

Implementing the Buy-Sell Agreement

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Preface

This book is formatted to be quick and easy to read. For that reason it is a parsed treatment of a complex and difficult subject. It is my hope that the reader will come to the book wanting to preserve the value of a business interest, increase it, and pass the value to heirs and experience from the book a good beginning.

While implementing a buy-sell agreement is not a do-it-yourself project, it does require leadership and effort. Learning what is in this book and becoming interested in finding out more will help the business owner begin the process, know how to expend the effort, and help determine when professional help is required.

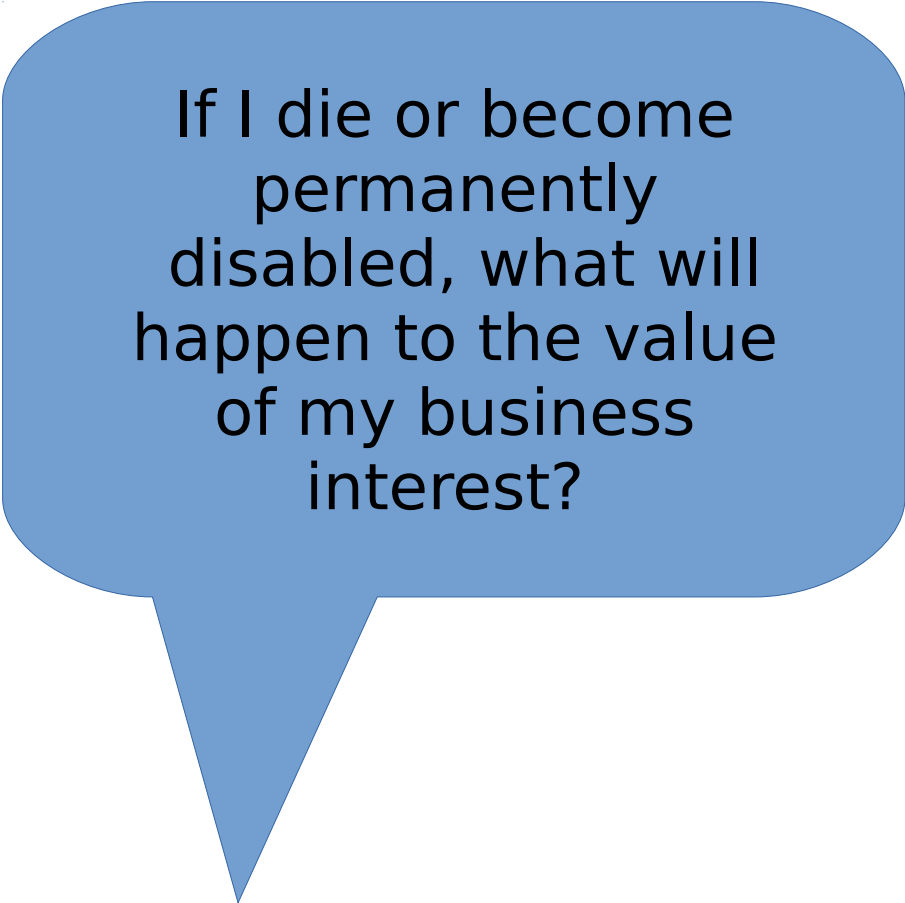
At its most rewarding, owning a business involves the creation of a process for making good decisions. This process, by necessity, will mean that a group of people involved with the business as employees, stakeholders, and owners are a part of the process. Nothing about this involves a majority owner losing control of a business.

Group decision-making, which is planning, is required for the creation of a succession plan. The buy-sell agreement can be drafted from the succession plan. But that should not stop the process of group decision-making. What we are about here is creating a decision-making process. Its first result can be the implementation of a buy-sell agreement.

Definition

A buy-sell agreement, preferably in writing, provides terms for each business owner to offer that owner's interest in the business to the business entity or to the other owners of the business on the occurrence of certain events (triggers).

Motivation for a Business-Interest Owner to Implement a Buy-Sell Agreement



If I die or become permanently disabled, what will happen to the value of my business interest?

Probable Reasons Why You Will Not Implement a Buy-Sell Agreement with Responses

“I am too busy managing my business.”

Founders of businesses tend to be owner-mangers. The ones that learn to create wealth become owners. Do not let the urgent tasks of management prevent you from engaging in the important tasks of ownership

“Odds are that in the near future I will not die or become disabled.”

True, but the odds are that within the next five years something will happen to separate you from your business. That event may be voluntary or involuntary. Are you prepared?

“I do not have other owners.”

Building a business of value requires the participation of others. They will annoy you, be a burden to you, and on occasion make you furious. They can also make you wealthy.

“I find the buy-sell agreement to be a complex and difficult agreement.”

How complex and difficult was it to start your business and make it profitable? The benefit of insuring the value of your business interest is worth the effort to master difficult tasks.

Please reject these reasons to not go forward. Use this book to start the rewarding process of implementing a buy-sell agreement for your business.

What if There is Only One Owner?

OPTIONS:

- Find another sole owner in a related or competing business.
- Select a principal employee or group of employees who would likely assume ownership roles in the event of the owner's death or permanent disability.
- Appoint a trusted person to oversee a transition period which might include the orderly sale of the business.

The Concept of Stakeholders

A person whose interests are affected by the agreement.

