or her interest?

**All Owners
May NOT Be Equal**

Buy-sell agreements are usually easier to develop if the owners have equal shares of the business. However, what if there is a majority owner? The majority owner may not want the minority owners to buy his or her stock, preferring to have family members or a key employee take over. A standard buy-sell agreement may not allow this to happen.

Perhaps two, completely different, buy-sell agreements are needed. One for the minority owner might call for the interest to be sold to the majority owner(s). The majority owner might wish to have an agreement that calls for other family members to acquire his or her shares. Perhaps a stock redemption agreement may be the most suitable arrangement for one of the owners.

Missing Triggers

Nearly all buy-sell agreements allow for the death or the retirement of the owners to trigger the buy-sell option. Sometimes overlooked is the disability or divorce of an owner.

In the event of divorce, for example, the stock could end up in the hands of the spouse, which the remaining owners may not want. Other triggering events can be the firing of a minority owner, or the personal bankruptcy of one owner.

**Refusing the Right
of First Refusal**

A common provision in buy-sell agreements is the right of first refusal. The departing owner cannot sell his or her interest without first offering the remaining owners the opportunity to buy it. This may sound like it puts each owner in control, but in reality that is not always the case.

A minority owner of a small business, for example, will probably have a hard time finding an outside buyer willing to pay for fair market value for a minority interest.

On the other hand, if the departing owner does find a buyer, the remaining owners may find it difficult to come up with the money to buy the owner out in order to avoid bringing in an undesired new co-owner.

By tailoring an agreement to your needs, these and other common buy-sell agreement problems can be anticipated and avoided.

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