AN EDUCATIONAL BUSINESS SERIES FOR SUCCESS: DEFINING HOW OWNERSHIP INTEREST(S) CAN BE TRANSFERRED IF ONE OR MORE OF THE OWNERS CAN NO LONGER OR DO NOT WANT TO CONTINUE IN THE BUSINESS

In our last article, we explained why setting in place an exit strategy when the time comes and minimizing the potential for conflict is important. In this post, we will be discussing how ownership interest(s) can be transferred if one or more of the owners can no longer or do not want to continue in the business.

PART 3 – DEFINING HOW OWNERSHIP INTEREST(S) CAN BE TRANSFERRED IF ONE OR MORE OF THE OWNERS CAN NO LONGER OR DO NOT WANT TO CONTINUE IN THE BUSINESS

Your business is soaring along, meeting or exceeding all projections and expectations, and then suddenly one of the owners wants to pull out of the company. Or something disastrous happens and an owner simply cannot continue.

There is a myriad of reasons an owner may leave the business, including simply not having the passion to remain in it, but no matter what, you can and should be prepared. Whether your business continues to function at a high level or crumbles during this transitional period depends on how well you have anticipated situations that involve transfers of ownership interests. A well-drafted buy-sell agreement can help keep your business on track by defining how and when ownership interests can be transferred, and for how much.

Typical Buy-Sell Provisions

In many cases, the owner's interest must be sold back to the company, the remaining shareholders, or a combination thereof. A solid buy-sell agreement may be structured in several different ways and account for differing triggering events. In all cases, however, the buy-sell agreement should specify the value of the interest after the owners agree on the method of valuation.

In the most common scenario involving the death or disability of an owner, co-owners are required to buy the departing owner's share. Under what is commonly called a "cross-purchase plan," each owner would buy a life insurance policy on every other owner and pay the premiums, either personally or using business funds. The remaining owner or owners could then purchase the departing owner's interest from their heirs using the life insurance proceeds.

When the business itself will buy the departing owner's share upon the death of an owner, the buy-sell is funded with a life insurance policy bought by the business and on which it pays the premiums. The business would then use the proceeds of the policy to purchase the owner's share from their heirs.

In a situation in which a sole proprietor has handpicked someone to take over the business, a one-way buy-sell agreement may be the best choice. In this case, the chosen person—whether it is an employee, child, sibling, spouse, etc.—would buy an insurance policy on the owner and name themselves as the beneficiary. Premiums may be paid by the business or by the future owner.

Buy-sell agreements may also give the business the option to buy a departing owner's interest first. If the business declines, the option then moves to the remaining owners, but if they do not buy all the remaining interest, the business must buy it. This type of arrangement is called a "wait and see" plan because it allows the business to decide whether it makes good financial and tax sense to purchase the departing owner's shares at the time of the triggering event.

A buy-sell agreement may also provide remaining owners with a "right of first refusal," giving them the option to buy the departing owner's interest before it is offered to anyone else for purchase. This provision can help ensure that the remaining owners maintain a say in who their future partner will be, though it is not foolproof if the remaining owners do not have the funds available to buy the interest.

Remember, too, that owners do not always have equal shares in the business, and that means that separate buy-sell agreements may be in order. For example, a buy-sell for a minority owner may require them to sell their interest to the majority owner while one for the majority owner may prefer that a particular person, such as a child, take over their shares.

Overall, a comprehensive buy-sell agreement can cover many triggering events and scenarios while also keeping all current owners happy both during the course of business and in the case that the contract must kick in. The best buy-sell for your business will minimize potential conflict while also considering exactly what your specific business needs as well as potential tax consequences.

Check out our next article in our business series covering what types of protection needs to be considered in a transition.

If you have questions about your company's succession, please contact a member of our Estate and Business Succession Planning team.

OTHER ARTICLES IN THIS SERIES:

- An Educational Business Series for Success: Setting in Place an Exit Strategy When the Time Comes and Minimizing the Potential for Conflict
- An Educational Business Series for Success: Why Buy-Sell Agreements are Necessary Even if You Don't Plan to Sell Your Company Soon