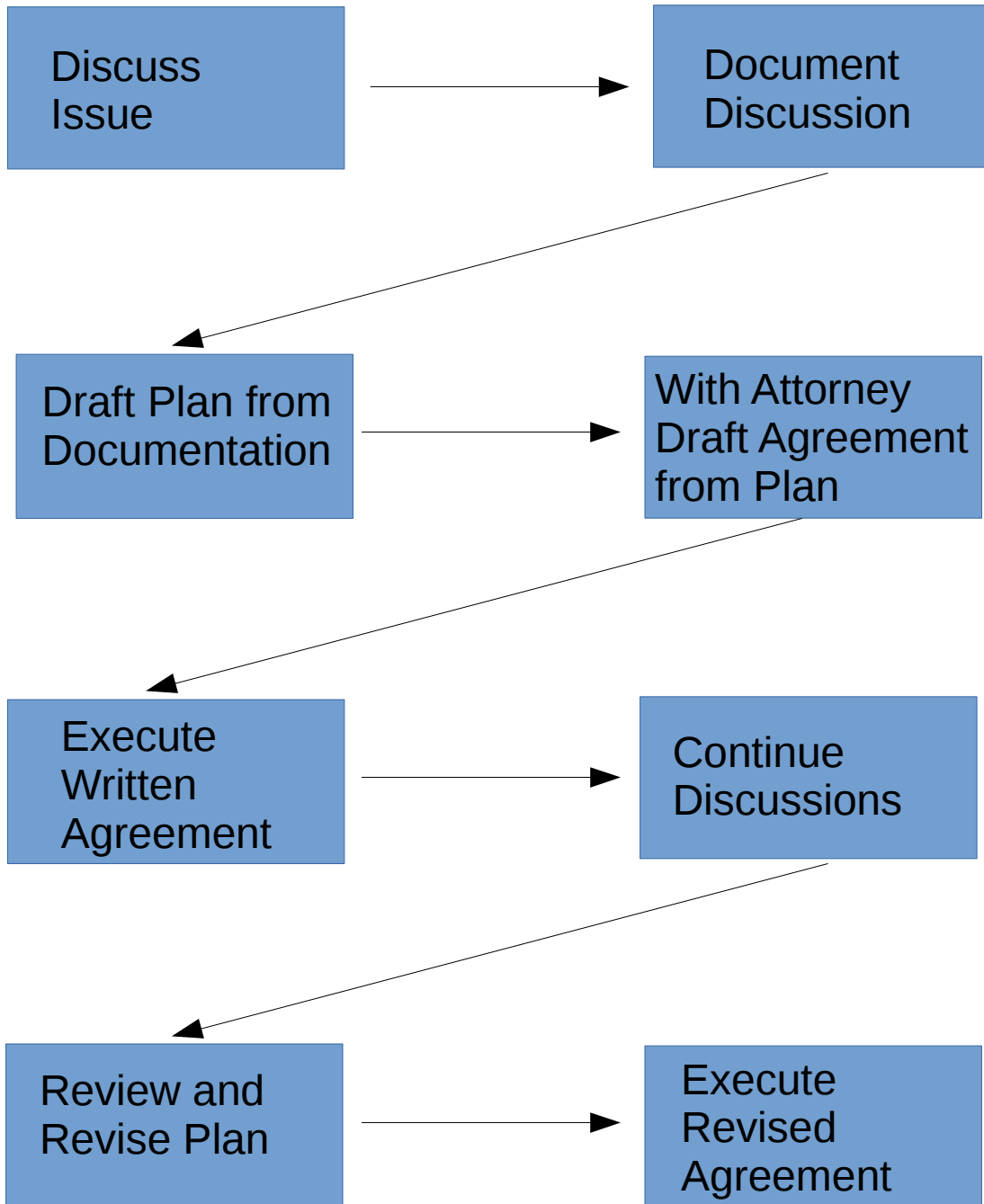
A person who might perceive a benefit in challenging the agreement

In the process of negotiating the agreement, stakeholders must be identified and their interests considered. If possible, stakeholders should be involved in the process of negotiation.

