Buy Sell Agreements

Peace of mind in case a partner dies or is permanently disabled

Introduction

When people own a business, a lot of their wealth can be tied up in it. They have worked for years to build it up and when two or more people are involved, exit scenarios can be tricky. It's not always easy to sell a share in a private business.

More often than not, the disposal of the business assets upon one proprietor's death or incapacity is not clearly and legally specified. The need for appropriate legal agreements between partners may seem painfully self-evident - but some sources indicate that as many as 95% of businesses may not have the right kind of agreements in place!

This can lead to immense problems for the business, for the surviving business owner(s) and for the departing proprietor or their family.

Without a formal Buy Sell Agreement in place to dictate the terms under which business assets are handled in the event of a death or serious incapacity, plus sufficient insurance to fund the settlement, scenarios like these are heartbreakingly common:

- Surviving proprietors have to negotiate with the spouse or other beneficiaries to buy out their share of the business.

Funds may not be available, the value of the business may be under contention, and beneficiaries may be forced to take whatever is on offer. Surviving proprietors may argue, for example, that the value of the business is diminished without the contribution of the partner who has departed.

- The beneficiaries may choose instead to take an active role in the business - whether or not they truly want to, are qualified to, or more importantly whether the other proprietors want them involved. This can happen with possibly devastating consequences for the business itself.

Whatever the situation, it is potentially fraught with emotion, cost and dangerous distractions from running the business - and can leave everyone involved unhappy with the ultimate outcome.

The Buy Sell Agreement

A Buy Sell Agreement - sometimes referred to as a "Business Will" - is a contract between business partners that sets out exactly what the rights and obligations of each partner are in the event of the involuntary departure of a partner.

The agreement specifies:

- "Trigger events" - those situations in which the contract is to be "triggered" (usually the death, critical illness/trauma or total and permanent disability of a proprietor).
- "Call options" - the right of one proprietor to purchase another's equity under specified circumstances.
- "Put options" - the right of one proprietor to force the other(s) to purchase their equity in the business under specified circumstances.
- "Agreed price" - the price at which the equity will be sold

Funding the Buyout

Funding is usually by way of insurance policies held by each proprietor. These insurance policies are noted in the Buy Sell Agreement as having been taken out to cover the proprietor's equity in the business.

These policies can also include amounts for personal use (which can help reduce the cost) although it's important that the Buy Sell Agreement notes the different uses to which the insurance is to be put ie personal, business and tax (more later).

How is the Purchase Price Set?

An agreed price is stipulated in the document, and is either:

1. The value of the business as determined by an independent valuation at the time of the trigger event; or

phone: 03 8621 9000 **email:** info@irongrouplawyers.com **Irongroup Lawyers Pty Ltd** ACN 102 794 249
fax: 03 8621 9001 **web:** www.irongrouplawyers.com Level 8, 533 Little Lonsdale St Melbourne VIC 3000

Buy Sell Agreements

2. The amount of the insurance benefits

Setting the formula to determine the value up front and getting adequate insurance coverage are critical parts of the process of establishing a Buy Sell Agreement.

As the business value may change over time, the agreed purchase price is usually the business value at the time of the trigger event.

The insurance payout is then deemed to be part of the purchase price and the remaining proprietors are usually then obligated to pay the difference between that amount and the agreed purchase price.

This caters for situations for example, where there is not enough insurance in place to cover the full value. For example, the business may have increased in value over the years but if the proprietor's health has changed they may not be able to get additional insurance cover.

The agreement, of course, is tailored to fit the requirements of the partners.

Capital Gains Tax Implications

When the equity or shares are transferred from one proprietor to another, following the insurance payout, capital gains tax may apply.

If the asset has increased in value (ie their share of the business), then the 'seller' incurs a capital gains tax liability.

This is usually funded by additional insurance. For example, if a proprietor's share of the business is worth $500,000 then an extra 30% for tax (assuming it's owned by a company) would be added ie a total of $650,000 in insurance would be taken out.

Capital gains tax is paid on whichever is higher at the time of the event - either the valuation of the equity or the agreed value. If additional insurance has been taken out to fund the tax, the agreement must be properly worded to avoid having to pay tax on the total insurance amount and not just the amount set aside for the share of the business.

In Summary...

Whenever two or more people own a business, it is essential to have a proper Buy Sell Agreement in place to ensure seamless and equitable transfer of equity in the event that one partner has to leave the business involuntarily.

The funding to execute that agreement must also be considered - with appropriate, linked insurance cover usually needed to ensure that all parties come away from the unfortunate event in the best possible way.

Even if proprietors have appropriate insurance cover, ownership of the business and transfer of equity can be unclear and pose enormous difficulties if the business does not have a properly worded supporting Buy Sell Agreement in place.

Unfortunately, too many businesses today don't. However putting the appropriate documentation in place is not an expensive or insurmountable task.

The Process

Irongroup Lawyers prepares fixed price Buy Sell Agreements. Once the client's Adviser contacts us, we organise to meet with the client. The Adviser is more than welcome to attend that meeting although it's not essential.

We talk through the issues and options and collect all relevant details. We then prepare a draft agreement pending final insurance policy details. Once the Adviser provides copies of those schedules we prepare the final agreement and send it to the client for review and signing.

We also conduct an annual review as it's important to ensure the Buy Sell Agreement continues to reflect current needs, and particularly to ensure adequate insurance is in place in case the business has increased in value.

"Voluntary" Departures

A Buy Sell Agreement is used to determine how business equity is handled if a partner has to leave the business involuntarily, through illness or death.

Conditions for the voluntary sale or purchase of equity between business partners are covered in another agreement called an Exit Agreement. Issues such as the method to be used to value the business at the time of sale or purchase, possible discount to that valuation (as an incentive or disincentive) and payment terms, all need to be covered when considering the voluntary departure of an equity holder or partner.

Irongroup Lawyers can also prepare these agreements for clients where required, providing the complete Business Succession package.

Contact us

For more information on either Buy Sell Agreements or Exit Agreements, please contact Irongroup Lawyers on 03 8621 9000. With our depth of experience, fixed prices and focus on providing positive outcomes for clients, we would be pleased to help.

©Irongroup Lawyers Pty Ltd 2010