Any Questions?

Call (949) 862-1233

Buy-sell agreement

What is it?

A buy-sell agreement is a written contract between two or more owners of a business, or among owners of the business and the entity. It sets out rules and expectations about what will happen in the event of the death, disability, divorce, insolvency, or retirement of any owner (a "triggering event").

How does it work?

The purchase and sale of interests of the business — at a price determined under the agreement — is dependent on the occurrence of certain triggering events. Additionally, the agreement will specify whether this is an option or an obligation. A buy-sell agreement:

- Can protect the business by preventing transfers of ownership to unqualified or unwanted persons (e.g., ex-spouses of a divorcing owner or heirs of a deceased owner).
- Sets out how a business interest will be transferred, and defines the process for settlement of the agreement.
- Usually includes a formula or procedure for determining the sale price.
- May establish a funding mechanism to facilitate the purchase of an owner's interest.
- May establish the value of the business for estate tax purposes, subject to IRS requirements.

Who needs a buy-sell agreement?

A buy-sell agreement provides a plan for the orderly transfer of any owner's business interest. You should consider a buy-sell agreement for your business if:

- You have two or more owners.
- You want to provide protection in the event of any owner's retirement, divorce, disability, or death.
- You want to provide a means for an orderly transfer of any owner's business interest.

How are these agreements funded?

Funding methods can include:

- **Installment payments.** The purchase price is paid to the seller over a period of time.
- **Borrowed funds**. The business may be able to borrow funds through commercial loans, allowing the business to redeem an owner's interest.
- **Sinking fund.** Over time, a business may build up a fund earmarked for redeeming an owner's interest. (This is not common.)
- **Insurance.** The proceeds from a life insurance or disability buyout policy can fund the agreement.

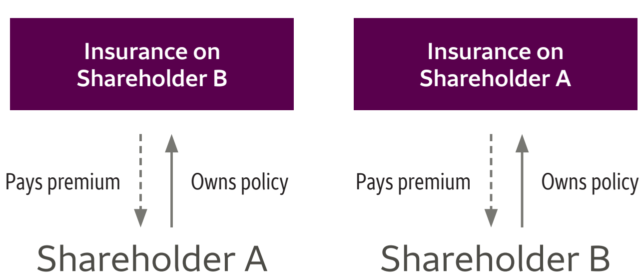
Factors that typically influence the choice of funding methods include the size and structure of a business and its tax bracket, the number of owners involved, their ages, the tax bracket and percentage of ownership, and the levels of cash and/or credit available to the business entity or to the owners, as well as the type of buy-sell agreement.

What are the most common types of agreements?

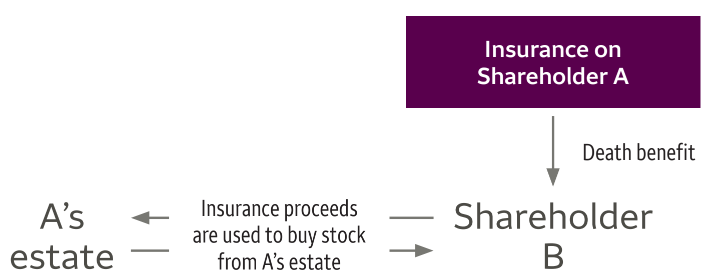
The most appropriate agreement depends on several factors, including how your business is organized and the number of owners in the business. The three most common designs are:

- **Cross purchase.** In a cross purchase arrangement, each owner of the business agrees to purchase some or all of another owner's interest after a triggering event occurs. When the death of an owner is the triggering event, one of the most common funding vehicles is life insurance. Each owner holds policies on all of the other owners. In the illustration below, Shareholder A holds a life insurance policy on Shareholder B and vice versa. Both are responsible for paying premiums associated with the respective policies. Upon a triggering event occurring — in this example, the death of Shareholder A — the proceeds of the insurance policy would be received tax-free by Shareholder B and provide him or her the liquidity needed to purchase Shareholder A's interest in the business.

