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Features of a Buy-Sell Agreement

Help protect and preserve your business capital

Key points

- A buy-sell agreement may be an important part of a comprehensive exit strategy
- The agreement should be treated as a "living document" that will evolve as a business moves through its life cycle and the owners' personal circumstances change
- Buy-sell agreements have several benefits, one of which is to help current owners maintain control and to preserve the marketability of ownership interests

An ownership interest in a closely held business often constitutes a significant part of a business owner's overall wealth. For owners concerned about preserving the value of this "business capital" for themselves, and/or as a legacy for their families, a well-drafted buy-sell agreement, also known as a buy sell agreement, buy/sell agreement, or simply BSA, by and among all of the owners can be critically important.

A buy-sell agreement is a legally binding contract that stipulates how a partner's share of a business may be reassigned if that partner dies or otherwise leaves the business. From a business' inception up until implementation of a final exit strategy by the continuing owners, a BSA is an important tool to help:

- Preserve the business' long-term viability by preventing control from passing to unwelcome and potentially disruptive parties
- Ensure that each departing owner (or his or her estate) receives a fair price for his or her interest
- Establish a funding source for the purchase of each departing owner's interest

Primary benefits of a buy sell agreement

Buy-sell agreements have many benefits, one of the most critical of which is to help current owners maintain control and to preserve the marketability of ownership interests.

Maintaining control by current owners

Over the long term, one of the greatest threats to preserving the viability of a closely held entity is the risk of ownership interests passing to outsiders who will disrupt the smooth operation of the business. For example, the children of a deceased owner may acquire an ownership interest through inheritance, but elect not to take an active role in the business. This could lead to clashes between the children and the existing active owners on issues where their respective interests are not aligned—such as whether to distribute or reinvest profits. Under another possible scenario, the former spouse of an owner might acquire an ownership interest through a divorce proceeding, creating an uncomfortable and potentially unworkable operating environment for the existing owners.

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In some cases, unrestricted transfers of ownership interests create legal and tax problems for the business. Certain types of entities, such as S Corporations and some professional services businesses, are required to limit their owners to enumerated permissible parties. In these situations, the transfer of an ownership interest to a prohibited party can result in adverse legal and/or tax consequences.

A BSA can mitigate the risk of these adverse outcomes by placing restrictions on transfers of ownership interests. To the extent possible, the restrictions should be structured in a thoughtful manner and accommodate an owner's desire to transfer ownership interests under his or her estate plan—as long as such transfers are not expected to disrupt the operation of the business. In these cases the BSA can identify and exclude transfers that are part of an owner's estate plan from the scope of the restrictions.

The restrictions on transfers typically take the form of *rights of first refusal* given to the business, or the current owners, to purchase the interest of a withdrawing or deceased owner, at a price established under the agreement. Rights of first refusal may be allocated among current owners either equally or on a pro-rata basis, or tailored to specific situations.

Where possible, an owner's purchase rights should dovetail with his or her individual estate planning goals. For example, if the owner's estate planning goals include transferring ownership interests to younger family members who are active in the business, it may be advantageous to reduce or eliminate his or her purchase rights in favor of expanded rights for the younger family members. In other instances, where a family's collective ownership interest is spread across different family members, it may be appropriate to allocate purchase rights in a way that maintains that family's total ownership interest as family members die or withdraw.

While maintaining control of the business is the most direct benefit of granting rights of first refusal to the current owners, these rights also carry indirect planning benefits for the owners. They make it possible for an owner to anticipate the cost of buying out co-owners' interests and to develop a plan for funding the purchase in advance. Additionally, they allow an owner to anticipate the value of his or her ownership interest for estate tax purposes, which facilitates effective estate planning. In some cases, the restrictions enable an owner to claim a valuation discount for the ownership interest based on lack of marketability, and thereby reduce gift and/or estate taxes upon transfers of the interests to family members. For owners who anticipate having a taxable estate, valuation discounts based on lack of marketability represent a compelling opportunity for tax savings on transfers to family members.

Preserving marketability of ownership interests

Another benefit of a BSA is that it can create a market for the ownership interest of a deceased or withdrawing owner where none may otherwise exist. This is accomplished by imposing a mandatory purchase obligation on the business, or remaining owners, to buy the interest at a price established under the agreement. In financial terms, this is analogous to granting a "put" option to the withdrawing owner, entitling him to sell his interest at a specified price.

