Questions/Answers on a Buy~Sell Agreement for Your Business

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1. **When does a business need a Buy~Sell agreement?**

Every co-owned business needs a buy-sell, or buyout agreement the moment the business is formed or as soon after that as possible. A buy-sell, or buyout agreement, protects business owners when a co-owner wants to leave the company (and protects the owner who's leaving). If a co-owner wants out of the business, wants to retire, wants to sell his shares to someone else, goes through a divorce, or passes away, a buyout agreement acts as a sort of "premarital agreement" to protect everyone's interests, setting the price and terms for a buyout. Every day that value is added to a business without a plan for future transition, it increases the owners' financial risk.

2. **A buy-sell agreement is used for buying and selling businesses, right?**

No. Despite the name, buy-sell agreements have little to do with buying and selling companies. Instead, they are binding contracts between co-owners that control when owners can sell their interest, who can buy an owner's interest, and what price will be paid. These agreements come into play when an owner retires, goes bankrupt, becomes disabled, gets divorced, or dies -- in other words, a buy-sell agreement is a sort of prenuptial agreement between business co-owners. Mainly these agreements guide buyouts between the owners themselves; that's why we like to call them buyout agreements.

3. **If a co-owner of a business divorces, can the former spouse ask for part ownership in the business?**

In some states, yes, and the former spouse can succeed in getting it, too. In community property states (Arizona, California, **Idaho**, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), all earnings during marriage and all property acquired with those earnings are considered community property, owned equally by husband and wife. When property is divided during a divorce, each spouse can claim a right to all community property.

Even in non-community property states, a spouse could argue for a partial interest in the business, because marital property laws require property to be divided equitably during divorce.

To avoid this prospect, a good buyout or buy-sell agreement requires the former spouse of a divorced owner to sell any interest received in a divorce settlement back to the company or the other co-owners, according to a valuation method provided in the agreement.

4. **Can a co-owner's personal bankruptcy affect the business?**

In the worst case scenario, a bankruptcy trustee could liquidate the business (sell all of its assets) and take half to pay the bankrupt owner's debts. To prevent a business from getting tied up in bankruptcy court, the owners can sign a buy-sell or buyout agreement that requires a co-owner who faces bankruptcy to notify other co-owners before filing. Under the terms of this agreement, this becomes an automatic offer to sell the bankrupt owner's interest back to the other owners. The buyout money goes to the bankruptcy trustee and the business can proceed without difficulties.

5. **What's the best way to value a company when an owner is being bought out?**

You can hire a professional appraiser or use a valuation formula to come up with a price using financial statements from one or more years. But the problem is that valuing a business at the time of sale usually results in co-owners seizing on different valuation formulas, which can produce very different results. For that reason, it helps for the owners to agree on a way to value the company in advance in a buy-sell or buyout agreement. This gives owners the chance to discuss and vote on how a reasonable price for the company should be calculated. The fact that a sound method was agreed to beforehand can go a long way to reducing conflict when the time for a buyout comes.

6. **What happens if a company needs to, but can't afford to, buy out one of its owners?**

Requiring an immediate 100% lump-sum cash payout can prevent even the most successful company from buying back an owner's interest. That's why having flexible payment terms built into a buy-sell or buyout agreement, signed in advance, can help. For instance, a buyout agreement can provide for a down payment of 1/4 to 1/3 of the buyout price followed by installment payments for three to five years at a reasonable rate of interest. For more on buyout agreements,

7. **Can a Buy~Sell agreement be used to avoid estate taxes?**

Buy-sell, or buyout, agreements have been used successfully to lower estate taxes in intergenerational businesses -- businesses where at least one co-owner plans to leave the interest to heirs who will remain active in the business. This can help a family business owner pass the business on to children or other relatives without burdening them with unnecessary estate taxes caused by an aggressive value of the business. The key for estate planning is choosing a conservative price or valuation formula for the business in the buy-sell or buyout agreement. The result can be to legally set the value of the ownership interest at an amount considerably lower than its sales value at the time of death.

Ways to Fund a Buy~Sell Agreement

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Cash Sinking Fund: Cash has the apparent advantage of being simple and requiring no immediate outlay. The problem is that the purchaser does not know precisely when or how much cash will be needed (or who the survivor will be), and thus must always keep a large after-tax cash reserve available. Inevitably, cash sinking funds are inadequate, because death or long-term disability of a working shareholder is always, premature.

Borrowing: Borrowing has the advantages of being simple and requiring no outlay until death or disability occurs. The question is: Will a bank lend money to a business that has just lost its most important asset, the person who made the corporation what it was? If the bank makes the loan, will the terms or rates be reasonable and affordable from the borrower's viewpoint? How will the cash-flow demands of repaying the loan impact the operation and credit-worthiness of the business? How much will the total loan cost?