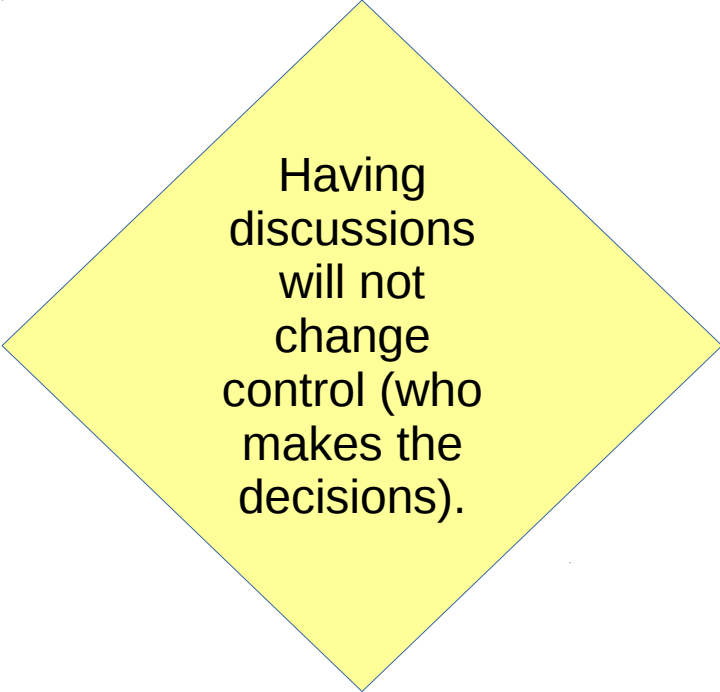
Negotiating the Agreement

- The agreement will involve issues that are difficult to discuss.
- Involve stakeholders and all members of the business in discussions.
- Because there will be difficult conversations, the negotiation process will require time.
- The issues should be discussed one at a time.
- The order of the discussion of the issues is important.
- Negotiation sessions – the difficult conversations about the issues – should be scheduled at regular intervals.
- Each negotiation session should be documented in writing. The accumulation of these writings will form the basis for a succession plan.