For an owner who anticipates selling the interest at the earlier of his or her death or retirement, the benefits of such a mandatory purchase obligation are considerable. It permits the owner to negotiate the price that will be paid upon retirement, or to the estate following death, well in advance and without unfair pressure. Absent such a provision, the estate of the deceased owner could be forced to either negotiate a sale from a position of weakness, or postpone any sale and risk a liquidity crisis when estate taxes become due and/or the surviving family members require funds for their support.

Beware of pitfalls

Of course, with any type of agreement, it's also important to understand any potential problems in advance. In some cases, the purchase price set by the buy sell agreement could become unrealistic over time (and at the death of the business owner). The economy and/or business could decline, or conversely, could thrive. If a fixed price is set and not updated over time, this could pose an issue. We cover more on ways to set a fair price later in the article.

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Identifying and understanding the potential benefits and pitfalls of a BSA is an important first step in evaluating and/or designing an agreement. The next step is selecting the optimal type of agreement and the most advantageous method to fund the purchases.

Agreement types and funding methods

Buy-sell agreements generally fall under one of the following two types, depending on who has the right and/or obligation to buy a withdrawing owner's interest under the agreement:

- **Cross-purchase agreement**
  The remaining owners are the designated buyers
- **Redemption agreement**
  The business is the designated buyer

When designing a BSA, the owners should consider not only what type of agreement to use—i.e., who should be the designated buyers—but also how the buyers will fund the purchase. Under both types of agreements, the buyers may purchase a withdrawing owner's interest out of his or her available assets or with borrowed funds. For purchases of a deceased owner's interest, buyers often use life insurance as a source of funding. This is appropriate where it is uncertain whether the buyers will have sufficient funds to purchase a deceased owner's interest. By procuring insurance coverage in advance, the buyers may help to avoid a potential funding crisis at the time of purchase. Under this approach, the buyers take out life insurance on each owner, and upon the death of an owner use the proceeds to purchase the deceased owner's interest. Permanent life insurance is advisable since it is usually difficult to predict an owner's life expectancy, but term insurance may be appropriate in some cases. Buyers should consult with their insurance advisors regarding the most appropriate type of coverage for this purpose.

In some cases, multiple funding sources may be needed in order to purchase a withdrawing owner's interest. For example, the cost of insurance to cover the entire purchase price may be prohibitive where the business is large, and the value of the withdrawing owner's interest is correspondingly high. In that instance, the buyers may be forced to supplement insurance coverage with bank financing or other capital raising strategies, as available, in order to cover the full buy-out amount.

It's important for an owner to consult with advisors to determine the type of agreement and funding option that is most advantageous for his or her particular situation.

Choice of agreement type

The optimal agreement type will vary depending on circumstance. In many cases, the number of owners may be the primary determining factor. Where there are multiple owners and purchases are to be funded through life insurance, a redemption agreement is simpler than a cross-purchase agreement, because it will require buying fewer insurance policies. Selecting the most suitable agreement type may also depend on the profiles of the owners. Where the ages and health of the owners vary, the younger and healthier owners may object to bearing the higher expense of purchasing life insurance on older and declining owners. In that case, it may be advantageous to use a redemption agreement where the business purchases all the insurance policies, including the policies on the lives of older and less healthy owners.

In some cases, the agreement type may be dictated by considerations at the business level. The business may be prohibited from redeeming owner interests due to existing loan covenants or due to minimum capital requirements that are imposed under state law. In these cases it may not be possible to use a redemption agreement, because the business is precluded from buying the owners' interests.

There may be tax consequences of selecting a particular agreement type depending on whether the business is organized as a C Corporation, an S Corporation, limited liability company, partnership, or otherwise.

Valuation of ownership interests

One of the most critical decisions in designing a BSA is selecting the mechanism for determining the purchase price of a withdrawing owner's interest. Three common ways to establish the purchase price under a BSA are:

- Setting a fixed price that is periodically renegotiated
- Establishing a formula to determine the price
- Using a professional business appraiser to determine a price

As with many planning decisions, the best approach for setting the purchase price under a BSA depends upon the owners' goals and intentions. If simplicity is the primary goal, it may be appropriate to set a fixed price for purchases under the BSA. Under this method, the agreement should provide for periodic renegotiation of the price, since the value of the business is likely to change over time. A fundamental problem with this approach is that the owners may forget to renegotiate the price until a buyout is triggered. At this point, the seller's

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For transfers of ownership among family members, it may be appropriate to use a formula that generates a price on the low end of the spectrum—and results in a reduced valuation for estate and gift tax purposes.

bargaining leverage (or that of the surviving spouse or estate) may be weak, resulting in a renegotiated purchase price that is lower than the true value of the seller's interest. Even where the owners have the discipline to renegotiate the purchase price on schedule, their relative bargaining positions may have shifted by that time to the point where a stronger party can block an otherwise fair upward adjustment if it is not in his or her favor.

