ONYX PARTNERS GROUP

IS YOUR BUSINESS READY FOR TRANSITIONS?

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In addition to managing day-to-day operations, partners in closely held businesses must also pay attention to the bigger picture, especially the long-term health and stability of the business. If you are a closely held business with one or more partners, one of the things that you should have on your mind is some type of agreement covering an unexpected change of circumstances with one of the partners. Imagine a partner could walking into the office one day and announcing that he or she:

- Has decided to retire;
- Is going through a divorce;
- Has a medical problem and must go on leave;
- Has personal financial trouble and must sell a portion of their share of the business or file for bankruptcy.

There are other scenarios that could disrupt the flow of business. Maybe the partners are just unable to get along anymore. Sometimes, a partner passes away unexpectedly. Any one of these events can have a devastating impact on a closely held business. It makes sense for a business to prepare itself in advance, with an agreement that spells out contingency plans for such eventualities. Without such an agreement in place, be prepared to break open the safe because you might be in for a long, costly legal battle before you come to a resolution.

The best way to avoid this kind confusion and interruption to business is for the partners to work out a Buy-Sell Agreement, a legally binding agreement between co-owners of a closely held business that governs the situation if a co-owner or shareholder chooses, or is forced to, leave the business. A properly constructed Buy-Sell Agreement will address the following important items:

1. What events trigger the buyout? Death, disability, retirement?
2. How will the buyout be funded? Insurance, financing or other means?
3. How soon will the buyout occur? 30 days, 90 days?
4. How is the interest to be valued? Fixed value, formula, outside valuation?

By establishing, ahead of time, the procedures that such an event would trigger, Buy-Sell Agreement can ease the tension and anxiety caused by a change of ownership interest, and allows for continuity of the business. The Agreement can accomplish the following:

1. Allow for a smooth transition while continuing the operation of the business
2. Provide a mechanism with which the owner can liquidate the ownership interest in the event of death, disability, termination, divorce or retirement.
3. Reduce the uncertainty of non-controlling shareholders
4. Prevent the sale or transfer of the ownership interest to any party not acceptable to the other owners.

5. Provide a benchmark for valuation of the entire business or partial interest for sale, or collateralization purposes.

Once the decision has been made to draw up a Buy-Sell Agreement, the partners can choose from a variety of options, including:

1. *Repurchasing agreement*: The partner of the business may buy the interest from the transferring partner or from the deceased partner's estate.
2. *Cross-purchase agreement*: Covers a situation in which multiple parties are interested in purchasing the interest from the transferring partner of the business.
3. *Hybrid agreement*: Grants the issuing partner first option to buy the interest, and the other partner or partners the second option to buy the interest.
4. *Tag-along Right*. This agreement is structured so the controlling owner sells on the same terms as the non-controlling interest partners.

Valuation Provisions

The provisions of the Agreement should serve the objectives of the selling party as well as the buying party. The buyer seeks to continue operations of the business as smoothly as possible without interruptions. The seller is more likely to be concerned about liquidity in the event of departing from the business. To best meet the needs of both parties, the first step in the process, and one of the most important, is to determine the value of the business. Most Buy-Sell Agreements call for a valuation of the business, or of the ownership interest in question, at the time of the triggering event. Since there are many different ways to value a business, all of which can arrive at different numbers, it is important that the Buy-Sell Agreement specify the method to be used. Some agreements call for the partners to agree on the value of the business at the beginning of each year. Others rely on a predetermined or prescribed formula, or require that an independent valuation be performed periodically.

Once the purpose of the valuation is established, the next step is to establish the standard of value. In the US, the most widely recognized and accepted standard of value is termed Fair Market Value (FMV). The IRS has defined FMV in Revenue Ruling 59-60 as follows:

> *The price at which the property would change hands between a willing buyer and a willing seller, when the former is not under compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.*

For the valuing interest, the non-controlling interest is valued at a proportionate share of the business value with no discount. There are two types of discounts that will not be applicable in a Buy-Sell Agreement:

> DLOC – Discount for lack of control: Wherein an amount or a percentage of the of the overall value of the business is deducted due to absence of full control.

DLOM – Discount for lack of marketability: Wherein an amount or percentage will be deducted from the value of the business to reflect absence of marketability.

The provision for the valuation could be the most critical part of the Buy-Sell Agreement. This valuation should be conducted by a professional independent valuator who understands not only your business, but also the purpose and nature of Buy-Sell Agreements. These agreements often can become very ambiguous therefore should be reviewed on a regular schedule for business planning.

A Binding, but Fluid, Agreement

Make sure to acknowledge that businesses, and business relationships, grow and evolve over time, so even after you have an Agreement in place, you remember to revisit it periodically, and make any adjustments necessary to stay current with any changes in business.

Seek the help of financial, legal, and management professionals when preparing your Buy-Sell Agreement, to ensure that it covers as many variables as possible while still meeting the needs of both buyers and sellers. Your Buy Sell Agreement is a legal document that must stand on its own merits. It must be fair, and clear, especially with the regard to the all-important valuation of the business. It's the surest way to protect the interest of all the partners and all their heirs.

For more information on how to structure a Buy Sell Agreement or have a consultation for your company, contact Onyx Partners Group for guidance and professional advice.