

Buy-Sell Agreements: The Missing Piece in Your Business's Contingency Plan



BY

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A Buy-Sell Agreement is one of the most important tools a small business can have to ensure smooth transitions and protect its future. Whether you're planning for retirement, preparing for the unexpected, or thinking about succession, a Buy-Sell Agreement lays out the terms for what happens to the ownership of your business when certain events occur, such as the death, disability, or retirement of a partner. However, while many business owners understand the importance of having this agreement in place, a significant number overlook one critical aspect: funding the agreement.

What Is a Buy-Sell Agreement?

A Buy-Sell Agreement is a legally binding contract between business owners that outlines how ownership will change hands in specific situations. It provides a roadmap for:

- Valuing the business.
- Determining who can purchase shares.
- Specifying the terms of the buyout.

Buy-Sell Agreements are essential for preventing disputes, ensuring continuity, and protecting the financial interests of all parties involved. They can be structured

in several ways, including cross-purchase agreements (partners buy each other's shares) or entity-purchase agreements (the business buys back shares).

The Funding Oversight

The most common pitfall with Buy-Sell Agreements is not addressing how the buyout will be funded. Without proper funding, even the most meticulously crafted agreement is essentially a promise without a plan. Here are some key funding options and considerations:

1. Life Insurance

Life insurance is one of the most common and effective ways to fund a Buy-Sell Agreement. If a partner passes away, the policy's death benefit provides the liquidity needed to buy out the deceased partner's share.

- **Cross-Purchase Plans:** Each owner takes out a life insurance policy on the other owners.
- **Entity-Purchase Plans:** The business owns the policy and uses the proceeds to buy back the departing partner's share.

2. Disability Insurance

While many business owners think about death, they often overlook disability. A partner who becomes disabled may no longer contribute to the business but will likely still

need an income. Disability buyout insurance ensures there's funding to purchase their share without draining the company's resources.

3. Sinking Fund

Some businesses set aside cash over time in a dedicated account to fund future buyouts. While this provides liquidity, it can tie up capital that might be better used for growth.

4. Borrowing

If a buyout becomes necessary, the business or remaining owners could take out a loan to fund the purchase. However, this method is risky, especially if the business's financial situation has been impacted by the event triggering the buyout.

5. Installment Payments

Another option is for the remaining owners or the business to buy out the departing partner's share over time. While this may be more manageable financially, it can leave the departing partner or their family waiting years to receive full payment.

Why Funding Matters

Without proper funding, a Buy-Sell Agreement can lead to:

- **Financial Strain:** The remaining owners or the business may struggle to come up with the money needed to buy out a departing partner's share.
- **Conflict:** Disputes may arise if one party believes the other isn't honoring the agreement.
- **Business Instability:** The uncertainty of an unfunded agreement can jeopardize operations, morale, and long-term success.

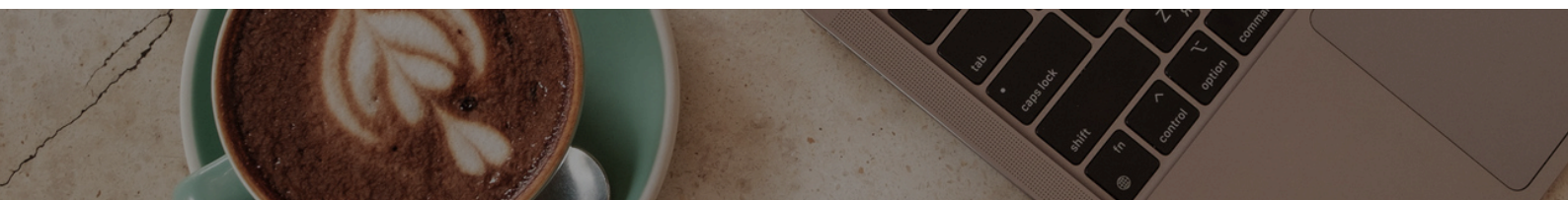
Taking Action

To ensure your Buy-Sell Agreement is comprehensive and effective:

1. **Work with Professionals:** Consult an attorney, financial planner, and insurance specialist to draft the agreement and identify the best funding strategy.
2. **Value Your Business:** Regularly update the valuation to ensure the agreement reflects the true worth of the company.
3. **Review Periodically:** As your business grows and circumstances change, revisit your Buy-Sell Agreement and funding mechanisms to ensure they're still appropriate.

The Bottom Line

A Buy-Sell Agreement without funding is like a car without gas — it won't get you where you need to go. By addressing the funding component, you'll not only safeguard your business's future but also provide peace of mind to yourself, your partners, and your loved ones. Don't wait for a triggering event to highlight gaps in your plan. Take steps today to ensure your Buy-Sell Agreement is fully prepared to handle whatever comes next.



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