Cross purchase: initial structure

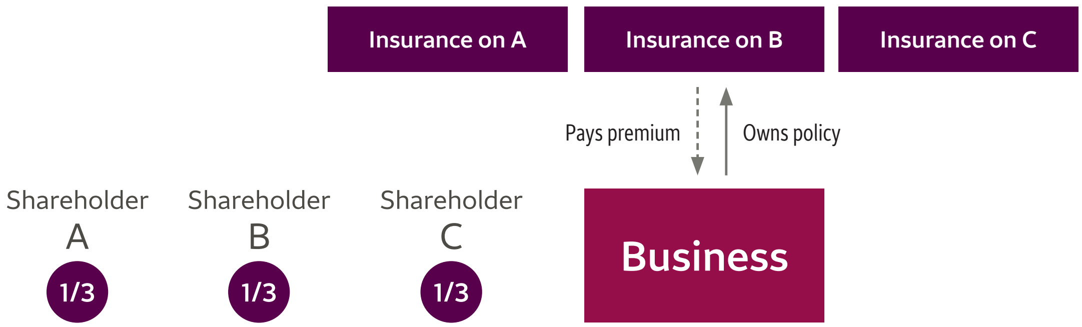


Cross purchase: if Shareholder A dies

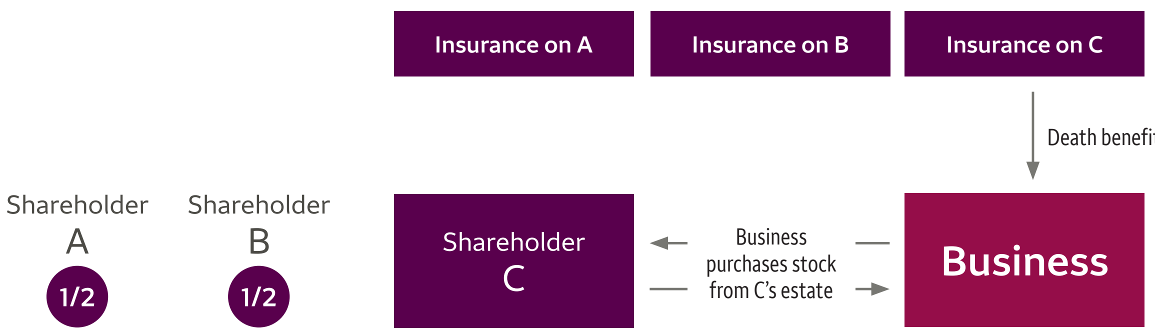


- **Entity purchase.** An entity arrangement is an agreement between the business and the owners. The business agrees to redeem (i.e., buy back) a shareholder's interest when the triggering event occurs. When the death of an owner is a triggering event, one of the most common funding vehicles is life insurance. The business owns policies on each owner. In the illustration on the next page, the business holds life insurance policies on Shareholders A, B, and C. The business is responsible for paying premiums associated with the policies to the insurance company. Upon a triggering event occurring — in this example, the death of Shareholder C — the proceeds of the insurance policy would be received by the business and provide it with the liquidity needed to purchase Shareholder C's interest in the business.

Entity purchase: initial structure



Entity purchase: if Shareholder C dies



- **"Wait and see"** agreement. A wait and see agreement is a hybrid of the cross purchase and entity agreements. It is designed to provide flexibility at the time a triggering event (death, disability, retirement, etc.) occurs. In a wait and see agreement, the process generally is as follows:
  1. The business might have a first option to buy the interest of a deceased or disabled owner.
  2. If the business does not exercise its option to purchase all or a portion of the deceased owner's interest, the remaining owners then have the option to buy the remaining interest.
  3. If the remaining owners do not exercise their option to purchase the deceased owner's interest, then the business must purchase the interest.

Wait and see agreement

Business receives death benefit from life insurance on deceased shareholder → Business has option to purchase some or all stock from estate of deceased shareholder → If not all stock is purchased, remaining shareholders have option to purchase stock pro rata → If not all stock is purchased, remaining shareholders have option to purchase in unequal amounts → Any remaining shares must be purchased by business

When death of an owner is a triggering event, life insurance is one of the most common funding vehicles; policies could be owned either by the business or by individual shareholders. In the illustration above, the business holds life insurance policies on its shareholders, and pays premiums to the insurance company. Upon a triggering event occurring — for example, the death of one shareholder — the proceeds of the insurance policy would be received by the business and provide it with the liquidity needed to purchase some or all of the deceased shareholder's interest in the business. If the business does not exercise its option to purchase, or it only purchases a portion of those shares, an option to purchase all or a portion of the deceased shareholder's interest — first on a pro-rata basis, or next in unequal amounts — the business must purchase any remaining shares. This design adds some complexity; however, because a buy-sell agreement by its nature must deal with unexpected events, the additional flexibility can be valuable.

What else should you consider?

A buy-sell agreement provides a plan for the orderly transfer of any owner's business interest. You should consider a buy-sell agreement for your business if:

- Life insurance premiums are not a deductible expense, but the proceeds received are income tax free.
- Heirs generally recognize little or no taxable gain or loss on the sale of stock, because the deceased owner's shares receive a "stepped-up" cost basis at death.

What is the best type of life insurance to fund a buy-sell agreement?

That depends on your specific situation and needs. For example, in a situation where owners have a strategic plan to sell the business in seven to 10 years, it could make sense to use a 10- or 15-year level term policy, as it could be more cost effective. (Premiums for term insurance will increase throughout the coverage period while whole life premiums generally remain level.) On the other hand, in a family business where owners expect to hold shares and participate in the business for their entire lifetime, permanent insurance may be more appropriate. If cost is a key factor, term insurance can help address that concern. If there is a desire or need to build cash value within a policy, there are various types of permanent insurance to help meet that objective.

Do I need to cover the entire value of the business?

That would be ideal, but is not always practical. Imagine yourself in the position of a surviving owner: Would you rather have a death benefit large enough so that you could simply write a check to buy out the deceased owner's heirs, or have to deal with the cash flow burden of making interest and principal payments to those heirs for many years? If you were the owner who died, would you want your spouse and children to receive an immediate buyout or drawn-out payments over many years?

