BUSINESS SUCCESSION PLANNING: WHY BUY-SELL AGREEMENTS ARE ADVANTAGEOUS

There are over 31 million privately-held businesses in the United States and of those, Baby Boomers (born between 1946 and 1964) account for approximately 40% of ownership. Experts estimate that roughly 10,000 Baby Boomers retire each day. Succession is only a matter of time.

This great transfer of wealth not only allows owners to pass along their business and their wealth but also ensures these businesses endure. Many of these businesses are service-based: restaurants, local retail stores, hardware repair, manufacturing, plumbing, auto shops and more. Having buy-sell agreements in place can safeguard the continuity of your business in an orderly manner and protect it from unexpected events.

Why you need an agreement

In simple terms, a buy-sell agreement is a legally enforceable contract among business owners, or in some cases family members, that sets forth the transfer of ownership upon certain defined events. Those events could be retirement, death or divorce, among many others. The agreement outlines a plan for the succession of the business that is contractually defined to avoid ambiguous transitions and the unknown that comes with them.

If you already have a buy-sell agreement in place, then you have taken an important step in ensuring the successful transition of your business upon exit. If you do not have one in place, you should speak with your financial and/or legal counsel and execute one as soon as practical.

Review annually

Even if you have a buy-sell agreement in place, it is recommended that you revisit your agreement on an annual basis. Reviewing annually gives you the ability to refresh yourself on the terms of the agreement and allows you the ability to revise for any life changes that may have occurred over the year. It also allows you the opportunity to review and challenge the valuation provision (the methodology for exactly how the purchase price is to be calculated) which drives the sales price upon a triggering event.

Valuation provisions

The valuation provision may become stale over time. What was considered reasonable and fair a couple of years ago may no longer hold up. Business disruptions may also throw a wrench into that valuation. Making sure you have factored into the provision all those considerations will go a long way in mitigating unwanted disputes.

There are many approaches that can be utilized with respect to the valuation provision in your buy-sell agreements.

Mechanical Formula

Using an agreed to formalistic approach helps alleviate challenges to the value assigned at the triggering event. This leads to less time and money spent negotiating values and fewer challenges to the agreement in place.

Independent Appraiser

This approach is not as cost-effective as the formalistic approach, but it leaves the determination of value to an independent third party, thereby reducing challenges to the assigned value.

Negotiate

You can also utilize having all parties negotiate the buyout price. This approach tends to be more cost-effective and allows for the parties to consider recent events in determining a fair price for the business.

Appraisal

In this more common approach, a valuation is performed by an independent third-party specialist close to the date of the agreed-upon buyout. This option can lead to more accurate results for the value of the business, but it also tends to be the most costly.

Buy-sell agreements may also include provisions for performing a valuation on an annual basis. The assigned value of the sale transaction may revert to the most recently completed valuation or the agreement may define that a new valuation is to be performed at or near the triggering event or transaction date.

Having clear valuation guidelines and premise clearly defined is an important aspect of the agreement. Examples of premise can be the fair market value or investment value and premise of value can be controlling interest or non-controlling interest.

To alleviate concerns of the triggering event being manipulated by the owner (retirement), it may make sense to have the valuation date be an agreed-upon date that reduces manipulation.

Formalistic Approach

Using a formalistic approach can add simplicity and allow for predictability but does come with some risk. Commonly used approaches include book value and EBITDA (or earnings methods) among others.

Book Value Approach

Utilizing a book value approach may result in the undervaluing of the buyout price as the method tends to undervalue companies that have consistent earnings.

Earnings methods may not be a reliable indicator of value at the point in time in which the valuation is performed.

Revisiting your buy-sell agreement on an annual basis and paying specific attention to the determination of the buy-out price will allow you to stay on top of all the changing facts and circumstances of the potential transaction.

Building consensus

Transitioning your business to the next group of owners can be a challenging endeavor for a number of reasons. One of the best steps you can take to ensure a seamless transition is to make the drafting and annual revisiting of the document a group effort. Be sure to include your key stakeholders and outside counsel - including a team of your professional advisors – to help you save time and effort in the long haul.