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Understanding Buy-Sell Agreements

A buy-sell agreement, also known as a buyout agreement, is a binding agreement between co-owners of a business that governs what happens if a co-owner dies or is otherwise forced to leave the business. Surviving owners generally want to ensure a continuity of ownership and management without having the departing owner's inheritor thrust upon them. They also do not want to unduly compromise the cash flow needs of the business by funding a significant buyout.

A buy-sell agreement is like a Business Will.

Disabled or deceased owners would want their families compensated fairly for their share of the business. A properly drafted buy-sell agreement can achieve all of these goals by:

- Providing that upon the occurrence of a specified "triggering event," retiring owners are guaranteed that their interest in the business will be purchased.
- Providing a mechanism whereby the purchase price is predetermined or the basis for the valuation to be undertaken and by whom.
- Providing a funding source, primarily through insurance policies, so that the cash flow requirements of the business or its owners will not be difficult.

Triggering Events

An essential part of any buy-sell agreement is to spell out what type of situations will cause a mandatory or optional buyout of an owner's interest by the other owners or the entity itself. The most common of these triggering events are described below.

Death or Disability

This event is almost universally provided for in the buy-sell agreement. Terms of this buyout will include the determination of disability, the time for payment to the owner or the owner's estate, whether the entity or the surviving shareholders have the obligation to purchase the interest, and whether a funding mechanism, such as life or disability insurance, should be maintained by the entity or the owners personally.

Retirement of an Owner

While a sale to a third party would provide the other owners an optional right to purchase the selling owner's interest, an owner's retirement will generally trigger a mandatory buyout. Of course, the conditions under which an owner may have the right to retire so that the remaining owners would be compelled to buy that owner out are often a point of negotiation. Once again, valuation methods and payment terms will be important issues, because there are no outside funding mechanisms, such as life or disability insurance, available to assist in the cost of purchase.

Owners' Divorce or Bankruptcy

Either of these events can subject the business to interference from outsiders. To prevent this, the other owners should have the option to compel the affected owner to sell their shares to the remaining owners or the entity itself, in accordance with the payment terms and valuation methods.

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Funding Upon an Owner's Death

There are two options:

Entity Redemption Arrangement

Under this plan, the business entity is obligated to purchase the exiting owner's interest. To minimise the impact this might have on the entity's cash flow, the entity could purchase a life insurance policy on each owner. The business names itself as the beneficiary of each policy, and the face amount of the policy will be equal to the agreed-upon purchase price set in the buy-sell agreement. This would be followed by a purchase of the owner's interest by the entity with the life insurance proceeds. This type of arrangement has the disadvantage that the cash value of the insurance policies and proceeds would be subject to the entity's creditors.

Cross-Purchase Arrangements

Under this plan, each surviving owner of a business becomes personally obligated to purchase the departing owner's interest. To provide the surviving owners with cash, each owner would own an insurance policy on the lives of the other owners. The proceeds of the life insurance policy would be received tax-free by the survivors and then used to compulsory purchase the outgoing / deceased owner's interest.

This method addresses the disadvantage associated with the entity redemption arrangement, including shielding the insurance policies and proceeds from the entity's creditors. Should the owners of a business differ significantly in age and / or health, the younger owners' premium payments on the older owners' lives will be significantly higher. Because the entity pays for all of the policies in an equity redemption arrangement, this problem would not exist. However, the buy-sell agreement could state that the payments be split evenly and transferred to their respective shareholder current accounts to avoid taxation issues including additional remuneration.

Buy-sell agreements are not something that should be put in place and never reviewed. An annual review with your Chartered Accountant and Financial Planning Advisor is an important part of the process to ensure the continuance of the business. The consequences of getting this wrong could see a business person selling their life's work for less that it is really worth.

We have a good number of our clients holding an active buy-sell agreement. This ensures that the uncertainty often encountered with the loss or disability of a business owner can be better managed, and provide greater comfort to the ongoing business and the affected owners family. Often the proceeds are key to provide an income or a retirement fund.

Again it is important that the agreement is reviewed at least annually to ensure that the results of a "triggering event" are what is expected, and fair to all parties.

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