Buy Sell Planning – Part 1: The Basics

For many business owners, the value of their business is one of the largest components of their overall net worth, and the business itself is the result of years of hard work and investment. Most business owners want to preserve the built up value of the business for themselves and their family while also ensuring that the business legacy they have helped create continues for years to come. The best solution is a well-considered Buy-Sell Agreement.

A Buy-Sell Agreement is a contract entered by owners of a business that specifies when and how ownership in the business will be sold or transferred. The agreement can be a stand-alone agreement or incorporated into a partnership or operating agreement for your business. Buy-Sell Agreements are not "one size fits all", so careful attention should be given to the details.

Most business owners have heard of the importance of a good Buy-Sell Agreement, but many push this planning to the "back burner" to focus on immediate business needs. A recent client of mine and his partner had even purchased life insurance for buy-sell purposes but had no agreement in place to govern the obligations of the business partners to buy the other's ownership interest if either dies. The client believed his partner would 'do the right thing,' but his wife wasn't so sure. I explained to the client that if he were to die, the absence of a Buy-Sell Agreement could allow his business partner to walk away with life insurance proceeds instead of using it to buy the client's ownership interest from his estate. This would leave the client's wife without a large portion of the inheritance she would need to survive her retirement.

Buy-Sell Agreements are best created when all owners are getting along and the parties are in a position to negotiate a plan amiably. Some business owners avoid discussing buy-sell planning because they think it only applies if there is a fight between the owners requiring a "business divorce," and they don't want to consider that possibility. However, a business divorce is only one of many triggering events to be considered in a Buy-Sell Agreement. Most triggering events, such as death, disability, retirement, and personal bankruptcy are entirely unrelated to the relationships among the owners. The main purpose of a Buy-Sell Agreement is to protect the owners, their families, and the business itself by creating a clear transition plan and a ready market for the parting owner to liquidate his business interest. A Buy-Sell Agreement may also limit how ownership is transferred to outsiders so that the owners have some control over who their business partners are.

Some of the main issues covered in a Buy-Sell Agreement include:

(i) Who has the right to buy the business interest (e.g. the business itself or the other owners);
(ii) Circumstances triggering a sale or transfer of a business owner's interest (e.g. death, disability, retirement, employment termination, divorce, personal bankruptcy, etc.);
(iii) The fair market value of the business and corresponding sale price for the business interest;
(iv) The payment terms for the purchase of a business interest (e.g. lump sum, installment payments, interest rates, payment schedules, etc.); and
(v) Any conditions or restrictions on the business interest (e.g. right of first refusal, consent to a standing shareholders agreement, commit not to violate S-election, etc.)

The next 4 parts of this 5-part series will highlight some aspects of a good Buy-Sell Agreement.

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