Don't Do Business Without This Agreement!
The Essential Business Agreement: A Business Continuity Agreement Among Owners

The business continuity agreement can be one of the single most important documents that you, as a co-owner of a closely held business, will sign. The following Acme In-Law hypothetical case study illustrates the importance of a well-crafted buy-sell or business continuity agreement.

George Acme well-appreciated his son-in-law, Tom Gardner. Tom had been with the company for over 20 years, had gradually assumed operational management and was the acting CEO. He had purchased 25 percent of the ownership from George over the years—mostly at a low value in recognition of his valuable services. Eventually, everyone knew that Tom would own the company and carry on the fine traditions of Acme. But that was before George died and Tom's sister-in-law became the executor of the estate. She was happy to sell 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 would she realize that without Tom's cooperation, the business was unlikely to sell—no buyer would want a disgruntled minority co-owner, especially the current CEO. Both owners had issues with value, control and successor ownership—issues best discussed and resolved before a transfer event such as a death or a sale opportunity arises. Had Tom and George acted on a timely basis and created a business continuity agreement, the business would have transferred at a fair price to the benefit of all concerned. Now, it likely wouldn't continue at all.

The business continuity agreement (also called a buy-sell agreement) controls the transfer of ownership in a business when certain events occur. Typically these events include the death of an owner, and a sale and transfer of stock from one owner to another or to an outside party. In addition to controlling these events, you also should consider having the agreement include transfers to take effect upon an owner's permanent and total disability, termination of employment, retirement, bankruptcy, divorce, and a business dispute among the owners.

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. Lastly, it may give the departing owner the option to require the company to buy his or her ownership interest.

The agreement also 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, in addition to other protection, tells you to whom you can sell, at what price and terms, and under what restrictions you can sell your stock.

Advantages of a Buy-Sell Agreement

With buy-sell agreements, disadvantages can be hard to find if the document is well-drafted and is kept updated for changes in ownership, value and other circumstances. With that in mind, we will look at the overall features that owners can experience with buy-sell agreements.

- *Ownership in the business can be transferred only in accordance with the agreement.* This benefits both the owner wishing to transfer stock and the other owner or owners wanting to acquire stock. In the first instance, the buy-sell agreement can assure a selling shareholder, or his/her estate, of a purchaser for fair value and upon terms and conditions that are mutually acceptable. For the remaining owners (such as Tom), the agreement means that any transfers of ownership must be made, or at least offered, to them. This eliminates the threat that an outside party or a co-owner's spouse or children will become owners of the business, thereby diminishing management, control and value.
- *Valuation is set not only for purposes of a sale, but also for estate tax valuation purposes.* Privately owned businesses are notoriously difficult to value. Your idea of your business's value at your death may be much lower than the IRS's. If you haven't created a binding process for valuing the business, the IRS is free to impose its own value determination. Take the initiative by designing a valuation appraisal process in your buy-sell agreement.
- *The terms and conditions of any transfer of stock, including interest rate, length of buyout period and security, can be fixed.* In addition, where possible, the transfer can be funded. The agreement provides 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.

Had Tom and George created an agreement providing for terms such as these, a valuable business would have been transferred to the benefit of all owners, as well as the employees, customers and others having an interest in seeing Acme continue.

As we have discussed above, there can be many advantages to a buy-sell agreement in regard to establishing transfer of ownership, valuation techniques, and terms and conditions.

We now continue the discussion of buy-sell agreements by looking at how these agreements can protect rights among shareholders, provide a means for joint owners to get on the same page in regard to the future of the business, and establish a market for an owner's stock at an agreed-upon price.

Buy-sell agreements establish and protect rights among shareholders that do not otherwise exist in the company.

Through a buy-sell agreement, a minority shareholder may attain more control over his or her destiny than is normally provided through voting rights. These safeguards may include placing limits on the sale or purchase of the stock of the majority owner(s), establishing valuation of all

owners' stock, giving minority owners the right to sell their stock if certain events occur, and other important items.

An example of the type of right that a buy-sell agreement can establish is providing the owner of a minority interest the right to serve on the board of directors. Obviously, this can be an important right because a minority shareholder might not otherwise be able to garner sufficient votes to be elected to the board.

A second example is requiring the corporation and remaining shareholders to do their best to obtain the release of the departing shareholder from any personally guaranteed indebtedness, as well as to release any personal collateral used for a corporate debt when the owner of that collateral sells his or her interest in the company.

Recall Tom Gardner from the hypothetical case study we discussed. As a minority owner, he was unable to buy control of the company and was unable to prevent a new majority owner from exercising total control over the company. A buy-sell agreement could have prevented that.

An intangible benefit lies in the process of designing the buy-sell agreement.

All too often when there are joint owners of a business, they do not sit down together to discuss business issues. In order to draft a buy-sell agreement, a meeting of all owners is essential. In doing so, they address major questions affecting their relationship such as: What happens if one of the owners dies? What happens if the owners don't get along? What happens if one wants to retire before the other? Obtaining answers to these important questions requires owners to discuss their ideas about the future of the business.

For an example of this, let's look at the hypothetical case study of John and Steve, both equal partners in a manufacturing business.

John and Steve had a poor relationship and they were certain each had opposing views on the future of the business in terms of both growth and their respective desires to remain in the business. They each also had their own ideas about their own importance to the business.

During meetings with their advisory team, they soon learned there were many reasons for their company's success. Although one owner was the "money man" and the other was more active in the business, they learned that both were equally concerned with the long-term future of the company. This recognition allowed them and their advisors to draft a complete buy-sell agreement for their mutual benefit.

The process took almost a year. During that time, the owners met periodically with their advisors to review business goals and aspirations. Increasingly, they found themselves in agreement, not just in matters contained in the buy-sell agreement, but also with respect to operational ideas. Those bases of agreement soon broadened into a consensus on how the business should proceed if one of them were no longer with it.

As a result of this process, their business became more vibrant and more directed. The owners became more committed than ever and, not coincidentally, the company's profitability and value increased steadily.

A buy-sell agreement establishes a market for an owner's stock at an agreed-upon price.

Without an agreement, there's no market for stock in a closely held business, even if you're a controlling owner. Your ability to sell your interest will be limited unless you can require your co-owner to also sell—most buyers want to own 100 percent of a company and don't want the potential "excess baggage" of a co-owner not of their choosing. Otherwise, if you have not made firm arrangements for the sale of your stock, the buy-sell agreement is the only means of disposing of your ownership interest at a fair price. The agreement can obligate the other owners to purchase your stock, thus creating a market if you must sell your stock due to unforeseen events such as death or disability.

As is evident in the discussion above, there are many advantages to a buy-sell agreement.

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