

Buy-Sell Agreements – Taking Care of the Eight D's

Most all closely held businesses, especially multi-owner corporations and partnerships need to have a buy-sell agreement in place. Individually owned businesses can also profit from the use of a buy-sell agreement. This is essential for smooth transition of ownership upon the occurrence of several events, namely the "Eight D's." We'll discuss each one individually in the corporate context, however, most would also apply to partnerships. In a single-owner business, the buyer could be key employee(s), a competitor, a supplier, or even a customer.

- 1. Death of a shareholder.** In the event of death of an owner, the business can suffer a financial setback (key person loss). This problem can be compounded if the surviving shareholders have to take in a new partner, the deceased owner's spouse. He / She may have very little knowledge of the business, but yet expect a salary and profits from the business. Harmonious transition of the business can be accomplished with a buy-sell agreement fully funded with life insurance coverage.
- 2. Disability of a shareholder.** While most buy-sells take into account death (even though the agreement value may be low or underfunded), many totally ignore what could be a more serious financial drain, disability (the living death). Alternatively, disability is poorly defined (if at all), not funded or underfunded. A disabled shareholder would expect his/her salary to continue, as well as to get a share of profits. If the disability was extended, how long could the business continue paying? All of these decisions should be outlined in the agreement. It should be a business decision based on previously agreed-upon terms, not on emotions. And, of course, the disability agreement needs to be fully funded.
- 3. Departure of a shareholder.** When a shareholder leaves, whether for regular retirement or early voluntary retirement, his/her business interest should be purchased. The purchase price can be the same as or less than the death price (it cannot be more). A lower purchase price might be set for early termination. As for retirement planning, a life insurance policy can provide a death benefit and cash values can also be used as a retirement supplement.
- 4. Divorce of a shareholder.** It would not be unusual for a spouse to end up with one half the business interest of a closely-held business, in event of a divorce. There should be a provision in the buy-sell to have such spouse forced to sell stock back to either the: (a) corporation; (b) original shareholder; or (c) other shareholders. Again, the price cannot be higher than the death price.
- 5. Deadlock.** If equal owners come to a major disagreement, the business can become "deadlocked" and unable to further conduct normal operations. In this case the business may have to be liquidated. This may have to be taken into consideration in the agreement.
- 6. Disagreement among owners.** If ownership is unequal, and there is a major disagreement, a minority shareholder could be forced out of active employment. In that case, it would also probably make sense to purchase his/her interest. This possibility should be taken care of in the agreement.
- 7. Default.** In most closely-held corporations, the individual shareholders must personally guarantee corporate loans from banks and/or contribute payments to the bank or business. There should be a provision whereby if a shareholder defaults, a buyout would be triggered for his/her interest.
- 8. Determination of value.** The most important item in a buy-sell is the valuation of the business interest. No one wants to over-pay for a business interest. In addition, each owner would want to be sure he/she or their family received fair value in event of a living buyout or death. Appraisals may be viable and even required if family members are involved. Another reason for proper valuation is to fix the value in the deceased's estate for Federal Estate Tax purposes. One of the stipulations is that the value must be Fair Market Value at the time the agreement is entered into. If appropriate life insurance is not purchased to fund the full value, then an installment purchase arrangement should be provided for the balance.

When buy-sells are drafted or reviewed, perhaps the "Eight D's" would make a good checklist for consideration. It's far easier to make business decisions regarding these situations then, than to make emotional decisions after the event has taken place.

This article published in conjunction with Lincoln Financial Advisors Corp.

Any discussion pertaining to taxes in this communication may be part of a promotion or marketing effort. As provided for in government regulations, advice related to federal taxes that is contained in this communication is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue code. Individuals should seek advice based on their own particular circumstances from an independent tax advisor.

Associates of Equity Strategies Group are registered representatives and investment advisor representatives of Lincoln Financial Advisors Corp., a broker/dealer (member SIPC) and registered investment advisor. 395 W. Passaic Street, 4th Floor, Rochelle Park, NJ 07662 201-556-4500

Insurance through Lincoln affiliates and other fine companies. This information should not be construed as legal or tax advice. You may want to consult a tax advisor regarding this information as it relates to your personal circumstances. CRN: 200802-2013459