Does Your Business Have a Buy-Sell Agreement?

Arthur F. Rothberg, Managing Director, CFO Edge, LLC

Have you given much thought to what would happen to your business if you were to unexpectedly die or become disabled and no longer able to run things? Many owners of small and mid-sized firms haven't — and this can end up being a huge mistake if one of these worst-case scenarios actually happens.

One of the best ways to prepare for such a scenario is to draft a buy-sell agreement, also referred to as a shareholder or member agreement when used in a corporation or Limited Liability Company (LLC). This is a legal document that will help make sure that your interest in the business is transferred to your partners in an orderly manner.

Having a buy-sell agreement in place will help your partners and surviving family members avoid potential conflicts of interest that could arise regarding how your ownership interests are transferred if you die or become disabled.

Potential Negative Ramifications

There are many negative ramifications that can arise if you were to unexpectedly die or become disabled without a buy-sell agreement in place, including the following:

- Important business decisions could be delayed as partners grapple with ownership and control issues, causing the business to miss out on potential opportunities.
- There could be disagreements among partners and your surviving family members about the terms for the sale of your ownership interest and the price of this interest.
- Your surviving spouse could end up being a reluctant partner-owner in the company, even if he or she knows little about the business and has little interest in participating.
- All this uncertainty and unsettledness could disrupt normal business operations, resulting in lost sales and lower revenue and profits.

A properly structured buy-sell agreement will detail the specific terms for the sale of your ownership interest, along with a pre-determined price, either to your surviving partners or your heirs. This will provide a high degree of certainty for all the stakeholders involved, including:

Your partners — Surviving partners won't have to deal with disputes between each other over how your interest is distributed, or with the possibility that one of your family members with little or no knowledge of the business will suddenly become a co-owner.

Your family — Surviving family members will have the assurance that they'll receive a fair price for your interest that has been pre-determined in advance, which reduces the potential for disputes between them and your partners.

Your employees — Company employees can rest assured that a smooth ownership transition has been planned for ahead of time, which will help reduce any anxiety they might have about the company's long-term future going forward and make them more productive.

Structuring the Buy-Sell Agreement

In drafting a buy-sell agreement, you and your partners will need to decide on the appropriate funding mechanism. Buy-sell agreements are usually funded with life insurance or a disability buyout insurance policy. There are two different ways to structure a buy-sell agreement funded with insurance:

1. **Cross-purchase agreement** — With this structure, partners purchase life or disability policies on each other, using the proceeds of the policies to buy the deceased or disabled owner's interest. The fewer partners there are, the better a cross-purchase agreement usually works.

2. **Entity purchase agreement** — With this structure, the business entity purchases the insurance policies on each partner. If a partner dies or becomes disabled, the business buys his or her interest, which is then divided among the partners. An entity purchase agreement is usually simpler when there are at least three partners in the business, since partners don't have to buy multiple insurance policies on each other.

Before drafting a buy-sell agreement, it's usually wise to have a professional business valuation conducted. This will assign a binding value for the company that all the partners must agree to accept. As time goes on and business conditions change, the business valuation should be updated to reflect these changing conditions so that it's accurate if it ever has to be executed.

An outsourced CFO services provider can help you draft a buy-sell agreement for your partnership. This financial professional has worked with many other businesses similar to yours in structuring buy-sell agreements that have enabled partners and families to avoid the negative ramifications that can arise when a partner dies or becomes disabled without such an agreement in place.

Concluding Thoughts

Many small and mid-sized business owners haven't given much thought to what would happen to their business if they were to die or become disabled. One of the best ways to prepare for such a scenario is to draft a buy-sell agreement: a legal document that will ensure that your business interest is transferred to your partners in an orderly manner. An outsourced CFO services provider can help you draft a buy-sell agreement that enables your surviving partners and heirs to avoid the pitfalls that can arise from your unexpected death or disability.

About CFO Edge

CFO Edge, LLC delivers enterprise-class financial and operational performance solutions to executives throughout Southern California. Based in Los Angeles, our formerly-seated chief financial officers engage on demand as part-time CFOs, single-project CFOs, and interim CFOs to help business leaders successfully resolve pressing challenges and realize their financial and operational goals. At CFO Edge, we are passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 800.276.1750 Ext 101.