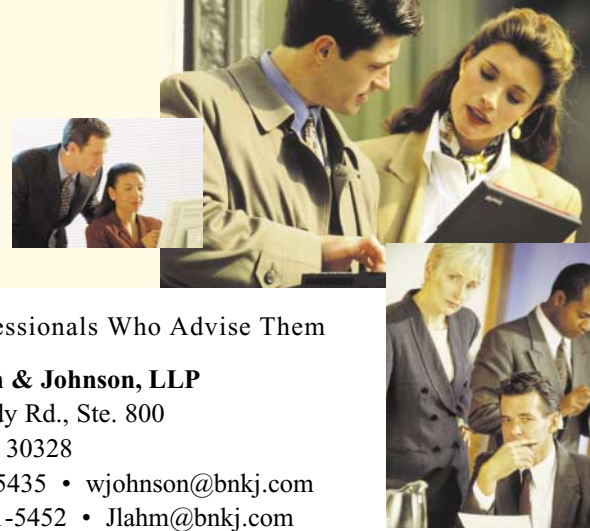


# BUILDING VALUE

## SUCCESS THROUGH COLLABORATION

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**Babush, Neiman, Kornman & Johnson, LLP**

5909 Peachtree Dunwoody Rd., Ste. 800

Atlanta, Georgia 30328

Bill Johnson, CPA/ABV • (770) 261-5435 • wjohnson@bnkj.com

James Lahm, CPA/ABV • (770) 261-5452 • Jlahm@bnkj.com

## TOP 10 TIPS FOR BUY-SELL AGREEMENTS

A properly crafted buy-sell agreement is a critical piece of the puzzle for many closely held businesses. Although each aspect is important in the context of getting the right result, this top 10 list is not necessarily ranked in order of importance; rather, this list should be used as a tool to help optimize the value and viability of the enterprise over time. Ask your FCG representative for more information on how to go about structuring a buy-sell agreement to protect the value associated with your business.

**1. Select the Form of the Buy-Sell Agreement.** Selection of the wrong terms and provisions can create unintended and unwanted results. Before implementing the agreement, test various scenarios that can cause the triggering events under the agreement to ensure the parties' real desires are not thwarted by unintended or unanticipated consequences. The buy-sell agreement is a complex legal document requiring an investment of time and resources to develop the proper model to fit a particular situation.

**2. Coordinate the Buy-Sell Agreement With Other Operating Requirements.** It is important to review all related agreements and documentation, including articles of incorporation/organization, employment agreements, loan covenants, and other significant contracts, to determine how the buy-sell agreement will interact with all other agreements and governing policies.

**3. Select the Triggering Events of the Buy-Sell Agreement.** If the agreement doesn't cover a particular event, the owner or the entity may have no rights to take action in such a situation. Consider the applicability of triggering events beyond death and disability, and be sure appropriate provisions are included to address such circumstances. For example, what if one owner loses a professional license or starts a competitive business?

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**4. Consider the Intended Rights and Obligations Following the Occurrence of a Triggering Event.** The consequences of a triggering event can run the gamut – from no action at all to mere notice to mandatory liquidation – and all points in between. Fully analyze the responsibilities of all parties to the agreement under each triggering event, including each member of the remaining ownership group, to make sure that these rights and obligations are understood and operate as intended. A properly structured arbitration clause also should be considered as an important element of the agreement.

**5. Coordinate the Agreement With Related Properties.** Sometimes the business depends on related properties not owned by the business. Related property can include life insurance policies on the life of the selling owner, interests in real estate and other business property (such as a leasehold upon which the business operates), patent and trademark rights, equipment leases, and other contractual rights. It is important to analyze the subject company to see if it relies on the property owned by others, as well as the terms and impacts of such arrangements on what the buy-sell intends to accomplish.

**6. Address the Valuation Issues.** A buy-sell arrangement focuses on the future value of an ownership interest. This orientation often causes business owners to struggle with the mechanics of how best to quantify the value of a business interest in the event of a triggering event. Be sure to fully define the standard of value that will be used to resolve any valuation related questions. If a formula is used, understand the formula's basis, test the various scenarios, and try to develop reasonable backup procedures for resolving disputes. If an appraiser will be involved, make sure the process for identifying and selecting a qualified appraiser is properly outlined within the agreement. Identify the terms of who is responsible for the costs of using such outside resources.

**7. Design Funding Requirements That Can be Met.** While they are putting together a buy-sell agreement, the parties

must consider funding sources that will function properly when called upon. An unfunded buy-sell agreement may be a bigger problem than no agreement at all if it does not fulfill the intended purpose. Be sure the parties to the agreement identify funding sources and that those sources, such as life insurance benefits, are properly aligned with the people who will be entitled/obligated to purchase. An additional, often overlooked aspect of a properly structured buy-sell arrangement is to fully comprehend the income tax impacts under each triggering event to ensure all parties are fully knowledgeable of the resulting tax treatment of each action. This includes ordinary versus capital gain choices and payments that are considered additions to tax basis or amortizable over extended periods, as opposed to being current tax deductions.

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**8. Consider the Need for Financing Terms.** It is not uncommon for buy-sell agreements to contain provisions that allow for extended financing terms for the payments of any calculated purchase price that exceeds funding available from life and disability insurance sources, or other identifiable benefit streams. When structuring the agreement, it is critical to evaluate the size of the potential commitment relative to the resources projected to be

available under each of the alternative scenarios that can occur. For example, what if a second owner leaves within a short period *after* a payout plan has been established for the first departing owner? Often the buy-sell can contain language that effectively limits the total funding that the enterprise will be obligated to provide for the combined funding of such payouts to protect the economic viability of the enterprise, such as a set percentage of gross revenues. In this situation, the result is an extended term of payments to the departing individuals, where they still receive the same amounts – but over a longer term.

**9. Put it All Together.** Many, if not all, of the preceding points are interrelated. For example, selection of a triggering event must be carefully coordinated with the rights and obligations that are triggered by that event. Those rights and obligations must, in turn, be carefully coordinated with the terms of installment payout for any purchased interest. Don't neglect to look over the document as a whole and mesh it with the owners' objectives and circumstances.

**10. Avoid the One-Size-Fits-All Approach.** The needs and objectives of ownership can differ substantially from business to business, and even between owners within the same enterprise. A properly drafted buy-sell must be able to take into account the key nuances and unique circumstances for each situation. The agreement also needs to be flexible and able to adapt over time as the business evolves and ownership changes. The agreement and particularly the triggering events should be revisited regularly to ensure it is still valid for its intended purpose, and enforceable for the evolving circumstances of the enterprise and its ownership group. Examples of when this might occur would be whenever the ownership composition changes or there is a significant change in the direction or scope of the business itself.

FCG specialists are uniquely qualified to assist business owners and their legal

counsel to implement a properly designed buy-sell agreement. Consultation with a qualified business appraiser when considering buy-sell issues helps resolve unanticipated problems upon a triggering event. Consultation also can be very helpful in identifying and focusing on the value drivers of the enterprise at the front end so that ownership can direct their on-going attention to enhancing the overall value to which the buy-sell itself provides access to.

— Ron Seigneur, CPA/ABV, CVA, MBA

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wjohnson@bnkj.com or  
Jlahm@bnkj.com