The importance of buy-sell agreements for business owners

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Advice and Planning Update

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Eric J. Smith
Business Owner Advisory Specialist
Wealth & Investment Management

Key takeaways

- A buy-sell agreement can be a critical part of any multi-owner business.
- The provisions can address a variety of contingencies to help ensure smooth transitions of ownership and continuity of operations.

What this may mean for you:

- If you are a co-owner in a business and don't have a buy-sell agreement, or haven't reviewed it in years, consider discussing this important document with your advisory team.

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, employment termination, or retirement of any owner (a "triggering event").

Who needs a buy-sell agreement?

A buy-sell agreement provides a plan for the orderly transfer of any owner's business interest. 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 termination of employment, retirement, divorce, disability, or death
- You want to provide a means for an orderly transfer of any owner's business interest

How can a buy-sell agreement help owners?

A buy-sell agreement can:

- Keep stock away from undesirable owners (for example, ex-spouses of a divorcing owner or heirs of a deceased owner)
- Ensure a reliable process for how a business interest will be transferred
- Establish a fair method to value the stock of the departing owner and for estate tax purposes
- Include a funding method to facilitate the purchase of an owner's interest
- Create provisions to remove owners under certain circumstances
- Include any number of governance or other provisions to ensure continuity of business operations

The buy-sell agreement can ensure that the ownership of the company continues on in a manner that is in the best interests of the company and fair to the owners by spelling out what happens under different triggering events.

What are common trigger events?

	Common trigger events
Death	• Are the beneficiaries entitled to the fair market value of the interest? • Do the surviving owners want the beneficiaries to be actively involved in the business?
Divorce	• Is the business interest an asset subject to division of property in case of divorce?
Disability	• If an owner becomes disabled, will the business require additional capital? • Should the other owners purchase the interest?
Withdrawal	• What restrictions should be placed on the interest of a departing owner? • Under what circumstances can an owner be forced out?
Bankruptcy	• Will creditors have the right to seize or otherwise encumber the interest of an insolvent owner?

What are common valuation methodologies?

Fixed price
Shareholders agree on a fixed price in the agreement

Independent appraisal
Shareholders agree on the appraisal process at the time the agreement is executed

Market approach
Shareholders agree to use comparables of recently sold, similarly situated companies

Formula
Typically an asset-based or earnings-based formula to determine value

How are these agreements funded?

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, tax brackets, and percentages 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.

Buy-sell agreement funding options	
Insurance policy	Life or disability insurance pays out to fund buyout of owner's shares
Installment note	Buyout of the owner's shares paid over time to help alleviate strain on the remaining owners and the business
Cash	Reserve cash in the company or held by the owners is the quickest and easiest way to fund a buyout
Sale or distribution of company assets	Selling or distributing assets that are not essential to the ongoing operations of the company can generate needed liquidity
Leverage company assets	Drawing on a line of credit or other borrowing against other assets may be another source of liquidity
Leveraged employee stock ownership plan	Selling to an ESOP creates beneficial ownership for the employees while also providing tax advantages

When the death of an owner is a triggering event, life insurance is one of the most common funding vehicles; policies could be owned by the business, by individual shareholders, or by a trust or a limited liability company for flexibility.

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 rule book 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.

Your team of professional advisors (Wells Fargo relationship manager, attorney, CPA, appraiser) can assist with building and reviewing your buy-sell agreement to help ensure it meets your current business needs. To learn more, contact your advisor.

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