Before "Till Death Do Us Part:"
What You Need to Know About Your Buy-Sell Agreement

When it comes to succession planning, few business owners or their advisors give enough attention to the possibility of a lifetime transfer. Instead, they focus their attention on dealing with the least likely event: an owner's death. Yet, in our experience, lifetime transfers occur much more frequently, and when they do can cause huge problems.

Typically, buy-sell agreements are created to work well in the event of a shareholder's death, but the same provisions (e.g. first right of refusal at a predetermined price should one owner wish to transfer ownership to anyone) will still govern in the case of a lifetime transfer. Because these agreements are designed for one event and used for another, the result is, at minimum, an impetus for re-negotiation, and at worst, a nightmare.

To illustrate, let's explore the impact this can have on two owners when plans changed.

Case Study: A&B Custom Metal

A&B Custom Metal almost didn't get off the ground. Aaron had a thriving metal supply business, and Bobby was one of the best custom metal fabricators in the Midwest. They had talked about pooling their resources for years when Bobby's twin brother had a heart attack at age 55. Bobby realized that life was too short to keep talking about creating a partnership, and the two decided to merge their talents at last.

Included with all of the other documents that Aaron and Bobby's attorney insisted on was a buy-sell agreement that established the price and the terms of the sale or purchase. Embedded in its creation was the assumption that one of them (probably Bobby since he was eight years older than Aaron) would die and Aaron would purchase Bobby's ownership using life insurance proceeds.

The good news was that Bobby answered the wake-up call to improve his life and lifestyle. He not only created a successful company, he replaced his daily drive across town to grab a cheeseburger with brisk walks to the new salad joint. He joined his wife for long bike rides on weekends and boasted that he'd never felt better.

Aaron began to think about retiring and selling out. A quick look at their buy-sell agreement told him that he had to sell his stock to Bobby based upon the price they had established when they assumed there would be more than adequate funding because of the life insurance policy.

The Problems This Situation Created

Because the price established in their buy-sell agreement had little to do with the fair market value of the company when one of them wanted to sell out, the price the buyer would pay was likely to be substantially higher or lower than the company's current value. This means that one or the other partner would suffer.

Some owners resolve this problem by agreeing to ignore their buy-sell agreement and hire a Certified Business Appraiser to establish a fair market value for the company. Aaron suggested this route, but Bobby insisted that they abide by their original agreement. He didn't want to put a damper on the future growth of the company by siphoning off its cash flow toward Aaron's buy out. And, the value in the buy-sell agreement was significantly lower than the company's current value.

Aaron felt he had proposed a fair alternative, resented Bobby's intransigence, and didn't want to sell his ownership interest for what he believed was an artificially low price. As you can imagine, the two partners stopped speaking.

Other Issues a Buy-Sell Agreement Should Address

Aaron's issue with the price was just the first hurdle. Because Aaron and Bobby had presumed that only death would separate them, they had done no plan-

ning to minimize the tax consequences of a lifetime sale. Further, since they assumed that the survivor would use life insurance proceeds (rather than company cash flow) to fund the buyout of the deceased shareholder's interest, they had established a very short, four-year timeframe to pay for the purchase. Finally, their buy/sell included no "forced buyout provision" to resolve irreconcilable differences between the owners.

In short, the only way for Aaron to leave the company with the amount of cash he felt he was owed was to die. Until he could do that, he was left owning a company whose performance he had absolutely no reason to improve.

How to Avoid These Problems

The best, and perhaps only, way to prevent this impasse with your company is to review your buy-sell agreement; particularly if it was drafted years ago. Review it to ensure that it addresses lifetime transfers. If you don't have a buy-sell agreement in place, you open yourself and your business up to even greater risk. Enlist the help of an experienced buy-sell advisor who will ensure that your interests are protected before and after "Till Death Do Us Part."

For more information or to learn how L. Harris Partners can help you plan your exit:

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