

Succeed at Business Succession: All About Buy-Sell Agreements

Running into financial trouble isn't the only reason that some small, closely held businesses fail to succeed. Their untimely demise may result from the lack of a formal plan providing for the orderly succession of management and ownership of the business. Such a plan frequently incorporates a buy-sell agreement—a legal arrangement between the owners of a business that ensures the entity will survive even after the departure, death or disability of an owner.

To head off future problems, it pays to understand the uses and structures of these agreements. Although they can be adopted at any time, it is best to decide whether to put a buy-sell agreement in place as early as possible in the life of a business.

The typical buy-sell agreement specifies that an owner's interest in the business will be sold, or at least offered for sale, to the other owners at a pre-determined price upon the occurrence of a specified "triggering" event—such as retirement, death or disability. Other possible triggers may include divorce, bankruptcy, loss of professional license or an owner's desire to sell his or her interest in the business.

The agreement usually restricts an owner's ability to transfer his or her interest and sets out the terms under which another owner or the business entity may acquire the departing owner's interest.

Key Benefits

Regardless of whether you leave the business by choice or by chance, a buy-sell agreement may offer peace of mind by enabling the business to continue to

provide for family, employees and partners who depend on it.

Specifically, a buy-sell agreement can:

- Provide a ready market for the departing owner's share of the business.
- In the event of death, provide the deceased owner's heirs with some liquidity to meet their needs and pay estate administrative costs.
- Help maintain job security for key non-owner employees.
- Establish the purchase price for the departing owner's interest.
- Set a value or create a mechanism for determining value on the business for estate tax purposes.

Possible Structures

There are generally three basic types of buy-sell agreements:

Cross purchase. Each owner enters into an agreement with every other owner. This approach becomes cumbersome if more than three or four individuals are involved. For example, 64 separate agreements would be required for eight owners.

Entity purchase. The business itself (be it a corporation, LLC or partnership) enters into an agreement with each owner and is obligated to buy the shares of a departing owner. This arrangement may simplify the administration of the sale, but some states limit the amount of stock a corporation can redeem.

A third type, or so-called **Hybrid plan**, is essentially a combination of the cross purchase and entity purchase. This approach allows the entity and its owners to delay a purchase decision until a triggering event occurs. The entity typically has the first right of refusal for purchasing the shares of a departing owner.

Funding the Purchase

Life insurance is the most popular funding mechanism for buy-sell agreements. Life insurance is unique in that it creates immediate funding in the event of death, while allowing tax-deferred cash to build up over time. In a cross purchase plan, each owner buys and maintains a policy on every other owner in an amount sufficient to cover the beneficiary's ownership interest. In an entity arrangement, the business purchases the insurance policy on each owner and the business is the beneficiary.

Besides life insurance, other less popular but potentially effective funding mechanisms include cash flow, asset sales, loans, sinking funds and reserves.

Tax and Planning Considerations

There are a number of potential tax issues associated with purchase agreements. Entity and hybrid purchase agreements in particular must be structured carefully so as to minimize income taxes at both the business and individual shareholder levels.

Like all business succession matters, buy-sell agreements are complex legal documents and require the assistance of qualified legal, tax, and insurance professionals to ensure proper drafting, execution and funding.

One last point: The best time to establish a buy-sell agreement is *before* a problem arises. Contact your financial advisor to learn more about the issues involved with private business ownership and about establishing working relationships with tax and legal professionals who specialize in business succession matters.

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