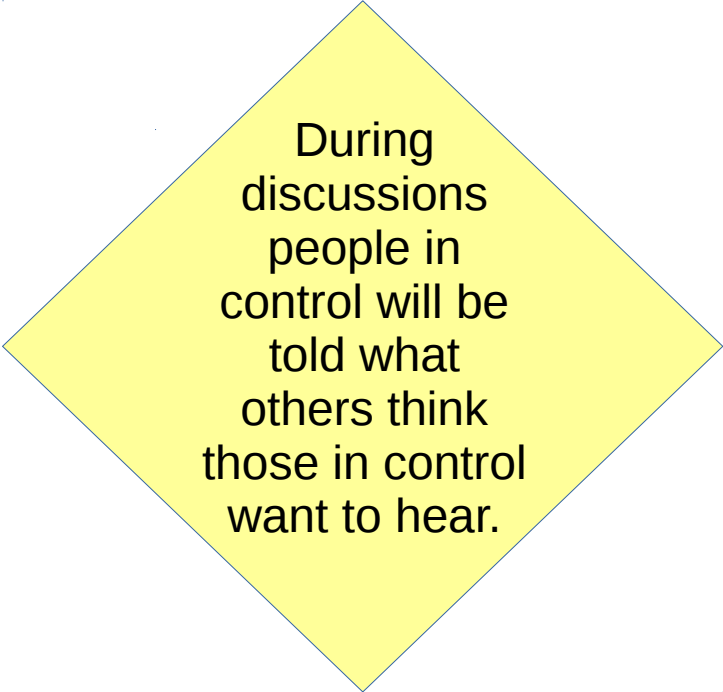
The Decision-Making Process



Control

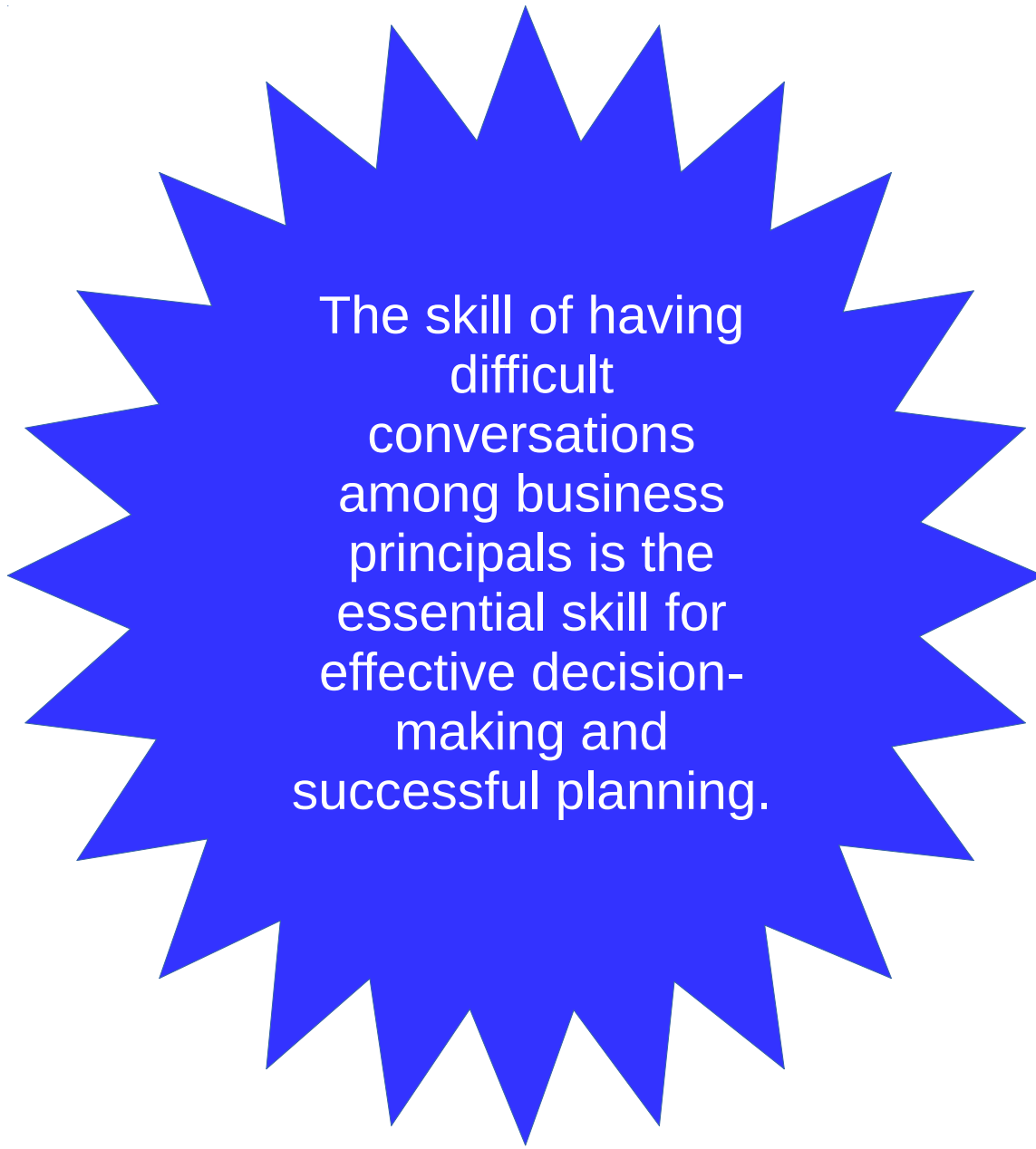


Having discussions will not change control (who makes the decisions).



During discussions people in control will be told what others think those in control want to hear.

Required Skill

A large, blue, multi-pointed starburst shape is centered on the page. Inside the starburst, the following text is written in white, centered, and arranged in seven lines:

The skill of having
difficult
conversations
among business
principals is the
essential skill for
effective decision-
making and
successful planning.

Conducting a Difficult Conversation

1. There needs to be an understanding that the participants will respect one another by listening and allowing each participant to speak.
2. Where there is difficulty, the negotiation session should be ended with an agreement to continue. Allowing emotions to take over (especially with family members) or cutting off without agreement to continue another time is injurious to the overall effort.
3. Controlling owners will have to listen carefully to avoid accepting what other owners think is what the controlling owners want to hear.
4. Participants should be encouraged to ask questions and avoid making statements.
5. The written documentation of the session should be distributed among the participants after each session and should reflect the listening skills of the recorder.
6. Having the discussion is more important than trying to state a solution to a perceived problem. Do not force conclusions. The process takes time and should continue as a planning process.

Use the Stress Test (Fire Drill) in Conversations

TO PERCEIVE THE PROBLEMS OF FAILING TO PROVIDE A PLAN:

- State the event (for example, John dies tonight).
- From the incidence of the event list all things that affect the business as a result of the event (what things would John have done for the business that he now cannot do).
- Image how these things would or would not be accomplished and what the consequences would be (Joe would take over for John, but Joe cannot sign checks).
- Proceed step by step and in a detailed manner to foresee the potential problems.
- The process should be documented in a meaningful way.

Common Issues Requiring Negotiation in Order of Discussion

1. There must be a strict prohibition concerning transfer of ownership except pursuant to the agreement such that the agreement cannot be avoided merely by transferring ownership to a party not bound by the agreement.
2. The business entity type must be defined. This is because the business entity is the platform upon which all control decisions will be based. Control issues will provide fuel for conflict among business owners.
3. The governance of the business must be defined. How is the CEO chosen? Who will be on the Board of Directors.
4. The triggers - events that cause the provisions of the agreement to take effect – must be defined.
5. When a trigger occurs an exact procedure must be described and have required adherence.
6. There provisions for funding the purchase price must be defined.
7. The value of the business interest must be defined in strict and clear terms.

ISSUE: Restrictions on Ownership

- There can be no transfer of ownership outside the provisions of the agreement; otherwise, the agreement could be undermined by a transfer of business interest to a party not bound by the agreement.
- In most states it is unlikely that a complete restriction on ownership transfer that could deny the value of the ownership interest to the owner would be enforceable. Therefore, a process for withdrawal from the business resulting in a transfer of ownership for value should be provided. Often the business is given a right of first opportunity or right of first refusal for any interest to be offered.
- A clear procedure should be specified providing for the admission of a new owner. As a part of that procedure, the new owner should accept and execute the agreement.
- In the situation where a new owner can affect the stability of the business entity, the procedure for admitting a new owner should require execution of appropriate documentation to secure the stability of the business entity.
- It may be appropriate to establish ownership groups to balance interests of family, seniority, and other divergent ownership interests.

ISSUE: Business Entity

- Different entities may be used for different activities within the business. The controlling operating business entity will usually provide the income and capital return to owners. The entity type for this controlling entity will affect tax treatment for the owners and be the basis of control of governance. The characteristics of the entity for income and capital distributions should be stated in the agreement.
- The entity characteristics to be examined are:
 - Will the entity retain value or distribute value?
 - Will ownership be in shares or capital accounts?
 - How will ownership be diluted when new owners are admitted?
- The entity must be a limited liability entity such that the liability for the business operation is not a personal obligation of the owners.
- Certain entities, such as partnerships (change in ownership could cause dissolution), S corporations (inappropriate owner terminates S election), and professional entities (state law prohibits non-licensed owners) could have a status change with an ownership change. Provisions in the agreement should assure the stability of the controlling business entity.

Parity of Interest

Employee motivation to become an owner is greatest when it is apparent that all owners will ultimately have an equal interest.

