Cannon Insights

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Planning—Avoiding Common Mistakes in Buy-Sell Agreements

Closely held business owners often enter into **buy-sell agreements** to assure that the business remains in the hands of the current owners and/or that a ready market exists for a departing owner's interest in the event of certain triggering events. Despite the widespread use of buy-sell agreements, Advisors can often add value by identifying and addressing one of several common mistakes associated with the agreements themselves or planning associated with such planning.

Mistake #1—Fixed Valuation

It is common for buy-sell agreements to reference a fixed dollar amount or a specified formula as determinant of the purchase price in the event of a triggering event. Where the agreement references a fixed dollar amount, it will usually call for a review and/or update to the valuation every year or two.

In and of itself, there is nothing problematic with this approach to valuation; however issues can arise for at least one of two reasons.

First, buy-sell agreements are often created at the time the business is formed. It is not uncommon for the agreement to be filed away shortly after its execution, never to be reviewed again until a buy-out is triggered. By then, if the business has prospered, the stated value in the agreement is likely to be way off the mark. To protect against this, the agreement may require the parties to negotiate an agreed upon price prior to sale. The problem is that the dynamics among the parties has changed. Surviving owners may find themselves negotiating with a surviving spouse in dire need of cash or an ex-spouse's divorce lawyer. Chances are, the price the parties agree to under these circumstances will not be the price they would have agreed to had they been on equal footing. Unfairness can result.

Second, even if the buy-sell agreement makes reference to the use of a formula for valuation (rather than a fixed dollar amount, subject to update), the appropriateness of the designated formula may have changed over time. The classic example involves the buy-sell agreement that refers to "book value" as the purchase price. Book value might have been appropriate for a start-up business with no earnings history, but is likely to far understate fair market value for a growing or mature business.

Even where use of a more sophisticated formula is required by the agreement, for example capitalization of net earnings, a more subtle problem may arise. Valuation of closely held businesses is as much of an art as it is a science. Approaches to pricing vary depending on the intentions of the parties. Thus, a sale to a strategic buyer may bring a different price than a sale to a financial buyer. Valuation for estate planning purposes is likely to be on the low end of the spectrum rather than the high. The question the Advisor has to ask is whether the valuation formula in the buy-sell agreement is appropriate to the parties' current goals and objectives. For example, a formula that calls for six times net earnings may reflect the value of the business to a strategic buyer in a *hot* mergers and acquisition market, but probably does not reflect the lower value at which a father would be willing to sell his interest to a son who is active in the business and likely to be the successor leader of the business.

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Solution—Advisors need to point out the importance of keeping fixed price valuations up-to-date. They need to encourage clients to have a specialist review valuation formulas in the buy-sell agreement to determine if the specified valuation approach remains appropriate given where the parties stand today.

Mistake #2—Failing to Fund

A second major mistake associated with buy-sell agreements involves failure to fund, inadequate funding, or improper arrangement of the funding vehicle.

Particularly during the start-up and growth stages, closely held businesses are vulnerable to a shortage of capital necessary to implement buy-outs of a departing owners' interest. During the start-up phase self-financing is common among closely held businesses, and cash is tight. During the growth phase, available capital from profits and bank financing is likely to be committed to product development, the purchase of new equipment, and the acquisition of distribution networks. Without proper funding, the survivors or the business itself may be unable to meet commitments under the buy-sell agreement, leaving a deceased owner's heirs or a disabled owner in the lurch.

The typical approach to funding is to purchase life and/or disability income insurance. One issue is adequacy of coverage. Although the initial face amount of life insurance or lump sum pay out for disability income insurance may have been adequate when the agreement was executed, subsequent growth may have created a shortfall. A challenge with both life and disability income insurance funding is that although additional amounts of insurance may be purchased, new purchases are likely to require new medical underwriting, which translates into new physicals or health questionnaires for the insureds. If one or more of the owners has experienced declining health, the insurance policy may be rated or the application declined.