If the owners are concerned with the drawbacks of setting a fixed price, they may elect to establish the purchase price according to a designated formula that is tied to some agreed-upon financial measure, such as book value, net earnings, or cash flow. The usefulness of a particular formula to establish an equitable value depends on the circumstances and nature of the business. Book value, which is generally the historic cost of assets less depreciation, may be appropriate when valuing a newer business that has little earnings history. For a growing or mature business, book value can significantly understate the entity's true value. In such cases, it may be advisable to use some adjusted form of book value or to set the purchase price based on a multiple of average income over some period. While the latter approach may be better for valuing a business with an established earnings track record, it can nonetheless produce an inaccurate result. For example, the business' net earnings may not accurately reflect its true earning power over a given period, and the price multiple or capitalization rate that is used in the formula may be inappropriate.

Where owners are concerned about the shortcomings of the fixed price and/or formula-based approaches, they should consider engaging the services of a professional business appraiser to establish the purchase price under a BSA. Under this approach, the agreement may specify the minimum credentials for an appraiser and set forth how the appraiser will be selected. Though it involves extra expense, a professional appraisal provides a greater degree of comfort that the purchase price paid for a withdrawing owner's interest fairly reflects current market conditions. Where expenses are a concern, the owners may simply request an appraiser to test whether an agreed-upon formula generates acceptable outcomes, but forego a full-blown appraisal.

In some cases, the mechanism for setting the purchase price may depend on the owners' relationship to each other. For transfers of ownership among family members, it may be appropriate to use a formula that generates a price on the low end of the spectrum—and results in a reduced valuation for estate and gift tax purposes. Alternatively, where the goal is to establish a purchase price among co-owners who have an arms-length relationship, the preferred approach may be a formula that generates a price in the middle or high range of the spectrum.

In theory, an appraisal should generate a valuation that is neither high nor low because the appraiser is offering his best estimate of fair value. That being said, appraisals can generate a range of results depending on the standard of value used. For example, the appraised value of an owner's interest will be higher if the appraiser is instructed not to consider discounts for lack of control and/or marketability that may apply to a specific ownership interest.

Impact of an exit strategy

Where the continuing owners ultimately cede control or sell the business entirely through an exit strategy, such as a recapitalization or a strategic sale engineered by an investment banker, the terms of the BSA rarely determine the final sale price.

In a well-run strategic sale or recapitalization, the selling owners' investment banker capitalizes on inefficiencies in the private markets that arise because different buyers may ascribe different values to the same business. The banker does this by preparing comprehensive marketing materials and contacting multiple potential buyers in order to create strong competition and generate the highest possible value for the business. That value will typically be higher than the purchase price established under the BSA, so that under almost all such exit strategies the provisions of the BSA are superseded or eliminated through pre-sale negotiations and do not determine the final sale price.

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Final thoughts—and a word of caution

Notwithstanding the impact of a superseding exit strategy, the BSA is a core element of each owner's estate plan for much of the life of the business. It is a valuable tool to help preserve the business' long-term viability, ensure that each departing owner (or his or her estate) receives a fair price for his or her interest, and establish a funding source for the purchase of each departing owner's interest.

The optimal terms for the BSA will vary across time, and the agreement should be treated as a living document that will evolve as a business moves through its life cycle and the owners' personal circumstances change. The BSA should be reviewed and modified at any point where changes in business, personal, or legal circumstances call for a different approach, as appropriate.

In some cases, the advisability of modifying a BSA depends on the date that it was created. One of the benefits of a BSA is that it can establish the value of a business for estate and gift tax purposes, as long as the agreement satisfies certain standards. Due to the way the law has evolved, the applicable standards are less stringent for a BSA created on or before October 8, 1990, as long as the agreement has never been substantially modified after that date. A substantial modification can include seemingly minor changes, such as adding a family member as a party. Consequently, owners are well advised to proceed with due caution before making any changes to a BSA that was created on or before October 8, 1990.

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