

# Contingency Planning: Do You Have a Buy-Sell Agreement?

Enrique C. Brito, CFA, AVA, CM&A

Most business owners are concerned with ensuring the continuity of their businesses' ownership and management in the event that one of the owners can no longer continue. Their primary considerations include such issues as how to deal with transferring ownership interests of the departing partner(s) and how to fund the buyout without compromising the liquidity of the business. Moreover, owners also would want their families to be compensated fairly for their share of the business should they die or become disabled.

A properly drafted buy-sell agreement should address many of the challenges that arise at such critical junctures in the life of a business. In essence, this contract establishes the framework for owners to agree on the price, terms and conditions of a future sale. It ensures a smooth transition and business stability and provides the departing owner with a ready market for the sale of his or her business interest.

## What is a Buy-Sell Agreement?

A buy-sell agreement is a contract that provides for the future sale of your business ownership interest or for the purchase of a co-owner's interest. The agreement outlines the terms for the transfer of your business interest by you (or your estate) upon the occurrence of a specified triggering event. The most common of these triggering events include: death,

disability, retirement, the sale of an interest to a third party or an owner's divorce or bankruptcy.

Typically, the buy-sell agreement provides that the remaining owners of the business, or the entity itself, will purchase the departing owner's share of the company. In addition to specifying the circumstances that will trigger a mandatory or optional buyout of an owner's interest, the agreement stipulates the price to be paid for the ownership interest, or alternatively provides a formula for determining the price. Ideally, buy-sell agreements are fully-funded (life insurance frequently is used for this purpose - see "Funding Buy-Sell Agreements," below).

## Types of Buy-Sell Agreements

A buy-sell agreement usually takes one of three forms: a cross-purchase agreement, a redemption agreement or a hybrid agreement.

In a **cross-purchase agreement** a departing owner agrees to sell his or her interest to the remaining owners. This is most suitable for the sale of a small business with only a few owners. As the number of owners increases, this form can become unwieldy as it requires each owner to obtain life insurance or disability insurance policies on the other partners in amounts sufficient to purchase the business interest. In larger businesses, redemption agreements may be more suitable.

In a **redemption agreement**, the departing owner agrees to sell his or her interest to the entity. The business is responsible for financing the purchase, which may be funded by using the business's resources or by an insurance policy on the life of the departing owner.

A **hybrid agreement** is a combination of the first two types. Typically, the departing owner must give the business the right of first refusal to buy the ownership interest. If the entity declines or is unable to make the purchase, then the shares must be offered to the other owners. Keep in mind, however, that if a business, with accumulated earnings and profits, assumes a shareholder's obligation to purchase another's ownership interest, the IRS may impute to the shareholder a constructive dividend (that is, reclassify the transaction as a dividend distribution).

### **Funding Buy-Sell Agreements**

A buy-sell agreement typically is funded with an insurance policy, either term or whole life insurance. Premiums for term life insurance increase throughout the coverage period, whereas premiums for whole life remain constant throughout the coverage period.

In addition to the cost of the insurance, the ability to maintain life insurance throughout a shareholder's life is an important consideration. Generally, whole life insurance policies provide coverage until death and cannot be cancelled by the insurance company. This feature has persuaded many shareholders that whole life insurance is the most advantageous way to finance corporate buy-sell agreements. In response to this trend, the term life insurance industry has modified its products so that policyholders can purchase term life policies having the same benefits. This can be accomplished with either a guaranteed insurability option or a lengthy policy term (usually 20 to 30 years).

While adding a guaranteed insurability option to a term policy increases its costs, the premium will still be lower than whole life premiums in the early years. Consequently, owners must weigh the increasing premiums of term insurance against the early returns that might be realized by purchasing less-

expensive term insurance and investing the money saved.

Another alternative available to business owners is to invest in the business' operations rather than purchasing life insurance policies. The underlying premise being that the return on corporate operations, especially in the early years, may yield substantially greater returns than those offered through life insurance. This is particularly true in those situations in which the business owners expect to live at least as long as their actuarially determined life expectancy.

A more conservative approach to funding the buy-sell agreement involves funding a portion of the buy-sell agreement with life insurance to safeguard against premature deaths, with the remainder funded by accumulated earnings and corporate profits of the business.

### **Conclusion**

Executing a well-drafted buy-sell agreement can assure owners in a closely-held business that their interest in the business is secured regardless of any unforeseen circumstances. In most cases this can be accomplished without creating an excessive strain on the business's cash flow, thus ensuring the continuity of operations while keeping financial disruptions to a minimum. Other provisions to consider in the buy-sell agreement might include a non-competition clause and a clause providing for the termination of the buy-sell agreement itself. Competent and experienced legal counsel should draft the agreement and advise each owner regarding their individual interests.

**About the Author:** Enrique C. Brito is a partner and senior managing director of The Mclean Group, a national investment bank providing merger and acquisition, valuation and private equity financing services. He has over 17 years of corporate finance and investment banking experience and lectures nationally on the subjects of M&A and business valuation. He can be reached via e-mail at [ebrito@mcleanllc.com](mailto:ebrito@mcleanllc.com) or call 703-827-5093.