Fortunately, most life insurance policies can be structured so that the death benefit increases without additional underwriting if the policies perform better than guaranteed. Furthermore, disability income insurance policies can be purchased with inflation protection, allowing the benefit amount to increase with the CPI. In both cases, however, precise correlation between the purchase price and available insurance proceeds at the time of a trigger event is almost impossible.

In some instances, the business will own the insurance and use the proceeds to fulfill the obligations of the individual owners under a cross-purchase agreement. The problem is that distribution of the insurance proceeds may be treated as a taxable dividend in the case of a C corporation, or carry out taxable retained earnings and profits in the case of an S corporation.

A second issue with insurance funding relates to improper ownership and beneficiary designations. In general, if the buy-sell agreement is an **entity agreement**, obligating the business entity to buy-out a departing owner's interest, the entity should be the owner and beneficiary. On the other hand, if the agreement is a **cross-purchase** agreement, each individual owner should apply for and own insurance on the lives of the other business owners. Owners should designate themselves as policy beneficiaries.

In some instances, the business will own the insurance and use the proceeds to fulfill the obligations of the individual owners under a cross-purchase agreement. The problem is that distribution of the insurance proceeds may be treated as a taxable dividend in the case of a C corporation, or carry out taxable retained earnings and profits in the case of an S corporation. In other instances, a shareholder will own insurance on the other shareholder(s) and designate a surviving spouse or decedent's estate as the beneficiary in consideration of a promise to by the surviving spouse or executor to transfer the decedent's business interest. One problem is that this arrangement is likely to be construed as a **transfer for value**, making the death benefit in excess of the value of the consideration paid taxable to the beneficiary. Normally, life insurance proceeds are entirely tax free, thus such an arrangement has the unfortunate result of converting tax-free cash into taxable (at least, in part) cash.

Solution—The Advisor should determine if insurance for funding has been acquired, if the funding remains adequate to the needs of the parties, and whether ownership and beneficiary designations have been properly handled.

Mistake #3—Improper Terms

Buy-sell agreements tend to fall into three broad categories. The agreement may call for a mandatory sale upon the occurrence of a triggering event, a put by the departing owner, or a first right of refusal on behalf of the survivors. Sometimes, little thought was given the structure of the agreement at the time it was entered into, but these terms can have a huge impact later on.

> *If the agreement provides for a first right of refusal, the affected shareholder must first offer his or her business interest to the other owners, who may accept or refuse the offer. If the offer is refused, the affected shareholder is free to sell his or her interest to an outsider. This type of agreement favors control and continuity over marketability.*

With a mandatory buy-sell agreement, the affected owner must offer his or her business interest upon the occurrence of a triggering event and the surviving owners or entity must purchase it. A mandatory buy-sell assures control by the survivors and marketability to the departing owners. On the other hand, if one of the owners has family members in the business to whom he or she wishes to transfer ownership interests, a mandatory buy-sell agreement without an exception for transfers to family members won't meet the party's needs.

If the agreement provides for a put, the departing owner may offer his or her interest to the survivors, who must purchase it if he or she does so. This type of agreement favors the departing owner and marketability of his or her interest over control and continuity by the survivors. More specifically, this type of agreement creates the risk that the current owners will end up in business with outsiders.

Also, if there is one super-majority owner and several smaller owners, this type of agreement places the super-majority owner in the driver's seat: if the owner can get a better offer from an outsider he or she is free to take it; if not, the super-majority owner can force the other owners into a buyout. Because the minority owners are likely to have lesser net worths than the majority owner, they could find themselves strapped to execute on the majority owner's put. By the same token, this type of agreement can place an undue hardship on the minority owners who are unlikely to find a ready third party market for their interests.

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Solution—Advisors need to review the terms for buy-out with owners to determine if the terms as originally drafted continue to meet changing needs. Owners should consider the terms from both sides of the equation—what would happen if they were the selling, what would happen if they were buying? The best result is one that is fair in all events.

Bottom Line

Business owner clients typically have a buy-sell agreement. These agreements typically offer plenty of opportunities for the savvy Advisor to add value to the client relationship. Furthermore, a review of the buy-sell agreement can lead to insurance sales, business valuations, and a broader discussion of business succession planning.

Planning Ideas and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.