Installment Payouts: An installment sale is simple and a relatively small outflow is required each year. Seemingly nothing is needed until death occurs, so action can be put off for many years. But the installment payout method merely delays the pain and obfuscates the full extent of the problem. From the buyer's perspective, an installment sale merely spreads out the obligation but does not provide the cash to effect the buy-out. The longer the term of the payments and greater the obligation, the more adverse the affect on the credit rating of the business. From the seller's (or seller's family's) point of view, an installment payout does not provide the large sums of cash often needed for estate settlement costs, living expenses, and debts. Furthermore, it entails great risk since it leaves substantial sums at the risk of a business which has just lost a key employee.

Life Insurance: Adequate life insurance makes it possible for a stockholder's surviving spouse or children to immediately receive the full fair market value of the decedent's business interest and bail out the business before it could lose value. The presence of life insurance is excellent evidence to bank loan officers and other creditors that the shareholders are financially responsible. Premiums can be viewed loosely as advance installment payments which are easily budgeted so the event of the buy-out doesn't hurt the cash flow of the business. If the buyout occurs during lifetime, the cash values of a life insurance policy can be used to help provide a portion of the purchase price. These cash values can be obtained from the policy on a tax-favored basis either by policy loan, withdrawal, or by a partial surrender of the policy. There is, of course, a cost; premium dollars are an outlay with a delayed economic benefit. But this is far offset by the great peace of mind attained by all parties when the buy-sell is fully and properly funded.

Advantages of using Life Insurance to Fund a Buy~Sell

- Life insurance creates a lump sum of cash to fund the buy-sell agreement at death
- Life insurance proceeds are usually paid quickly after your death, ensuring that the buy-sell transaction can be settled quickly
- Life insurance proceeds are generally income tax free; a C corporation may be subject to the alternative minimum tax (AMT)
- If sufficient cash values have built up within the policies, the funds can be accessed to purchase your business interest following your retirement or disability

Disadvantages of using Life Insurance

- Life insurance premiums are paid with after-tax dollars because the premiums are generally not a tax-deductible expense
- Premium requirements are an ongoing expense
- One or more co-owners may be uninsurable due to age or illness
- If the co-owners' ages vary widely, younger co-owners will have to pay higher premiums on the lives of the older co-owners
- If the ownership percentages vary widely, more insurance will be needed to cover the owners with the larger ownership interests, resulting in higher premium costs for those with smaller ownership interests

BREAKING DOWN a 'Buy~Sell Agreement'

In order to ensure the availability of funds in the event of a partner's death, most parties will purchase life insurance policies on the other partners. In the event of a death, the proceeds from the life insurance policy are used to purchase a portion of the deceased's business interest. It is important to note that when a sole proprietor dies, since he/she has no partners, a key employee may be the buyer or successor.

How to set up different types of Buy~Sell agreements

In an entity purchase buy-sell agreement, the business itself buys separate life insurance policies on the lives of each of the co-owners. The business usually pays the annual premiums and is the owner and beneficiary of the policies.

In a cross purchase buy-sell agreement, each co-owner buys a life insurance policy on each of the other co-owners. Each co-owner usually pays the annual premiums on the policies they own and are the beneficiaries of the policies. If your company has a large number of co-owners, multiple policies must be purchased by each co-owner.

A wait and see (or hybrid) buy-sell agreement allows you to combine features from both the entity purchase and cross purchase models. The business can buy policies on each co-owner, the individual co-owners can buy policies on each other, or a mixture of both methods can be used.

**Keeping track of your Buy~Sell agreement

Each year, the premiums on the policies must be paid, or the insurance will lapse. So monitor premium payments carefully. Your buy-sell agreement should include a feature requiring ongoing proof of payment. Also, review the amount of insurance regularly. The insurance coverage may have to be increased periodically to reflect increases in the value of the business. If additional insurance is not possible, another funding method should be established. Finally, periodically check the financial rating of your insurance company. The policies funding your buy-sell agreement will do your family no good if the insurer becomes insolvent.

What Insurance Product do I use?

When establishing a Buy~Sell Agreement you may use either a Term Insurance product or a Permanent Insurance product. It depends on how you want to set things up.

A **Term product** would cover primarily the death of an owner or co-owner with some possible accelerated death benefits. Premiums are considerably lower and length of coverage is only to 30 years. No Cash Value.

A **Permanent Product**, with its *Cash Value factor can, over time, develop a strong cash value that can be borrowed against for other than death reasons i.e. disability, divorce, business debt etc. Premiums are definitely higher; however, over the lifetime of the policy the actual cost of insurance is lower. Coverage can go to 121 years.

Sources for this information: 360 degrees of Financial Literacy (American Institute of CPA's), Bay Financial, Nolo.com