Depending on the cost of insurance and available cash flow, it is not always possible to insure the entire value of the business. A balanced approach might be to target an amount of coverage that is affordable for the business and would provide a substantial down payment on the sale. Then, plan on having the business pay any remaining portion of the sale price on an installment basis over time.

I don't have a strong sense about the value of my business. Must I get an appraisal to determine the value of the business before executing a buy-sell agreement?

Obtaining an appraisal is usually a good idea, but not absolutely essential. At a minimum, you need a "ballpark estimate" of your business value so that you can design a sensible agreement and acquire an adequate amount of insurance. But in many well-drafted buy-sell agreements, the price is "to be determined." A buy-sell agreement may include a formula valuation clause, or provide that the price will be determined by an appraisal at the time the triggering event occurs. So, you don't always have to peg an exact value for the business at the time you are creating the buy-sell agreement.

Your business may be your most important asset, so it makes sense to learn about valuation from as many reliable viewpoints as you can access. Your CPA is a good place to start when trying to get a handle on value. If you belong to a trade group or industry association, that organization may be able to provide some guidelines about how buyers and sellers determine value for businesses like yours. If you have contacts with other owners in your industry who have acquired or sold similar businesses, ask whether they are willing to talk with you about how they arrived at a value for those deals. You might find free or very low cost valuation tools online (remember, these are usually worth what you pay for them). You should certainly strongly consider working with an experienced business appraiser who can provide an in-depth analysis of the factors that drive value in your business.

Why not just use a "rule of thumb" value that is accepted in my industry?

You may be shortchanging yourself by using a rule of thumb value. Rules of thumb reflect an average — and perhaps your business is above average. For example, if you have a particularly valuable location, offer a unique product or service, or regularly achieve above-average profitability, a rule of thumb formula will not reflect the true value of your business.

Does a buy-sell agreement need to treat all owners the same way?

Not necessarily. Different circumstances may call for different structures. An agreement for two founders, with similar ages and 50/50 ownership, will probably treat both owners the same. But if your ownership group includes, for example, a couple who owns 95% and a son-in-law with a 5% ownership interest, the rights and terms that apply to that minority owner might be very different. There could also be reasons to apply different terms to owners who are very different in age or financial condition, who have different roles in the business, or who have ownership interests but are not active in the business.

It is often appropriate to have different rules apply for different "triggers." Here's a hypothetical example: You might want to provide for a mandatory purchase of shares if an owner dies. But what if someone voluntarily resigns, and you suspect they intend to start a competing business? If your buy-sell agreement requires an immediate purchase of the departing owner's shares, remaining owners could face a cash crunch — not to mention that you have just helped fund your ex-partner's new business. In that situation, perhaps it would be better to mandate a long-term installment payout for voluntary departures before normal retirement age.

The divorce of an owner poses similar problems. You probably don't want the ex-spouse to remain as an owner, but you also want to avoid placing the burden of paying for the buyout on the company or the other owners. Your attorney and CPA can help you recognize and anticipate situations that call for special planning, and craft a buy-sell agreement that fits the unique needs of your business and ownership structure.

Is a buy-sell agreement the same thing as having a business succession plan?

In most cases, the buy-sell agreement is more of a contingency plan. It serves as an agreement about what we will do "in case of emergency" if something goes wrong or off plan. Often, the terms of the buy-sell agreement will have little to do with your long-term succession and exit plan, whether that entails transferring a business to children, selling to a key employee, or someday taking the business public.

However, there are some circumstances where a buy-sell agreement can function as a long-term succession plan. For example, in a professional practice with multiple owners, a buy-sell agreement could function over many years like a rulebook that governs how new owners are selected, how they buy into the business, and how they exit the business and sell their ownership interests at retirement.

How is this strategy implemented?

- It makes sense to use a team of professionals to build your buy-sell agreement.
- Your attorney will design and draft the legal document which is central to this planning strategy.
- Your CPA can provide valuable insights relating to valuation, tax structure, and the cash flow consequences of different funding mechanisms.
- A professional appraiser can help with valuation issues.
- Your financial advisor can assist you in acquiring life insurance to fund your buy-sell agreement.

Every few years, meet with the team of your advisors (attorney, CPA, appraiser, financial advisor) to review the agreement and related insurance coverage. Assess whether the structure of the agreement still makes sense, as your business may have changed. Review the formula or procedure that is used to determine value. Make sure that insurance coverage is still adequate if the value of the business has changed. Review how your policies are performing.

Business owners are faced with many day-to-day demands, and it can be difficult to find the time to address long-range planning matters. But an outdated or under-funded buy-sell agreement is of little value. It's worth the effort to review these issues regularly.

Talk to Wells Fargo Advisors

We welcome the opportunity to work with you to help you achieve your planning goals. Contact us for more information and to learn about how we can assist you.

Any Questions?

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