

# Understanding Buy-Sell Agreements for Small-Business Owners

By Vernon W. Holleman, III

Now is a tremendous time to call on your small-business-owner clients, or prospective clients, to talk about their buy-sell agreements – to either review the one they have, or create the one they should have.

It is not lost on small business owners that the value they receive for their business in the event of death, disability, retirement, or sale is as important as ever. But that doesn't mean they are *doing* anything about it and that is where you as an advisor come in.

You might be wondering if asking a client to review their "Succession Plan" would be better, as it might address more global issues. Although these terms can, in some cases, mean the same thing, the term "succession" can often carry with it more baggage than a small business owner may want to carry. Furthermore, there is plenty of room to go global in the buy-sell agreement discussion, so be specific to ask about reviewing the "buy-sell agreement."

The buy-sell agreement is often the corner stone of a succession plan; it is the legal document you either want to help review or help them create – it is a key piece of the bigger puzzle, and if they don't have one, there is

no way to hide it. If you ask when the last time it was reviewed, and they have to think about it – you can help them. If someone can honestly tell you they have reviewed it within the last year, that it is up to date and funded, someone has likely beaten you on that circumstance. So, simply congratulate them and call on the next person on your list.

Ultimately, what this planning is attempting to accomplish is avoiding any surprises or conflicts for the business owners and their families. This may sound too simplistic, but a clear buy-sell that everyone understands, has agreed to, and reviews regularly should eliminate the surprises, such as: no funding, dispute in price, a missed contingency, a sale offer less than a desired value. All of these, and others, lead to nothing but headaches, fighting, and un-productivity—not to mention the end of the business. Your most important job is keeping your client focused on the big picture goal as the details get reviewed, discussed, debated, and focused on. This is clearly easier said than done, but shepherding these discussions while things can be thought through without pressure or dispute is meaningful and important work.



**Vernon W. Holleman, III,** Vernon W. Holleman, III, is president of The Holleman Companies in Chevy Chase, Md., which focuses on business-succession, executive-benefit and financial-security planning. He can be reached [vernon@hollemanco.com](mailto:vernon@hollemanco.com).  
[www.hollemanco.com](http://www.hollemanco.com)

## Buy-Sell Basics

You don't have to know all the legal aspects of buy-sell planning, but you do need to know the basics and the key questions that must be both asked and answered.

A buy-sell agreement is like a pre-nuptial agreement for business owner shareholders or partners. It is also sometimes referred to as a "business will." The agreement is a legally binding contract (either separate from or a part of the partnership or business operating agreement) that controls future ownership of the business—it covers the potential "what ifs" that could occur. Those what-ifs include death, disability, retirement, the sale to a

third party, bankruptcy, and divorce of an owner. The idea is to preserve the continuity of the ownership of the business and to ensure that both the buyers and sellers feel the deal was fair. Along with what events trigger a buy-out of an owner, a good buy-sell agreement will also cover who can buy shares of the business and at what price.

There are four primary forms of buy-sell agreements: An Entity (also called Repurchase or Entity Redemption) Agreement, A Cross-Purchase Agreement, a Wait and See (or Mixed Agreement), and the No-Sell Buy-Sell Agreement.

In an Entity arrangement, the business entity itself (corporation, LLC, partnership, etc.) is obligated to purchase the owner's interest in the business if one of the named triggering events occurs.

In a Cross-purchase arrangement, the surviving owners are responsible to acquire the interest of a fellow owner who has died, retired, or become disabled.

The Wait and See approach allows for flexibility in that the surviving owners have the ability to choose whether to employ the business entity or the individuals should acquire the interest in the business after one of the triggering events.

The No-Sell Buy-Sell is for owners who want the future appreciation of their stock to go to heirs, but not the outright ownership. Therefore, the agreement passes control of the business to surviving owners, but non-voting interest stays with an heir(s).

Some plan must be in place to pay for the obligations created under the agreement. Typically, insurance is utilized to create cash at the time of death or disability. In an Entity Agreement, the insurance is owned by the business entity and it is the beneficiary. The face amount (death

benefit) of the policy equals the purchase price that set out in the legal agreement. In a Cross-purchase Agreement, the individual owners own policies on one another and use the policy proceeds to purchase the deceased owner's interest in the business.

Disability income products exist for funding the buyout of an owner who becomes disabled. It is important to be familiar with how these function and how they are priced. DI is as important as life insurance.

Life insurance is crucial too, and if permanent life insurance is used, the cash can provide dollars in the event of retirement or departure via bankruptcy or divorce. Of course, other investments or cash can be used, but cash-value insurance makes tremendous economic sense.

As a financial professional, you are being counted on to explain the various ways in which the insurance should be owned, how to designate the beneficiary, the pros and cons of the type of insurance to be used, and what specific products and carriers make sense. For example, you need to understand that a corporate trustee may make sense, especially when a cross-purchase agreement is desired, but too many policies would need to be required. It can get complicated, but work hard to keep it simple. Again, keep yourself and your client focused on the big picture.

Valuation of the business is also a key component to Buy-Sell planning. The objective is to get as close to the fair market value for the business as possible. This is often easier said than done, as each business owner may have his or her own belief in the value of the company. Although the details of each are beyond the scope of this article, understand the basics of these valuation methods: book value, discounted cash flow, capitalization of earnings, and sales multiple valuations.

Don't let your client over-think the valuation and be sure to keep this part of the process moving—far too many agreements don't get done because of disagreements here. Sometimes it is as simple as the owners agreeing to a number and funding the insurance to that level.

Helping small businesses review their buy-sell agreements and succession plans is a great thing to do at today. You'll be doing right by your clients and doing well for yourself.

## Key Questions to Ask

### Ask those with a Buy-Sell

- When did you last review your agreement with your partners/co-owners?
- What valuation method (or formula) does your agreement call for?
- Are you comfortable that the agreement properly rewards all your hard work?
- How does your agreement handle divorce or bankruptcy?

### Those without a Buy-Sell

- Why don't you have one?
- Are comfortable that all your hard work may not be rewarded without an actual agreement if something happens to you?
- Does your spouse understand that no definitive, legally binding arrangement regarding your business is in place?