



Buy/Sell Agreements



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What is your business worth? Have you considered what would result if you, or a co-proprietor of your business died or was unable to continue in the business? How would you or your family feel if the value of the business was unable to be realised? Or indeed, how would you feel if you were forced to continue the business with your co-proprietor's family as your business partner?

These matters are often overlooked by businesses with two or more non-related proprietors, yet this scenario occurs in over 40% of businesses with four or more co-proprietors.

Failure to discuss these issues can lead to the value of the business plummeting and often litigation from disappointed family members.

What is a Buy/Sell Agreement?

A buy/sell agreement involves the proprietors of a business agreeing to a plan which sets out what they are to do with their respective interests in the business if any one of them:-

- suffers a critical illness,
- becomes disabled, or
- dies.

This is just like having a will for the business. Essentially, the agreement provides for the outgoing proprietor to sell his or her interest in the business to the continuing proprietor(s), and for the continuing proprietor(s) to purchase the outgoing proprietor's interest in the business.

The agreement should also include a means of funding the buy/sell obligations of the respective proprietors, commonly through insurance.

Why is a Buy/Sell Agreement Important

Critical illness, total and permanent disability or death of a proprietor can have a dramatic effect on a business. The following are some of the problems that can occur:-

- The outgoing proprietor (or in the case of death, his or her estate) may make demands for the business to be wound up, for his or her interest in the business to be paid out, for repayment of loan account balances, shares or income, even though the outgoing proprietor may not have contributed to that income;
- In the case of a critical illness, such as a heart attack, stroke or cancer, there can be misunderstanding as to whether or not the ill proprietor can take time off work to recuperate, and if so, for how long;
- The continuing proprietor(s) may end up doing 100% of the work, but splitting the profits;
- In the case of death, the estate of the deceased proprietor may insist on immediate and direct involvement in the control and operation of the business, but may not have the expertise. Indeed, the remaining proprietor(s) may be forced to work with the deceased proprietor's family even though they do not want to or they feel it is detrimental to the business; and
- In the case of death, the estate of the deceased proprietor may be forced by circumstances to sell his or her interest in the business to an outside buyer for an amount lower than its true value.

A buy/sell agreement can provide a ready buyer and seller, ensuring a fair and pre-agreed price or an agreed method to determine the price, without significant delay.

What is the procedure for setting up a Buy/Sell Agreement?

The proprietors should, with the assistance of their financial, accounting, legal and insurance advisers:-

- Negotiate to establish the events which will trigger the arrangement;
- Negotiate how the outgoing proprietor's interest in the business will be valued and the respective buy and sell obligations of the proprietors;
- Set up a funding plan which will provide the cash to achieve the financial obligations of the proprietors should any of the trigger events occur;
- If the funding plan includes insurance, liaise with a reputable insurance agent who is very experienced in this area; and
- Set up the necessary legal documentation which will set out the terms and conditions of the buy/sell arrangement.

Mandatory Agreements versus Option Agreements

A buy/sell agreement may be based upon mandatory buy-outs or based on put and call options.

Buy/sell agreements have traditionally been based upon a mandatory "must buy/must sell" arrangement, where the continuing proprietor(s) and the outgoing proprietor (or his or her estate) do not have a choice as to whether to buy and sell. The proprietors know in advance exactly what the obligations imposed upon them are, and can plan accordingly, however, there are significant stamp duty and capital gains tax disadvantages which are triggered immediately by the execution of a mandatory agreement.

Put and call options can be used in the agreement to make it a "may buy/may sell" arrangement, however, the use of put and call options in the agreement provides the proprietors with the same level of comfort as a mandatory agreement. In other words, if just one party wants to proceed the transfer must go ahead.

The put and call option arrangement operates as follows:-

- Each proprietor grants to the other proprietor(s) a call option, which entitles the other proprietor(s) to call on the outgoing proprietor or in the case of death, his or her estate, to sell his, her or its interest in the business.
- Each proprietor also grants to the other proprietor(s) a put option, which entitles the outgoing proprietor or in the case of death, his or her estate, to require the other proprietor(s) to purchase his, her or its interest in the business.

The arrangement may be extended in the case of critical illness (often referred to as "trauma" in insurance policies) so that if a proprietor is off work for a certain, defined, period of time (e.g. six or twelve months) then the put and call options can operate as above.

Advantages of Put and Call Options Versus Mandatory Agreements

The put and call option approach should eliminate any significant stamp duty liability arising on the execution of the buy/sell agreement. As well, for capital gains tax purposes, there will be no disposal of each proprietor's interest in the business when the put and call option agreement is signed.

Issues to Consider

The types of issues to be considered by business proprietors can seem daunting and include:-

- Arriving at a suitable valuation for the business and ensuring all parties (and the beneficiaries of each party's will) are aware of and comfortable with, the valuation method;
- Ensuring there are adequate funds – through optimum levels of insurance and correct ownership of policies;
- Dealing with the results of any shortfalls in insurance.

These matters are able to be solved with careful consideration. At Attwood Marshall Lawyers, we pool our specialised knowledge in this area with that of other experienced practitioners in the areas of financial planning, accounting and insurance, to ensure our clients not only receive the right advice, but are also comfortable with the process, and fully aware of all of the issues.

For enquiries regarding Buy/Sell Agreements please contact Christine Martin on (07) 5506 8245 or by email cmartin@attwoodmarshall.com.au.



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