BUY-SELL AGREEMENTS

DEFINITION

A buy-sell agreement is a legally binding agreement between co-owners of a business in the event one of the owner dies, is forced to leave, or chooses to leave the business. They are also known as business continuation agreements and buyout agreements. Determining what would occur to a closely held business if one of the owners could no longer continue is a vital question for the remaining owners as it is very important to maintain continuity of ownership and management. A buy-sell agreement acts as a sort of premarital agreement between business partners and can also be funded in advance with life insurance on the participating owners' lives.

HOW THEY WORK

OVERVIEW

A buy-sell arrangement accomplishes four main objectives:

- Defines "triggering events" of which, upon their occurrence, the stipulations of the buy-sell agreement are to be followed.
- Stipulates who can buy a departing owner's share of the business.
- Provides a mechanism whereby the purchase price may be determined.
- Establishes a funding source, primarily through insurance policies, in order for the remaining owners to have the liquid assets needed to complete the purchase.

TRIGGERING EVENTS

The first section of a buy-sell agreement will specify certain "triggers" which will set the agreement in motion. These events typically include:

- Death
- Disability
- Retirement
- Owner's divorce or bankruptcy

PARTIES INVOLVED

Depending on the situation of an owner's exit, the remaining owners will want to protect the business from a divorced spouse, minor beneficiary, or even the courts. To maintain continuity of ownership and management and ensure the viability of the company's operations, a buy-sell agreement stipulates who can buy a departing owner's share of the business. This may include outsiders or be limited to other shareholders.

VALUATION

Although it is difficult to know what the value of a company will be in the future, a buy-sell agreement can establish the valuation metrics to be used in the case of a triggering event. Remaining owners will not want to over-pay for a business interest, and the departing owner will want to ensure that they (or their family) will receive fair value for their interest. In order to determine the fair market value, independent appraisals may be necessary, or standard methods such as book value or other formulas may be used. In the case of a deceased owner, proper valuation also determines the value in the deceased's estate for federal estate tax purposes.

FUNDING

The final, and possibly most important, part of a buy-sell agreement is the manner in which the business interest will be paid for. In order to ensure adequate liquidity at the time of purchase, a buy-sell agreement may be fully funded. This entails purchasing life insurance on the lives of a business' owners in order for the business to receive the death benefit, ensuring there will be money when the buy-sell event is triggered. If sufficient life insurance is not purchased to fund the full value, then an installment purchase arrangement should be provided for the remaining balance. The price might be paid in cash or installments over time and there can be different terms for different events.