

# Business succession planning, Part II: Buy-sell agreements

Last year I provided an overview of business succession planning. (See the article dated April 25, 2008, at [www.lacykatzen.com](http://www.lacykatzen.com)).

This article focuses on agreements among the owners of the business, including shareholders' agreements for a corporation, operating agreements for a limited liability company, and partnership agreements for a limited or general partnership. For ease of reference, the business will be "the company" and the agreement, regardless of its format, "the buy-sell agreement."

## Professional Opinion



**Karen Schaefer**  
Lacy Katzen LLP

Buy-sell agreements are difficult to create. Not only are there many disciplines involved, but the business owner and his or her advisers all need to address the issues at the same time. This can be a challenge, as the owner may not be motivated to take the time and lawyers or accountants may not be motivated to think through the issues, especially if they don't have the experience and expertise. Often a boiler-plate document pulled off the computer can do more harm than good.

Let's look at what the agreement is trying to accomplish. The business owner seeks to restrict the transfer of ownership interests by other owners so that he or she does not end up as a partner with a spouse, a child who

may or may not be working in the business, or another partner not of his or her choosing. Even a transfer from one owner to another could upset the balance of power.

On the other hand, the business owners may wish to permit transfers of, say, non-voting stock to children or trusts for a spouse or children for estate planning purposes. For tax planning purposes and because most state law does not permit a complete prohibition on transferability of interests, a buy-sell agreement should include a right of first refusal so that a business owner may transfer interests if the company and remaining owners do not exercise the option to purchase.

A properly drafted restriction on the transfer of interests with an exception for permitted transfers and a right of first refusal makes clear that the identified successor will have the opportunity to control the business, alone or with the other owners.

Note that the buy-sell agreement normally governs ownership of interests in the company and not a sale of the business assets. Controlling owners can sell the business assets without the consent of the minority successors, defeating the purpose of the buy-sell agreement. The minority owner in this situation will want either a right of first refusal for purchase of the business assets or "tag along" rights. Tag along rights assure the minority owner that if controlling owners sell their interests, the minority owner will share on a proportional basis. The buy-sell agreement can also include "drag along" rights to assure controlling owners that minority owners

will be required to sell their interests.

Another objective of the business owner that is accomplished through a buy-sell agreement is to provide a market for his or her business interest at retirement, death or some other triggering event. The identified successor or remaining owners also seek to establish trigger events. For instance, they wish to ensure that upon the death of another owner, they will have control of the business. They may wish to establish a fixed retirement date. If ownership is tied to continued employment in the business, then termination of employment by a business owner should be a key triggering event.

Once all the trigger events are identified, the issue will be whether the company or remaining owners will have an option or an obligation to purchase the interest. In addition, the business owner whose interest is at stake could have a "put," an option to require the company or the remaining owners to buy that interest.

There is no substitute for thinking through various scenarios. For instance, if one of two equal owners dies, a mandatory buyout funded by life insurance will ease the transition. On the other hand, if the owner who dies is a part of the senior generation in the process of gifting ownership to children in the business, and if a buyout is not required to provide support for the spouse or to equalize inheritance for non-business-owner children, then the younger generation should have an option, not an obligation, to buy the interest.

Another objective of the buy-sell

agreement is to establish a favorable price for the business interest, which may not be marketable for fair value after the death, disability or retirement of the key business owner. Establishing an appropriate value is critical when peer owners are relying on obtaining a fair price. The successor owner also seeks to fix the purchase price methodology, payment terms and source of financing to ensure feasibility of the purchase.

The purchase price can be established by agreement (updated periodically), formula or professional appraisal. The parties also

should determine whether the price will be based on a fractional share of full business value or the value of the fractional interest itself. The latter could involve significant discounts for minority interests and lack of marketability. Also important is whether the price will be discounted for events such as voluntary termination of employment prior to retirement. The agreement should outline the terms of payment (installments or cash), whether there will be collateral and whether the installment obligation will be subordinate to any debt to the company's primary lender.

A buy-sell agreement that is thought through well and developed in conjunction with the business succession plan and the estate planning for the owners will ensure that the owners and the business itself are protected, accomplishing their objectives and avoiding costly litigation. ■



Karen Schaefer is a partner at Lacy Katzen LLP who concentrates her practice in business and estate planning law. She can be reached at [kschaefer@lacykatzen.com](mailto:kschaefer@lacykatzen.com) or 324-5718.