An employee may be more willing to risk capital to purchase a small initial business interest if the path is clear to an equal interest with other owners.

An employee or nominal owner who sees continuing control by a group not including him or her will be less likely to purchase or increase his or her ownership share.

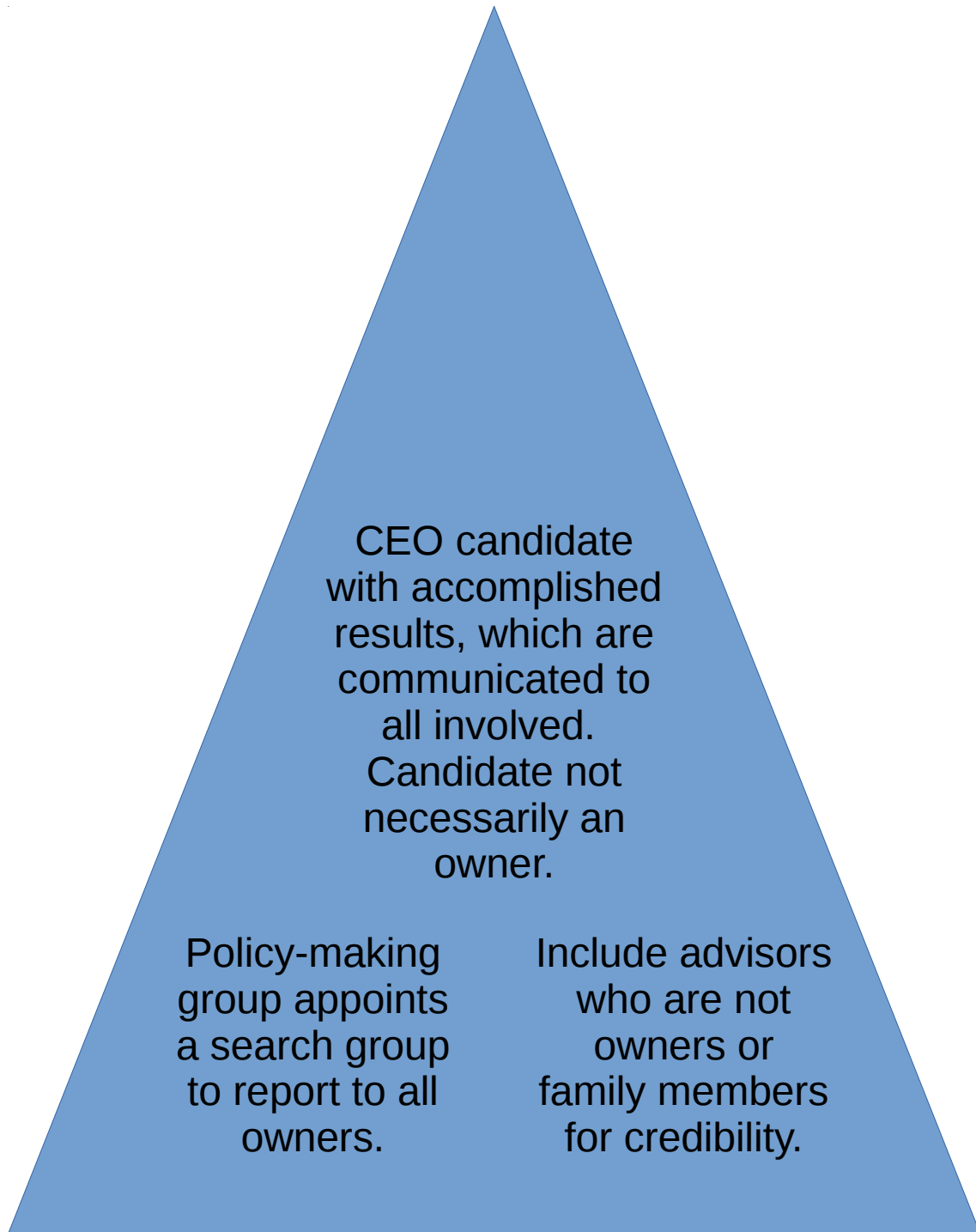
ISSUE: Restraint on Competition

- Most states allow reasonable restraint against owners competing with the business.
- Reasonable restraint generally means providing limitations on the restraint relating to duration and geography. While an overall restraint against an owner competing with the business might not be enforced in most states as a matter of public policy, a restraint against the owner competing against the business within a certain geographical area for a certain period of time would be enforced. The restriction cannot be unduly harsh and oppressive to the owner's ability to earn a living.
- A corollary provision to a restraint on competition is a provision regarding confidentiality. Many businesses have employee confidentiality agreements, but with respect to an owner, there may be additional concerns, especially is if the owner is not an employee.
 - ♦ When may the owner meet with competitors? In addition to antitrust concerns there may be a reasonable requirement of notification to the business of such a meeting.
 - ♦ What internal documents may be made public or shared with competitors? There needs to be a sensible and enforced policy on identifying confidential and protected information.

