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# BUY-SELL AGREEMENTS: CHECKLIST FOR BUSINESS OWNERS

When two or more individuals own a business, whether through a corporation, partnership or limited liability company, it is important that they enter into a business continuation agreement with buy-sell provisions (a buy-sell agreement). Such an agreement provides for the purchase and sale of an owner's interest in the business upon the occurrence of certain future events, such as death, disability, termination of employment, retirement or withdrawal from the business. The following are some of the important questions that a buy-sell agreement should address:

1. **Death of an Owner**. What happens if an owner dies? Is the deceased owner's interest in the business then to be taken over by the beneficiaries of his or her estate, such as the spouse, children or other relatives; or do the remaining owners of the business have the option or obligation to buy the deceased owner's interest from the estate of the deceased owner?

2. **Life Insurance Funding.** Is there life insurance in place to fund a buy-out in the event of death? If so, does each life insurance policy have the proper owner and beneficiary designation to coordinate with the terms of the buy-sell agreement and to avoid adverse income and estate tax consequences?

3. **Employment.** Does an individual need to be employed by the business to be an owner of the business? What happens if an owner who is an employee voluntarily terminates his or her own employment? What happens if the company terminates such owner’s employment? Does it make a difference if the company terminates such owner’s employment with cause or without cause? Do the other owners have the option or obligation to purchase the terminated employee’s ownership interest, or will the departing employee continue to own his or her interest in the business?

4. **Permanent Disability of an Owner.** What happens if an owner becomes permanently disabled? How is permanent disability to be determined? Do the other owners have the option or obligation to purchase the disabled owner's interest, or will the disabled owner continue to own the interest despite the fact the disabled owner cannot work in the business?

5. **Right of First Refusal**. If an owner wants to transfer his or her interest during such owner's lifetime, do the other owners have a right of first refusal to buy that interest before it is sold to a third party who is not presently involved in the business? Most of the time, the existing owners of a business do not want to find themselves in partnership with a new individual whom they have not approved; however this may occur without a buy-sell agreement in place.

6. **Creditor Protection.** If an owner's interest is attached by a creditor, or if that owner files for bankruptcy, do the other owners have the option to buy out the owner with creditor problems to prevent such owner's interest from being transferred to the creditor?

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7. **<u>Divorce</u>**. If an owner's interest is about to be distributed to the owner's spouse as part of a divorce proceeding, do the other owners have the right to buy such interest to prevent the interest from being transferred to the spouse? In order to provide additional protection for the business in the event of an owner's divorce, a buy-sell agreement might also include a provision requiring unmarried owners to enter into a pre-nuptial agreement before getting married.

8. **<u>Buy-Out Price</u>**. How is the price to be determined upon the occurrence of a buy-out? The price might be established by an appraisal, by an agreed formula or by an agreed value which is set out in the buy-sell agreement and is reviewed and adjusted by the owners on a regular basis. The IRS reviews prices in buy-sell agreements involving family members with special strict standards. In determining tax consequences, the IRS can ignore the buy-out price in a family business buy-out agreement unless the business can show that the price was determined in an "arms-length" manner which would have been agreed to by <u>unrelated</u> parties.

9. **<u>Cross Purchase or Redemption</u>.** Should the interest of the departing owner be purchased by the remaining owners (cross-purchase) or the by the corporation, partnership or limited liability company itself (redemption)? A buy-sell agreement should be structured in a flexible manner to allow either a cross-purchase or redemption to occur at the option of the owners so that the owners can evaluate the legal and tax consequences of this choice at the time a particular buy-out occurs.

10. **<u>Payment Terms</u>.** Is the buy-out price to be paid in full immediately, or paid in installments over time? If payment is to be made in installments, will such installment payments be secured with additional collateral? Some types of security which are often required are stock pledges, security interests on the business assets, mortgages on real estate and personal guarantees.

11. **<u>Non-competitive Covenants</u>.** If an owner leaves the business after receiving payment for his or her interest in the business, can such a departing owner then also enter into a competing business and/or solicit customers away from the remaining owners? It may be important for the agreement to contain non-competitive and non-solicitation covenants which restrict a departing owner's ability to engage in these activities.

12. **<u>Dispute Resolution</u>.** If the owners get into a dispute, how can they resolve their differences without a long, expensive battle which could paralyze or destroy the business? The agreement can provide specific binding procedures for resolving disputes quickly and economically through private arbitration, mediation or other alternative methods which are agreed to in advance by all owners.

The above questions should not be left unanswered. These questions are only some of the issues which a buy-sell agreement can address. If you don't have a written buy-sell agreement, you should consider obtaining one. If you have an existing agreement, you might want to review it to see if it answers these questions and addresses any other issues relating to the arrangements between the owners.

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