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Buy-Sell Agreements

Key Components and Considerations

Buy-sell agreements provide a means for business owners to control the eventual transfer of their ownership interests, avoid conflict between owners, and protect their families.

Successful business owners are known for being forward thinking. They are able to spot future opportunities, predict changing client needs, foresee potential challenges, and then plan appropriately to profit from these future opportunities and overcome the challenges. Using the same skills, we believe business owners should consider the eventual transition of their ownership interest and plan how to make it successful.

A key component of business transition planning is the buy-sell agreement. Buy-sell agreements are commonly implemented by closely held business owners to place contractual limitations and guidelines on future transfers of their business interests. Properly documented buy-sell agreements allow for continued success of the business by avoiding conflicts between business owners. Each agreement should be drafted to accomplish the specific goals of the owners. Below is an overview of key considerations to be addressed when constructing an agreement.

Structure of Buy-Out Terms

Factors such as the ownership structure, number of owners, entity type, tax issues, and the nature of the business should be taken into consideration when determining the specific transactions provided for by the agreement. This is because the

buy-sell agreement will control future transfers of the business and will have a direct impact on the owner's overall business succession plan. For example, the agreement may require each owner to purchase the business interest of a deceased owner, or may require the business to redeem the deceased owner's interest.

Triggering Events

It is a best practice to consider the possible applicability of triggering events beyond death and disability. These may include involuntary (or voluntary) termination of employment, divorce, loss of a professional license, and bankruptcy. If the buy-sell agreement doesn't cover a particular event, there is a greater potential for conflict and financial uncertainty if one should occur.

Rights versus Obligations

When a triggering event occurs, the agreement may require a mandatory buy out, give one party an option to purchase or sell, or give both parties options. Owners should be aware of the rights and obligations created by the agreement and confirm that they are appropriate given their business succession goals. Buy-sell agreements should be drafted with the advice of legal counsel.

Valuation

A closely held business is one of the most difficult assets on which to place a proper valuation. Even more difficult is trying to set an appropriate value for that business at some unknown point in the future. The buy-sell agreement needs to contain a method for valuing the business that all parties not only can agree on, but can fully understand. Some agreements state a specific value and require all owners to agree to a new value annually. A better option, in our view, may be to provide a stated formula (for example, four times earnings before interests, taxation, depreciation, and amortization), or to leave the valuation up to appraisers who are approved by the owners. Again, the goal is to reduce the potential for conflict and to allow for the owner's business succession goals to be accomplished.

Buy-Out Terms

The specific timing and details of the actual buy out can greatly affect the success and efficiency of the transfer of ownership. The needs and goals of both the potential buyer and the seller should be taken into consideration. For example, spreading out the purchase price over a period of years versus requiring a lump sum payment may help to avoid cash-flow issues for the buyer. Sellers, on the other hand, will want to keep the installment period shorter to minimize the risk of not getting paid and to expedite their liquidity event. Interest rates on any installment sale should be tied to an index (such as the prime rate) rather than setting a fixed rate that may be

out of date when a triggering event occurs.

Funding

The transition of a business ownership interest may be a sensitive time in its lifecycle, and is likely a bad time for the business to have overly burdensome strains on cash flow. We believe it is important to plan for liquidity demands placed on owners or the business itself by the agreement. To avoid such pressures, triggering events such as death and disability may be funded with insurance contracts, while other triggering events may be funded with the establishment of side fund investments.

Tax Considerations

The purchase and sale of a business should be designed to be as tax efficient as possible for all parties involved. Buy-sell agreements should be drafted with the advice of tax professionals.

Separate Business Properties

It is important to identify all assets related to the business and provide the appropriate terms for each in the agreement. These may include land that is separate from buildings, intellectual property, client lists, equipment, and life insurance policies covering the lives of owners or key employees. Any long-term goals for specific assets might also be addressed in this agreement.

Exceptions for Family

Consider the impact of overly restrictive language that prohibits the transfer/gift of your interest to future

generations. A blanket statement that restricts all transfers without the approval of other owners may create conflict when a business owner later desires to bring a child or grandchild into the business as an owner, either during the owner's life or upon death.

Other Considerations

There can be fundamental tensions that arise when individuals who are not involved in the business obtain an ownership interest. As owners, they may have access to company financials, the right to dissent to certain business transactions, the right to a buy out of their interests, and even a right to demand that the business be judicially dissolved. These rights should be taken into consideration before providing an individual who is not active in the business a right to purchase an ownership interest.

As your business grows, enters new markets, adds shareholders, or goes through any number of changes in the typical lifecycle of a business, your buy-sell agreement needs to be reviewed to continue to be aligned with the goals of the business owners.

Conclusion

Buy-sell agreements allow you to express your goals as to how your business interests should be transferred in the future while creating contractual limits intended to allow those goals to be met. Including a comprehensive exploration of the points discussed above when crafting a buy-sell agreement can help set a plan that will avoid conflict between owners and family members and create an efficient transition.

For more information, please contact your Hawthorn advisor.

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