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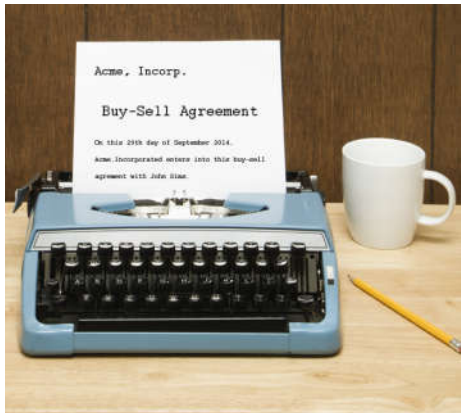
Creating Value. We Know How.

The Advantages of a Well-Conceived Buy-Sell Agreement

In the previous issue of this newsletter, we made a strong case for creating a buy-sell agreement for co-owned businesses. To summarize, if owners agree in advance of any transfer event about how to appraise business value, and about the terms of payment, they can avoid the heated and often damaging negotiations that can occur when one owner leaves the company.



In this issue, we continue making our case by outlining several other advantages of a (well-drafted and recently-reviewed) buy-sell agreement.

Controls Transfers

A buy-sell agreement can control all transfers of business ownership to the benefit of both the owner wishing to transfer ownership and the other owner (or owners) wanting to acquire ownership. This agreement can assure a selling owner (or his/her estate) of a purchase for fair value and upon terms and conditions that are acceptable to all parties. Further, the agreement assures remaining owners that any transfers of ownership must be at least offered to them. This eliminates the potential for an outside party or a co-owner's spouse or children to assume ownership of the business, thereby diminishing management, control, and value.

A Valuation for All Reasons

A buy-sell agreement sets forth an agreed-upon method of valuing the business that applies to all transfers.

Your idea of your business's value may be much lower than that of the IRS or a co-owner. If you rely on a “stated value” or on a formula-based value, you may run into difficulties with both the IRS and with other owners because value in privately owned businesses changes often and rapidly. If your buy-sell agreement is not revised every year, its valuation formula will favor either the buyer or the seller and provide ample opportunity for disputes. Avoid this by requiring a value determination by a certified business appraiser—even that provision needs to be carefully drafted.

Similarly, if you are buying a living co-owner’s interest, the value of his/her interest will likely be lower in your opinion than his/hers. If, however, your buy-sell agreement requires the involvement of a business appraiser, you can avoid this impasse.

It is best to agree—today—upon a method of valuing the business when no owner knows on which side of the transfer table he/she will be sitting. Not knowing whether one will be a buyer or a seller tends to ensure that all owners work to protect the interests of both buyer and seller.

If you don’t have an existing, binding process for valuing the business, ideally using a credentialed business appraiser, you can expect disagreements when one of the owners leaves the business. We strongly recommend that you take the reins and design a valuation appraisal process suitable for your company.

The Fine Print

In a buy-sell agreement, you can fix the terms and conditions of any transfer of ownership, including interest rate, length of buyout period and security. In addition, it is often possible to provide for the funding for future ownership acquisition at either lifetime or death.

Finally, Saving Income Taxes

Buy-sell agreements should be drafted to anticipate the likeliest transfer of ownership event: the sale of an ownership interest from one owner to another. While it requires additional planning and document drafting, intra-owner sales can be designed to save as much as 30% of the company's cash flow from taxation. For example, if the purchase price is $1 million, the cash flow required to pay a departing owner could be reduced by $300,000 or more. To repeat, this does take additional tax planning—but the result is well worth it.

For more information or to learn how L. Harris Partners can help you plan your exit:

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