Buy Sell Planning – Part 2: Triggering Events and Buyout Payment Terms

The most fundamental detail of any Buy-Sell Agreement is defining what circumstances will trigger a buyout. Buyout payment terms should be carefully tailored to each triggering event. Here are a few common triggering events and some considerations for payment terms.

Death. An untimely death is almost universally included in any Buy-Sell Agreement. Despite being the worst of all possible triggering events, death is actually the easiest event to plan for in a Buy-Sell Agreement. Life insurance policies in connection with a Buy-Sell Agreement allow an immediate source of liquidity to fund a buyout obligation without burdening the assets or ongoing cash flow of the business. Given the immediate source of insurance proceeds, a death buyout often occurs as a lump sum payment within a certain time period after the death of the owner. Immediate payment can also be important for estate tax purposes if the value of the business interest will be included in the deceased owner's taxable estate and a tax payment is due within 9 months after death. Obviously, it is important to ensure the life insurance amounts are in line with the buyout price in the Buy-Sell Agreement.

Disability. A permanent disability is another common triggering event. The Buy-Sell Agreement should very clearly define permanent disability and who determines whether a disability has occurred (e.g. business management or Board of Directors, a panel of physicians, an insurance company under a disability policy, etc.). I have had clients who have resorted to lawsuits over whether a disability buyout has been triggered under their buy-sell (It wasn't my buy-sell agreement they were fighting over ☺). Disability is another triggering event where insurance is extremely useful, but unlike life insurance, disability insurance is frequently paid in installments over time. So it makes sense to coordinate the payment terms under a disability buyout with the payment terms under a corresponding disability insurance policy.

Retirement. An owner's retirement is another common triggering event, but let's not all leave the party at once! The conditions under which an owner has the right to retire (e.g. age, years of service, etc.) can be a heavily negotiated detail and specified in the Buy-Sell Agreement. Since an owner's retirement won't produce insurance proceeds, the payment terms are very important. Often there is a down payment with installments made over time under a promissory note bearing interest. These payments may come from borrowed funds, cash reserves of the company, or ongoing cash flow from operations. In either case, this will put stress on the finances of the company which reinforces the importance of addressing Buy-Sell Agreements well in advance so owners can plan and prepare accordingly.

Termination (of Employment or Business Relationship). This is the triggering event that most often prevents owners from addressing their Buy-Sell Agreement in the first place. The possibility of a business break-up is one of the biggest fears of any business owner, especially when the owners are good friends. If the business doesn't work out, the best way to preserve any remaining friendship is to have a very clear written agreement that was negotiated amiably and in good faith that outlines the steps to be taken. Purchase price and payment terms are sometimes structured to penalize owners for events of termination, but this often adds to the tensions and typically guarantees ongoing disputes between owners.

Owner's divorce or bankruptcy. Many business owners candidly admit they would not want to do business with their partner's spouse, and the same can be said for a partner's personal creditors in a bankruptcy. Divorce or bankruptcy is an important, and often overlooked, triggering event in a Buy-Sell Agreement. To prevent an owner's spouse or creditors from interfering in the business, the other owners should have a buyout option to compel the affected owner to sell his interest to the remaining owners or the entity itself. This is usually structured as an optional buyout to give the business and other owners the maximum flexibility to make a decision that is best for the business – either deal with an undesirable business owner or endure financial stress on the company to buy out the interest. As with termination events above, purchase price and payment terms can be structured to penalize ex-spouses or creditors to discourage pursuit of the business interest to satisfy a divorce or creditor judgment.

Desire to sell the interest to a third party. Some Buy-Sell Agreements generally prevent a sale or transfer of a business interest to a third party without prior consent of the other owners or management. Even without this general transferability restrictions, most Buy-Sell Agreements provide a "right of first refusal" that requires an owner to present the terms of the potential third party sale to the business and/or other owners and give the option of: (i) matching the offer made by the outsider; (ii) having the business or the other purchase the interest in accordance with the Buy-Sell Agreement; or (iii) allowing the sale to be completed with the outsider.

Part of any good business plan is an exit strategy if the unexpected happens. A good Buy-Sell Agreement should anticipate certain unfortunate but foreseeable events, and make sure a fair and reasonable plan is in place.