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NEWSLETTER

THE IMPORTANCE OF BUY-SELL AGREEMENTS

This Newsletter shall discuss the benefits of a Buy-Sell Agreement (also known as a Buyout Agreement) between the shareholders of a corporation.

Why do the owners of a business need a Buy-Sell Agreement?

A Buy-Sell Agreement can ensure that the stock of a corporation does not pass into the hands of an outsider in the event of a shareholder's death, or if a shareholder desires to transfer shares to a non-shareholder. It may also permit the company to purchase the shares of a disabled shareholder or upon termination of a shareholder's employment. A Buy-Sell Agreement may also enable a shareholder (or the shareholder's estate) to sell shares in the corporation despite there being no public market for the shares. This is particularly important in a closely held corporation in which the owners of the corporation are also the officers, directors and employees of the corporation.

What are the types of Buy-Sell Agreements?

There are two basic types of Buy-Sell Agreements. A cross-purchase agreement requires or permits the shareholders to purchase the shares of a retiring, disabled or deceased shareholder. An entity purchase agreement requires or permits the corporation to purchase (redeem) the shares of a retiring, disabled or deceased shareholder. There are differences in the tax treatment of the two types of Buy-Sell Agreements, which should be considered.

What is the best type of Buy-Sell Agreement?

There is no one best type of Buy-Sell Agreement. The type of Buy-Sell Agreement, and the specific provisions of the Buy-Sell Agreement, will depend on a number of factors, including the number and ages of the shareholders, the financial capability of the company and each of the shareholders, and the availability and cost of life insurance to fund the Buy-Sell Agreement.

How does the Company ensure a shareholder does not transfer shares to an outsider?

The Buy-Sell Agreement should have a provision that the shareholders may not transfer shares during their lifetime without first offering the shares to either the company or the other shareholders at the price specified in the Buy-Sell Agreement. The stock certificates should have a legend setting forth that transfer of the shares is subject to the terms of the Buy-Sell Agreement.

How is the Buy-Sell Agreement funded?

The most typical way of funding a Buy-Sell Agreement is with life insurance. In a cross-purchase agreement, each shareholder owns a policy on the life of every other shareholder. In an entity purchase agreement, the corporation owns the policy on each shareholder. In cases where life insurance is not available at a reasonable cost, or in cases other than the death of a shareholder, the agreement often provides for a down payment on the purchase price, with the balance of the payments over some period so that the payments are affordable by the company of the other shareholders.

How are the shares valued in a Buy-Sell Agreement?

There are many possible ways to value the shares of the shareholder. One method is to have the shareholders determine the value each year for the succeeding year. Other methods are to base the valuation on (a) a specified multiple of the company's earnings, (b) or the book value of the company. Another method is to provide that the valuation of the company is determined by one or more qualified business appraisers at the time of the event requiring the purchase of the shares. Sometimes a combination of these methods is used so that the first method is mutual agreement, but if that is not possible, the second method is appraisal. There is no one "best" method of valuation; the valuation method depends on the nature of the company's business.

Can the Buy-Sell Agreement be amended?

Yes, a Buy-Sell Agreement can be amended, but it requires the consent of all parties to the agreement. The shareholders should periodically review the Buy-Sell Agreement to determine if it needs to be amended due to the personal or financial situation of the shareholders or the company, or if a change in the method of valuation of the company is desired.