Buy Sell Planning – Part 5: Funding a Buy-Sell Agreement

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. When a triggering event occurs, everyone should be fully comfortable and prepared to move forward with the plan.

The most critical detail of the Buy-Sell Agreement to the company's survival is how to pay the purchase price for a departing owner's interest. If the company or other owners do not have adequate assets, cash reserves, or credit available to fund the payment obligations, then they cannot fulfill their side of the agreement. This isn't good for anyone – the departing owner (or his estate and family), the company itself, or the remaining owners.

Insurance. Since death and disability are two of the most basic triggering events in any Buy-Sell Agreement, life and disability insurance can be the most attractive methods for funding the payment obligation after those triggering events.

Term or permanent life insurance or a mix of both may make sense depending on the circumstances. The structure of the Buy-Sell Agreement as a redemption, cross-purchase, or hybrid will determine who should own the insurance policies. Careful attention should be given to the ages and insurability of the owners to determine a structure that is fair, cost effective, and will cover the appropriate time horizon the business owners' needs. As the business grows and its fair market value increases, owners should ensure that additional life insurance can be acquired over time to keep pace with the increasing value of the business. Guaranteed insurability options on term or permanent insurance can allow the policyholder to acquire additional life insurance at certain intervals.

If an owner is not insurable at the time that the Buy-Sell Agreement is entered, it may be possible to use an existing policy of the uninsurable owner, if one exists. If an existing policy is transferred to the company or other shareholders, there are certain rules and strategies to follow to help prevent adverse tax consequences to the insurance proceeds after the insured's death. Make sure you have good tax and insurance advisors helping you with these details.

Funding without insurance. Some owners choose not to use life or disability insurance in funding death or disability triggering events in Buy-Sell Agreements. Typically these owners believe that, in the long-run, the returns on capital reinvested into the company will far exceed the potential returns from any investment in insurance, and they are willing to roll the dice that they will live long enough for this to be the case. Also, keep in mind that there are other triggering events for which insurance is not relevant (e.g. retirement, bankruptcy, divorce).

If insurance is not used or not applicable, some businesses and owners will strategically set-aside and invest funds to cover any anticipated buy-sell payment obligations. Even if funds have been set aside, it is always important to structure buyout payment terms giving the business or owners a sufficient time to pay for a departing owner's interest. Talk with your bank and lenders to discuss payment obligations under buy-sell planning and the possible need for credit facilities in case debt funding is required.

Combination funding. Some owners choose a combination of life insurance and other funding methods for the Buy-Sell Agreement. Life insurance can guard against premature deaths, with the remainder funded by accumulated earnings and corporate profits. For example, shareholders in a corporation could create a buy-sell arrangement to purchase 65% of the stock through a cross-purchase agreement (with immediate funding by life insurance), and 35% of the stock would be redeemed by the corporation over time after the death of a shareholder. Alternatively, shareholders may opt to initially fund 100% of the buy-sell agreement with a cross-purchase design funded by insurance. The funding of the agreement can then change annually, with the corporation assuming responsibility for purchasing any incremental increases in shareholder value as the corporation grows. This eliminates the need to increase the amount of life insurance over time. It also provides assurance to the shareholder's family that it will receive a minimum amount whether or not the corporation can generate the funds needed for the buy-sell arrangement.

A Buy-Sell Agreement is a critical component of any business plan. If protecting the value and future of your business is important to you, your family, your partners, and employees, then don't get caught off guard without a plan!