Buy/Sell Agreement
Information Guide

What is a Business Succession (Buy/Sell Agreement)?

A business succession (buy/sell agreement) sets out the procedure and method of dealing with interests held by business owners when they exit the business. The agreement typically covers one or more of these events: death, total permanent disability (TPD) or trauma (Trigger Events).

The agreement provides a mechanism for determining the price payable for the outgoing owner's interest in the business when a Trigger Event happens to an individual associated with the owner (the Outgoing Principal). In addition, it sets out how the purchase price will be funded and how debt is to be repaid to or by the outgoing business owners.

Often the price is funded through insurance held by the Outgoing Principal, with the insurance proceeds being paid directly to the Outgoing Principal or their estate when the Trigger Event occurs.

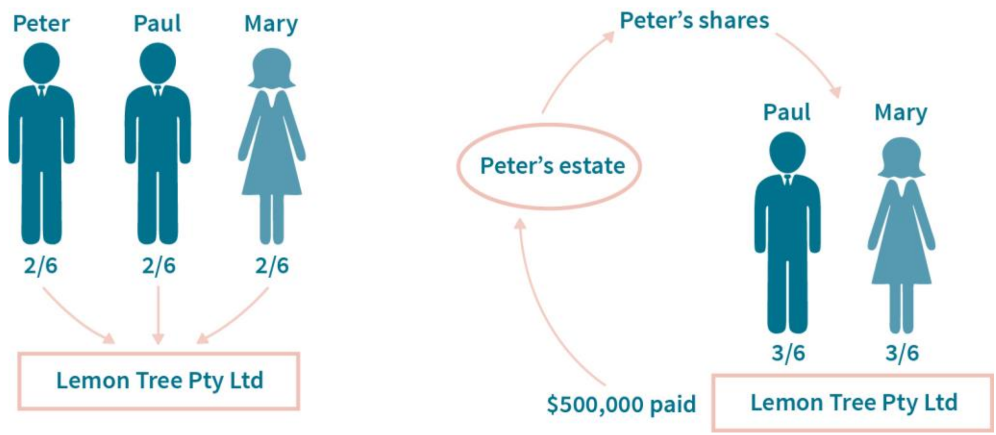
How a Business Succession Agreement works

Peter, Paul and Mary between them own all the shares in Lemon Tree Pty Ltd, which operates a mining services business. The company has a value of $1.5 million.

They enter into a Business Succession (Buy/Sell Agreement) which is triggered if any of the business owners dies or becomes totally and permanently disabled.

Peter is killed in an accident at a mine site.

Example



Under the Buy/Sell Agreement, Paul and Mary have the option to purchase Peter's shares for their current market value. Under the same agreement, Peter has the option to force Paul and Mary to buy his shares for their current market value. As part of the agreement, each party has in place Life and TPD insurance, and agrees that any proceeds received count as part of the purchase price.

Following Peter's death, Paul and Mary trigger the option to buy Peter's shares. Peter's estate receives $500,000 under his insurance policy.

Without the agreement in place, Paul and Mary could not force Peter's estate to sell his shares to them, and even if they agreed to a sale, Paul and Mary would need to find a way to fund the purchase. Similarly, Peter's estate could not have forced Paul and Mary to buy his shares, and even if they were willing to purchase the shares, the parties may have needed to negotiate time to pay out Peter if no insurance funding had been put in place.

Overview of issues that should be addressed and agreed by the parties to the Agreement

The funding mechanism

Typically these agreements will look at funding the buyout through insurance. However, where insurance is either not available, or full cover cannot be secured, the agreement can also make provision for the payment of the unfunded portion of the purchase price.

One way of dealing with this issue is to have the unfunded portion of the purchase price paid by way of instalments (e.g. over 24 months or 36 months).

Dealing with business debt

The agreement can also address any business debt, whether internal (i.e. loans from owners) or external (e.g. bank debt), both in terms of paying out these debts, as well as releasing Outgoing Principals and their related parties from guarantees or other security provided by them.

Agreeing the basis of the valuation

The valuation approach should also be set out in the agreement. In many cases, the parties will agree that a valuation is to be obtained as at the date of the Trigger Event so that a current valuation applies. In other circumstances the parties might agree to set a valuation from time to time that will apply under the agreement. In other cases, the parties might agree that a particular formula or valuation methodology is to be used to determine the valuation.

Whatever the approach, the agreement provides certainty to the parties as to the valuation which will be used if a Trigger Event occurs.

Trauma – protecting the affected party

Where the agreement includes trauma, the agreement should stipulate when trauma is treated as a Triggering Event. In most instances, the parties will agree that it is not sufficient for the other parties to trigger their options merely because one party has suffered a trauma. Instead, the agreement will often allow the trauma sufferer some reasonable time to return to work – say 3, 6 or 12 months depending upon what the parties decide. This ensures that a party cannot be forced out of the business merely because they suffer a trauma. If a person suffers a trauma, but is able to return to work within the time stipulated in the agreement, the agreement will also set out what happens with the insurance proceeds.

Matching wills and other succession documents with the business succession agreement

It is important that any wills prepared for the owners contemplate the effect of the business succession agreement. In most cases, this will help to simplify the estate planning for the business owners, because their estates will expect to receive insurance proceeds or other sale proceeds, rather than shares, units or a partnership interest which the business owner current holds. Also, the expectation is that debts owing to the business owner would be paid out, and any guarantees or other security released.

Tax implications

It is important to note that the business succession agreement will not generally change the tax impact on the sale which might be triggered by the agreement but specific tax advice is recommended.