ISSUE: Governance

- Governance enables the process of decision-making for a group.
- In a business entity, the basic governance structure is provided by the entity type. For example, a corporation will have a president and a board of directors, while a limited liability company will have a manager and ownership shares.
- The stated policy of governance should answer the following questions:
 - ♦ Should there be a separation between ownership and control? The president of a corporation does not have to be an owner of the corporation. The manager of a limited liability company is an owner of the limited liability company.
 - ♦ Is the group to make policy specified and in place? This is the group that should meet on a regular basis to have difficult conversations about the business and formulate planning for the business.
 - ♦ How is the chief executive officer selected? It is important to consider whether it is necessary that the CEO be an owner.
 - ♦ How is the CEO reviewed? Is it important that the same group that selects the CEO also review the performance of the CEO?

CEO Selection Process



ISSUE: Triggers

- The event that causes the provisions of the agreement to take effect is a trigger.
- Trigger events must be precisely described in the agreement.
- Common trigger events are:
 - ♦ *Death* – the easiest to define.
 - ♦ *Disability* – the difficulty will be to determine permanent disability from partial disability.
 - ♦ *Retirement* – the determination will be whether an owner need be active in the business to remain an owner.
 - ♦ *Termination of Employment* – there may be a requirement that the owner be employed by the business (as in a professional corporation).
 - ♦ *Competition* – normally an owner engaged in competition with the business will be removed as an owner.
 - ♦ *Pledges of Ownership Interest* – an owner engaging in a debt transaction may seek to offer an ownership interest as collateral. This transaction should violate the agreement and terminate the ownership interest.
 - ♦ *Divorce* – property disputes in divorce proceedings can be a burden on the normal conduct of the business.
 - ♦ *Tag-along Provisions* – minority owners may be compelled to agree to certain sales transactions.
 - ♦ *Deadlock* – usually defined in terms of a failure of the business to take action.

ISSUE: Procedure After a Trigger

- Death should result in a mandatory procedure to purchase the interest as soon as possible. The terms for payment should provide that to the extent liquidity is available (from life insurance or otherwise), that liquid amount up to the purchase price should be paid as soon as possible.
- Permanent disability may be treated similarly to death, but it may be more acceptable to provide for payment of the purchase price in installments over time.
- In many situations partial disability will not require a purchase, except in those businesses where owners must maintain a presence or employment is required. In most cases an effective and detailed definition of permanent disability will be required.
- Where an employee-owner is terminated, it is usually required that the ownership shares of the employee be purchased but this can be at a reduced price with payments over a long period of time.
- Where an employee withdraws, such as with retirement or otherwise leaving the business, purchase terms can be adjusted to fit the liquidity situation of the business and considering tax consequences to the withdrawing owner.

Types of Agreements

The procedure after the trigger and the funding of the purchase will be affected by the architecture of the agreement. Funds will have to be resident in the entity that needs to make the payment. Insurance payments should be made to the correct entity or individual, and the entity or individual obligated to pay must have access to funding.

Cross Purchase:
owners purchase from one another.

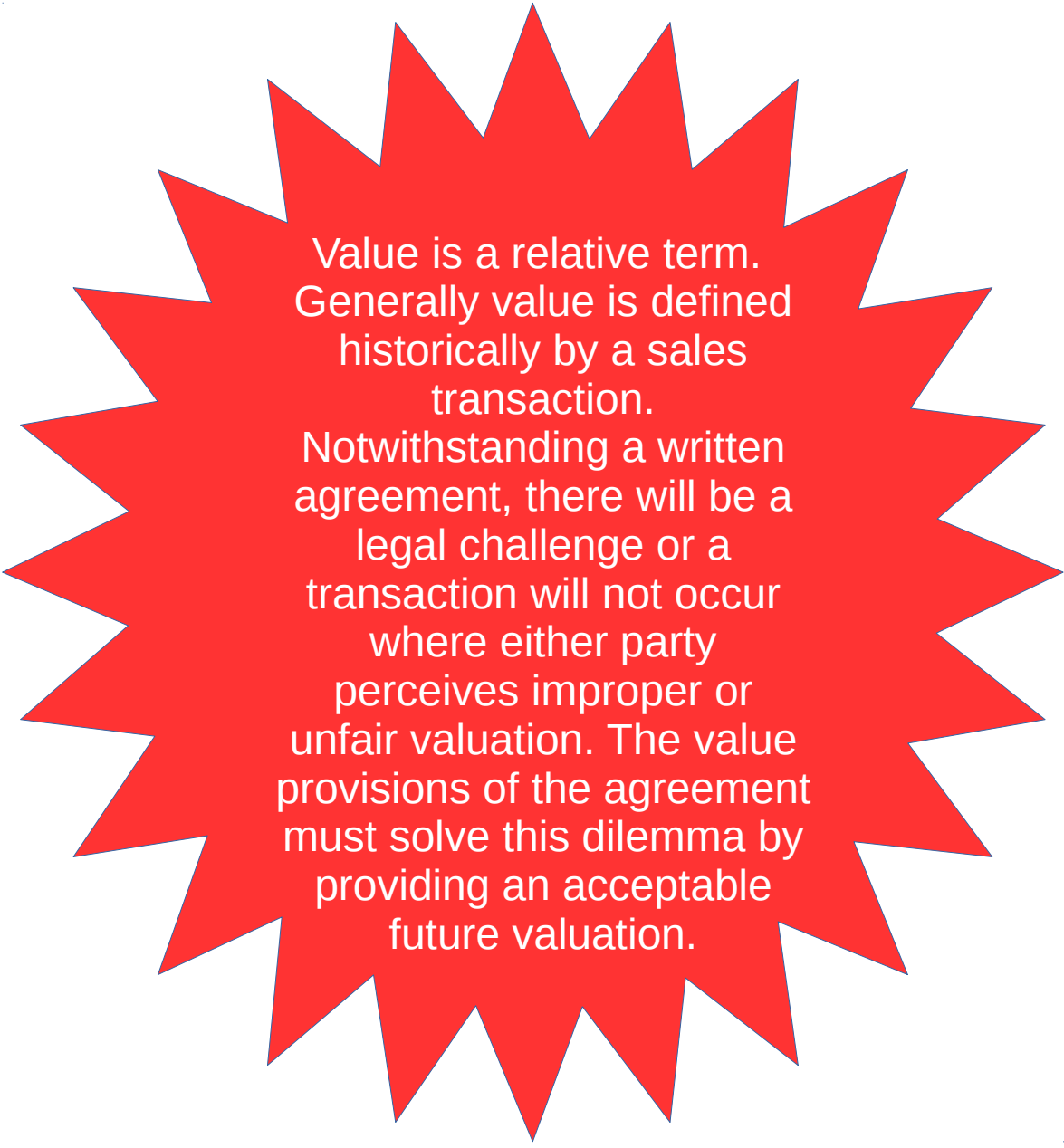
Redemption:
also called entity purchase – the business purchases the ownership interest.

