Buy-Sell Agreements

A Buy-Sell Agreement is an agreement among the owners of a business to control <u>who</u> can own the shares or an interest in your business in the future and how much the interests will be worth in the event of an owner's death, disability, bankruptcy, divorce or retirement. The reason for having one is simple – you'll want to avoid the headache, heartache, and expense of a dispute and potential lawsuit among you and your partners when one of you decides to depart, dies, gets divorced, goes bankrupt, or tries to sell to a third party. You could be placing yourself at grave risk to be in business with someone you never intended.

The new shareholder can vote at annual shareholder meetings and be involved in all major decisions brought before the shareholders. This new interest holder might even be able to get elected to the Board of Directors or become a co-managing member in your LLC.

A properly drafted Buy-Sell Agreement can short circuit these types of problems in advance. The agreement can address how the company or the owners will buy out what the outsider would ordinarily assume an interest in.

The agreement can also provide for whether the remaining owners have a right of first refusal to purchase or whether they are required to purchase the business shares of the deceased, disabled, or divorced owner.

Another important aspect of a good Buy-Sell Agreement is the setting of a price or a procedure for arriving at the full market value (FMV) of the company shares. This last issue is paramount because this is where a lot of litigation arises. There are several ways to arrive at this calculation of value, but one of the best options is appraisal by two certified Business Appraisers – one for the Buyer and one for the Seller. One note of interest however is the amount of life insurance to buy in order to fund the agreement. An appraisal should be done contemporaneously with the Buy-Sell Agreement formation with an annual review so that the shares are adequately funded if one of those separation events listed above were to occur. We want to make sure the agreement is funded with enough life insurance and/or provide for a longer payout provision possibly over a number of years.

It is also critical to recognize that the value of your business in your estimations may be lower or higher than what the IRS considers to be the true fair market value (FMV). This could affect the way taxes on the transfer are computed. There are other risks if proper maintenance of the agreement doesn't occur. A closely held business' value can fluctuate rapidly leaving he parties to the agreement with negative consequences. For instance, if you don't revise your agreement every year to account for these possible changes, you could end up with an underfunded agreement on the life insurance side.

Further, you can agree in advance to the repayment terms of any particular type of transfer of ownership including such things as the length of the buy-out (months or even years), what security if any will be used to secure the buy-out and the repayment interest rate, just to name a few.

Some other issues that a good Buy-Sell Agreement can solve upfront are:

1. Determining what happens when an owner tries to sell to a third party.

2. Deciding upfront if a shareholder can give his shares to his children or other relatives.

3. Determining what happens to the shares when a shareholder dies.

4. Setting out whether a shareholder can transfer his or her shares to a revocable trust.

5. Or whether the shares can be transferred to an irrevocable trust for the benefit of family members.

6. Deciding what happens if a shareholder quits and decides not to work in the business anymore.

7. Setting up rules for what happens if a company owner gets divorced.

8. Laying out what happens if a company owner becomes disabled and can no longer perform in the business.

9. Prescribing how the bankruptcy of an owner will be handled.

10. Determining the value of the shares and how they will be calculated (these could be different formulas for different buy-back situations). Proviso: the IRS calculation of the value may be significantly different than your value which could affect taxes on the transfer.

11. The method for the payment – the terms for repayment of the shares (ie. over a term of years, immediately, within 90 days, etc.)

12. Life Insurance and Disability funding of the Agreement.

It can be tempting to give this advance planning in your business the back-burner treatment. But keep in mind that an ounce of prevention is worth a pound of cure. If you would like to meet with me to discuss your Buy-Sell Agreement or a review of your existing Buy-Sell Agreement, please contact Lexi Davis at (760) 448-2220 or email her at lexi@geigerlawoffice.net to schedule a meeting.

About the Author

Brenda Geiger, J.D.
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Mrs. Geiger's practice is located in Carlsbad, California. Her firm focuses on Business Planning, Asset Protection, Estate Planning, Trust Administration, and Elder Law. She obtained her law degree from the University of San Diego School of Law where she served as an Editor on the board of the San Diego International Law Journal.

She is also involved in a variety of professional and community organizations. She serves as an editor for the North County San Diego Bar Association Magazine (The North County Lawyer). She is also an active member of the North County Estate Planning Council, WealthCounsel, LLC and ElderCounsel, LLC. Mrs. Geiger is a frequent speaker for many local organizations and the North County San Diego Bar Association.

Additionally, she is the author of an estate planning book and an elder law planning book. The book on estate planning is titled "Safeguarding the Nest, Third Edition" (2013) and her book on elder law planning is titled “How to Avoid the Catastrophic Costs and Effects of Long Term Care: A California Elder Law Guide” (2013). She also authored the law journal article “Authorization to Kill Terrorist Leaders and Those Who Harbor Them: An International Analysis of Defensive Assassination, San Diego International Law Journal, 4 San Diego Int'l L.J. 491, Spring 2003”, and has published several articles.

Mrs. Geiger is admitted to practice before the United States Federal Court for the Ninth District and California State Courts and is an accredited V.A. Planning Attorney. On a more personal note, Brenda is married to Len, the CEO of a San Diego based company and has two young children. She loves running, travel and spending time with her family.

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