What is a buy-sell agreement?

Editor's note: The operative clause of any business entity agreement is the buy-sell agreement, which can restrict ownership to family members, and protect the farm manager from the sudden pressure of a buy-out. The following is part of a series produced by John Baker, Esq. of the Iowa Beginning Farmer Center.

A **buy-sell agreement** is a contract obligating one business owner to buy all or a portion of the business upon the retirement, death or disability of another business owner. Such agreements are often found in the governing documents of business entities such as partnerships and limited liability companies to restrict ownership of business interests. The contract specifies who will buy the ownership interest, what price will be paid and the interest rate. A well-drafted agreemenet will also include whether any discounts apply as well as terms of sale. Funding is an important aspect of this planning technique and is usually accomplished with current cash flow, loans, life insurance proceeds or through the sale of other assets.

A buy-sell agreement allows the business owners to agree on a process to value the company at a future date and the ownership interests therein in a mutually beneficial agreement for all owners and their families. The agreement also avoids or reduces disruptions to the business operations after one owner leaves the business because the event has been planned for and management will continue. Planning for the future in this way helps assure the business's stability and continuity and provides job stability for the buying owner and other key employees. A buy-sell agreement also can prevent off-farm heirs or unqualified shareholders from obtaining an ownership interest, or selling an interest to an outsider. Below are several variations of buy-sell agreeemnts that may be alternated within one agreement.

Cross Purchase Agreement – Each business owner buys a life insurance policy on the lives of the other owners. Under the agreement, the owners are obligated to use the proceeds from the insurance at the death of an owner to purchase the business interests from the deceased's estate.

Entity Purchase Agreement – The business itself is obligated to purchase the business interests of the deceased using life insurance policies that the business has purchased on each of its owners. The company incurs the cost of the life insurance and also retains the cash value instead of the individual owners.

Wait and See Buy-Sell Plan – The business itself has a first right of refusal and therefore has the first right to buy the deceased owner's shares. The business can wait to decide whether to purchase the share or let the remaining owners purchase the shares personally. If the business elects to let the remaining owners purchase shares, it is required to buy any remaining shares that remaining owners do not purchase.

Option Agreements

One of the most common option agreements is a "right of first refusal." This is an option contract between a future seller and a potential buyer that allows the buyer the first chance to purchase property by matching other bids. This type of agreement may be useful when current property owners wish to retain the property but ensure that it will first be offered for sale to a specific individual or group of individuals.

The agreement will always be triggered by the sellers and not the potential buyer. The potential buyer has no right to force the sellers to give up their property, only the right to be the first in line to buy the property if the sellers decide to put the property on the market. There is no guarantee that the property will ever be put up for sale or even that it will be put up for sale at a time where the option holder is able to cash flow the sale.

A right of first refusal does not shelter sales from any kind of taxes or gift implications if the price is artificially low. It only ensures that the option holder will have the option to purchase the land above anyone else.

Options to buy may also be easily written into a trust. This is a slightly different situation than a right of first refusal because the option is triggered at death of the property owner instead of during life when the owner wishes to sell. A specific person may be given the first option to purchase property from the estate of the deceased with the specified heirs receiving the proceeds from the sale. Fair market value, a discounted price or a specific below market value price may be set as the sale price by the will. Gift tax will not be an issue if the price is set artificially