Hybrid:
If the business does not make the purchase, owners will purchase.

ISSUE: Funding

- The typical business owner has a substantial portion of the owner's wealth invested in the business interest and subject to business risk.
- A business interest in a closely-held business is relatively illiquid with the value of the interest unstated.
- The buy-sell agreement may establish the funding, including the purchase of life insurance, for the purchase of the shares of a withdrawing owner.
- To the extent a purchaser cannot pay the total purchase price up front, there should be a provision for installment payments with specified interest accruing on the unpaid balance.
- Especially with a redemption agreement, it can be beneficial to make regular contributions to a reserve to fund buy-sell transactions.

Future Value is Difficult to Specify



Value is a relative term. Generally value is defined historically by a sales transaction.

Notwithstanding a written agreement, there will be a legal challenge or a transaction will not occur where either party perceives improper or unfair valuation. The value provisions of the agreement must solve this dilemma by providing an acceptable future valuation.

ISSUE: Specifying Value for Transactions

- For each type of transaction contemplated under the agreement, there will be a different price for the sale of the business interest.
 - ♦ Where owners sell interests to one another, the value for the transaction between the owners (sometimes called “fair value”) is different than value for a transaction where someone not an owner buys the business (“fair market value”).
 - ♦ Owners leaving a business to compete with the business will not receive a valuation as high as that where the transaction involves an employee’s retirement from the business.
 - ♦ Terms of payment can have a significant effect on the real value received for the interest. Death and permanent disability situations should be paid as quickly as possible. There may be very little motivation to make a significant initial payment or make total payments in a short period of time to an owner leaving the business to compete with the business.
- When the event triggers the agreement, the procedure for determining the price for the purchase of the business interest, if not the actual price, should be clearly established by the agreement.

Value Concepts

Book value is an accounting concept – assets less liabilities equaling “net worth.”

The price and the terms of payment determine the value received by the seller.

The parties to an agreement could agree to a stated price.

An appraiser is instructed on the standard of value, level of value, and point of time.

The parties to an agreement could agree to a formula to determine price.

Value Received

- There is an old saying that reverberates about transactions: “I will give you your price if you give me my terms.” This saying is simply a way of acknowledging the time value of money. One would rather have the lesser price right away in cash than the greater price in small installments over a long time. This generally will be the case even where interest accrues.
- There is always the possibility that the party required to purchase an ownership interest by the terms of the agreement will not have the cash up front to pay the price. The agreement must specify the terms of payment of the price for each trigger.
- The variables for the terms of payment are the amount paid upon the transaction, the amount of installment payments, the interest rate to accrue, and the date when the entire amount is to be paid.
- Many times it will be the source of funding that will determine the terms of payment.
- An agreement not specifying the terms of payment for each trigger transaction will be deficient and allow future conflict.

Book Value

- Book value is an accounting concept and does not provide a set price for a transaction unless that is provided in the agreement.
- Specifically, the accounting concept is that from the balance sheet the stated assets less the liabilities show the net worth of the business.
 - ♦ Assets are stated at a cost amount decreased by depreciation charges. Those depreciation charges do not necessarily reflect actual depreciation costs.
 - ♦ Intangible assets such as franchises, trade secrets, or goodwill are usually carried on the balance sheet at a nominal amount.
 - ♦ The balance sheet does accurately reflect the cash flow status of the business.
 - ♦ Inventory figures can vary widely as to accuracy.
 - ♦ Retained earnings affect net worth but may not properly be a significant part of business valuation.
- While book value is a useful concept, it rarely is appropriate to equate book value with a transaction price.

