



Business Planning

WHY YOU NEED A BUY-SELL AGREEMENT

As the owner of a closely held business, the failure to adequately plan for the continuation of the business upon an owner's death, can have disastrous consequences. There are adverse consequences: (1) to the business (e.g., loss of revenue, lack of continuity, loss of skills, credit risk, etc.); (2) to the surviving owners (e.g., disputes with deceased owner's family, having an "unwanted" new partner, inability to move on with the business without distractions, etc.); and (3) to the deceased owner's family (e.g., preserving the fair value of the business for the family's needs, replacing a lost income, meeting estate liabilities, etc.). All of these issues can also apply when an owner becomes disabled and can no longer help the business.

One Solution: A Buy-Sell Agreement

It is not uncommon for surviving business owners to find that the heirs of the deceased business owner want to take on a role in the management of the business, even though the family members may have insufficient skills or experience to participate in the business, let alone, the management of the business. Perhaps, the surviving business owners want nothing to do with the deceased owner's family because of the lack of trust or chemistry. Alternatively, the deceased owner's family may be under pressure to raise cash to pay taxes, administration and probate expenses and the business interest is the only substantial asset available to be liquidated. In the case of a forced liquidation, the value realized may be significantly less than expected or required.

What is clear is that regardless of whether the business is to be continued, sold to the surviving owners or outsiders, or even liquidated, the death of a business owner creates a need for cash. Only cash can:

- Be used by the business owner's executor to pay estate taxes, administration and probate expenses;
- Provide surviving family members with the full and fair value of the deceased owner's interest in the business;
- Provide surviving family members with an adequate source of funds to replace the income stream lost; and
- Ensure that at an extremely emotional time, the business will continue in an uninterrupted fashion.

A properly funded buy-sell agreement is required to avoid all of these issues, and more.

How Does It Work?

A buy-sell agreement is a legal contract drafted by an attorney that obligates surviving owners or the company itself, to buy-out the interest of an owner who dies or becomes disabled. The estate of the deceased owner or a departing owner is obligated to sell. The agreement may also spell out other triggers such as the retirement of an owner, the criminal conviction of an owner, and more. This agreement ensures that there will be a ready market for your business interest should you die, become disabled or otherwise leave the business. The agreement also spells out methods to determine a fair price for your ownership interest.

There are several ways to structure a buy-sell agreement. Each is dependent upon the number of owners, the legal structure of the business entity, and tax considerations. Generally, however, the three main types of agreements are called: (1) cross purchase agreements; (2) entity purchase agreements; and (3) a wait-and-see agreement which is a hybrid of the first two.



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The cross purchase agreement envisions that a co-owner will buy out the interest of a deceased or departing owner. The entity purchase obligates the company to buy out the deceased or departing owner. For corporations, the entity purchase is also known as a stock redemption plan. The wait-and-see purchase is a hybrid that allows the company and owners to defer the choice between cross purchase and entity purchase until a triggering event. This allows the owners and the company to react to financial conditions and tax issues at the time of the triggering event. By working with your financial advisor as well as your tax and legal advisors, they will help you to determine the best structure for your business and your needs.

There are also several ways to fund a buy-sell agreement. Funding the agreement means that when a triggering event occurs, there is a source of funds to actually pay the buy-out price. The typical methods of funding an agreement are as follows:

Reserves – if your company maintains cash reserves, it might be able to dip into those reserves. More likely, however, is that the reserves are insufficient to pay the buy-out price and that the funds were earmarked for other purposes, such as growth initiatives, new hires, research and development, etc.

Borrowing – many businesses utilize credit for their business but oftentimes, credit is an impractical and expensive solution. That assumes that the lending institution is even willing to loan money to the company or to co-owners, now that one of the owners has died or left the business.

Installment Sales – some businesses or co-owners may decide to self-finance the buy-out from business cash flow. That is typically as impractical or expensive as using reserves or borrowing. Cash flow will be tied up to meet debts that do not contribute to the revenue and growth of the company. In addition, upon the death or departure of an owner, how will that impact business cash flow?

Insurance – life insurance and disability buy-out insurance are the most economical and practical solutions to funding your buy-sell agreement. Policy benefits are paid out when the triggering event occurs and by using permanent life insurance, cash values can be used to partially fund a lifetime buy-out.

As you can see, successful owners of closely held businesses need to worry about the future, when they or their partners may no longer be part of the business due to death, disability, retirement or other factor. To ensure that the business remains strong and can continue to grow by overcoming the loss of an owner requires proper business continuation planning through a properly funded and structured buy-sell agreement.

Please consult with your Guardian Financial Representative if you have any questions concerning this document.

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