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Legal Update

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BUY-SELL AGREEMENTS: CONSIDERATIONS FOR FUNDING A BUY-OUT

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You and your partner(s) have nurtured and grown your business to become a critical piece of your families' and employees' financial futures, and now you want to assure that it can survive and prosper when you are gone. One of the issues that keeps many business owners up at night is how their loved ones and their companies will fare if they or one of their partners leaves the business unexpectedly.

A company unprepared for the sudden loss of an owner-manager risks considerable organizational upheaval and financial hardship that can threaten its survival. Privately-held, owner-managed businesses in particular depend on the leadership and efforts of their owners. If one of the owners dies, becomes disabled, or for some other reason ceases to fulfill her role as employee/manager, equity owner, or both, her remaining partners likely will need to replace her services.

In order to be in the best position to weather this potential storm, business owners often need to include, as part of their estate planning and business succession planning, what is known as a "buy-sell agreement." A buy-sell agreement is an agreement among the company's owners that provides the terms for transition of ownership upon an owner's departure from the company. Preparation and agreement among the owners on the structure and terms of this document can make all the difference in ensuring an effective transition of the business following the death, disability, retirement or other departure of an owner-manager.

One of the big hurdles owners often face in structuring a buy-sell agreement is determining how the purchase of a departing owner's interest will be funded without bringing in a new owner. Generally, there are three potential funding sources for the internal buy-out of a departing owner's interest: 1) company cash, 2) the remaining owners' non-company resources, and 3) insurance proceeds.

For many businesses, however, available cash is in short supply, and owners are unable or unwilling to count on borrowing or drawing upon other personal assets to finance a buy-out. Therefore, owners often turn to insurance products for these events. For example, to address a possible death, companies will purchase life insurance on the life of each owner with death benefits payable to either the company or the surviving owners. These benefits would then be paid to the deceased owner's family in exchange for his equity in the business.

While the life insurance option solves the liquidity problem, many business owners find it has some unattractive drawbacks. Chief among them, many entrepreneurs are troubled by the idea that their families will receive only the proceeds of insurance, the premiums for which were paid out of the cash flows of their companies, in return for their equity in the businesses they worked so hard to build. They see that the end result is the same as if they had purchased the life insurance themselves (using the same dollars that would have been used by the company to buy the insurance), named their family members as the beneficiaries, and given their equity to their business partners. There are also tax issues that can result in a family paying more in estate taxes than they receive for the business in this scenario. For these owners, it is not acceptable to have their families, in effect, receive nothing for their equity if they die before they can either sell their companies or implement a succession plan.

Instead, owners may prefer to purchase and hold life insurance policies through tax-advantaged vehicles (such as irrevocable life insurance trusts) in amounts that are based on their families' financial needs, rather than the estimated values of their businesses, and to use "seller financing" for a separate redemption of their ownership interests out of the cash flows of their businesses over a period of time following their deaths. In this financing arrangement, the purchaser of the departing owner's interest would make installment payments of the purchase price, plus interest, to the owner or the owner's family over a number of years, and the family's need for immediate cash would be satisfied through separate life insurance.

Regardless of your preferences for funding the buy-out of an owners' interest, planning for the untimely exit from your company of you or one of your partners is critical. A carefully designed buy-sell agreement can provide valuable clarity and piece-of-mind for all of the stake-holders in an owner-managed business. Careful planning can minimize the tax costs while providing financial security for all owners' families.

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