Appraiser

- The best source for the value of a business is a certified appraiser with experience in the type of business under valuation.
- Accountants for the business are often asked to provide a value for a business. It is difficult for the accountant for the business to provide an objective valuation.
- Without having to make assumptions, an appraiser cannot provide a valuation without being instructed on the standard of value, the level of value, and the date for the valuation.
 - ♦ Standard of value is often stated to be fair market value. There are various valuation standards that contain definitions, and the definition should be in the agreement. Many times the transaction is between owners and fair market value should not be the standard. The term fair value has been used for that situation but its use also demands an accompanying definition (often from a court case).
 - ♦ The level of value has to do with the interest to be sold. Is it a majority interest? Does the interest provide a certain majority percentage? Is it a minority interest? There appropriately will be premiums and discounts assigned to these interests.
 - ♦ The appraiser must know the point of time for the valuation. That is the date as of which available information pertaining to valuation should be considered.

Stated Price

- The agreement can state a price for each trigger transaction.
- This will push valuation issues to the forefront and will eliminate many contentious possibilities in the future.
- To sensibly place stated prices in the agreement, a current valuation needs to be accomplished. This will push valuation issues to the forefront.
- Once the stated prices are in the agreement, there should be a mechanism for valuation review on a periodic basis.
- The agreement should contain provisions for the situation where the stated prices have not been updated as contemplated by the agreement. Usually this is a requirement for a certified appraiser to establish value and set the prices.
- The principal advantage and disadvantage of stating prices in the agreement is that the effectiveness of the agreement will depend on the ability of the business to have a periodic valuation. This can be very good for the business and it can be quite disruptive depending on the changing motivations of the owners.

Formula

- While it is tempting to specify a formula to set the price for a transaction, what seems to produce an excellent result at one time can in the future produce nonsense.
- Often book value is used as the basis for a formula. There factors involved with accounting procedures that can cause the book value number to skew validation results inappropriately.
- Another formula basis is earnings. The earnings term is very problematic with respect to definition. In addition, as business practices change, it is often earnings that are affected.
- While formulas are often easier to negotiate, they cannot be trusted.
- The best practice is to keep the formula out of the agreement and use a stated price. The formula can provide credibility for the stated price, but it will not remove the need for periodic valuation reviews.

Suggested Path Through the Value Thicket

To have a viable buy-sell agreement, the owners will have to find a way to discuss value and set prices for the relevant trigger transactions. This is difficult to accomplish without the help of a certified appraiser.

I recommend having discussions about value and then bringing one appraiser into the discussion. The appraiser develops initial appraisal information which allows setting the transaction prices. This will result in a stated value format for the buy-sell agreement. The appraiser needs to help with instructions to the appraiser to be provided in the agreement if the stated value pricing has not been kept current.

The accountant for the business will be a valuable resource, and should be involved, but the appraiser will be more objective if the appraiser is not affiliated with the accountant.

This process should be repeated each year for at least three years, and thereafter could occur biannually. While this may seem expensive, the cost of subsequent appraisal activity is often quite a bit less than the seminal activity.

Repeating the process of agreeing about value and prices will provide integrity for the expectation that the process will be effective in the future. It does not matter how well the agreement is written if the parties refuse to follow the procedure.

OVERRIDING ISSUE: Conflict Resolution

- Even with careful preparation and frequent reviews, owner agreements, including buy-sell agreements, are often changed by the parties when it comes time to execute the transactions contemplated by the agreement. This is not necessarily a bad thing, unless there is no agreement reached about a way of going forward.
- The predominant maxim: if the provision of the agreement is not perceived by a party to be fair then the party will not comply with the provision of the agreement.
- The worst result will be to become part of the civil litigation process. At the least it will take too long and be very expensive. The agreement needs to have a provision for dispute resolution.
- I recommend arbitration. The mediation process often comes to mind, but mediation is a negotiation technique, and the mediation process has no provision for final resolution of the dispute. An arbitration clause should provide a reasonable time-line by the end of which the dispute is settled without the possibility of further proceedings.

Do These Things to Implement a Buy-Sell Agreement and a Decision-Making Process

Have Difficult Conversations with Business
Associates and Stakeholders

Document the Conversations

Seek Professional Help (Appraiser and
Attorney) as Needed

Draft a Succession Plan

Execute the Plan Including a Buy-Sell
Agreement

Continue to Have Difficult Conversations

Continue to Document the Conversations

Revise the Succession Plan

Execute the Revised Succession Plan


Revise the Buy-Sell Agreement

What Not to Do to Implement a Buy-Sell Agreement

Without creating a plan go to a lawyer and ask the lawyer to draft a buy-sell agreement. If you go to a bad lawyer, he will draft a form buy-sell agreement and send it to you to review. If you execute that document it will likely do you more harm than good. (If you go to a good lawyer, he will tell you that he needs a written succession plan or will have to have some extensive conferences to gather the information to draft a plan.)

Have a series of meeting with other owners, employees and stakeholders only to find that all are in agreement with you. If you are the majority owner in control, you are being told what the people dependent upon you think you want to hear. A plan based on this information will fail.

Take longer than six months to formulate a succession plan. Yes, you should take your time. Yes, you should not force conclusions. But do not go into a paralysis of analysis. Get the plan drafted and start executing it. It does not have to be and will not be perfect. It will need review and revision through a continuing decision-making process.



When you finish this book, wipe the tears from your eyes and resolve as follows:

Have regularly scheduled difficult conversations that you or someone close to you documents.

Create a written succession plan.

Involve the professionals – an appraiser and a lawyer – to obtain an executed agreement.

Carry on with your decision-making process that deals with reality and produces wise decisions.

You have my best wishes.