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The Essential Business Agreement: A Business Continuity Agreement Among Owners

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If you co-own your business, the business continuity agreement (or “buy-sell”) is one of the most important documents that you will sign. If you have a buy-sell that is out-of-date, un-reviewed or focuses on the wrong issues, it may well be worse than having no agreement at all.

Let’s start with a hypothetical case study that illustrates the importance of drafting a buy-sell agreement that anticipates and provides for *all transfer events* (lifetime transfers or death).

George Acme’s son-in-law, Tom Gardner, had been with George’s company for over 20 years. Tom had gradually assumed operational management, was the acting CEO, and had purchased 25 percent of George’s ownership over the years—mostly at a low value in recognition of his valuable services. Eventually, everyone acknowledged that Tom would one day own the company and carry on the fine traditions of Acme.

But that was before George died and Tom’s sister-in-law, Babette, became the executor of the estate. Babette told Tom that she would sell him the balance of the company—but at full fair market value and in cash—or she would sell the business to the highest bidder.

Only later did she realize that without Tom’s cooperation, the business was unlikely to sell. No buyer wants a disgruntled minority co-owner, especially when he’s the current CEO.

Tom and Babette disagreed about value, control and successor ownership. All these issues could have best been discussed and resolved before George’s death. Had Tom and George created a business continuity agreement, the business would have transferred at a fair price to the benefit of all concerned. Now, because the owners weren’t talking—except through their lawyers—it was unlikely that Acme could even keep its doors open.

Lifetime or Death Events

The business continuity agreement (also called a buy-sell agreement) controls the transfer of ownership in a business when certain lifetime or death events occur. Typically the “trigger” events include the death of an owner, and a sale and transfer of stock from one owner to another or to an outside party. Your buy-sell can also describe your agreement about how transfers will take place during the owners’ lifetimes such as an owner’s permanent and total disability, termination of employment, retirement, bankruptcy, divorce, and/or a business dispute among the owners.

Consider one example: Assume George didn’t die, but that one of the owners wanted to exit. How do they agree

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on value, buyout terms, or design the acquisition? Without a buy-sell agreement agreed to in advance, one owner's desire to exit can transform longtime co-owners into adversaries. The buy-sell sets the valuation method, the terms of the purchase and outlines the tax planning.

In essence a lifetime buyout of an owner is similar in design and consequence to the sale of the entire company to a third party.

The value of the business, the terms of the sale (payment, security, etc.) will all be negotiated. In internal transfers, however, hard-nosed negotiation tactics and disputes about value and payments can quickly destroy friendships, company culture or even the value of the business.

The best way to avoid this is to agree in advance on the method of appraising value and payment terms when all of the co-owners are on the same page—looking out for the ultimate welfare of the company and not knowing whether they will ultimately be a buyer or a seller.

At each of these events, the business continuity agreement may require the business or the remaining owners to purchase the departing owner's stock; or it may give an option to the business or the remaining owners to buy that ownership interest. Or it may give the departing owner the option to require the company to buy his or her ownership interest.

Remove the Guesswork

The agreement should provide a clear picture to a departing shareholder of how much money he or she will receive and how often. Likewise, the remaining shareholders know *in advance* the extent and duration of their buyout obligations. This allows both parties to plan their respective futures.

The agreement can and should establish the value of the stock, set the terms and conditions of the buyout, and give additional protection to all owners. In short, the business continuity agreement is intended to protect all the owners by telling each to whom they can sell, at what price and terms, and under what restrictions.

In This Case, Nothing is Better Than Something

As we stated at the outset, an out-of-date buy-sell agreement is often worse than no agreement because it may require an owner to buy or sell based on inaccurate values or terms that may have made sense during boom times, but may mortally wound the business in tough times.

We urge you to review your buy-sell agreement *at least annually* as part of your annual planning meeting with your advisors. At a minimum, ask:

- Does it reflect when you want to depart?
- Does it give you the amount of cash you need to be financially secure?
- Is it designed to minimize income taxes to the seller and the buyer in the event of any type of lifetime ownership transfer?

If your buy-sell agreement is well drafted and conscientiously updated for changes in ownership, value and other circumstances, there just aren't many disadvantages. In the next issue of this newsletter, we'll look at how the major elements of a buy-sell agreement protect all owners.

Subsequent issues of The Exit Planning Review™ provide balanced and advertising-free information about all aspects of Exit Planning. We have newsletter articles and detailed White Papers related to this and other Exit Planning topics. If you have any questions or want additional Exit Planning information, please contact us.

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