The Case for Buy-Sell Agreements Between Family Owners

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Of all of the potential threats to the success of a family-owned business, one of the most destabilizing can come from inside the family—when an individual owner or a faction of owners attempts to sell their ownership stake to an outside party. While this is a rare occurrence, when it happens, it can bring distress to the system, such as steep financial consequences, embarrassment to the family and company, and injury to family relationships. Just knowing that it *could happen* is enough to unsettle a business family.

Family owners may look outside the family for a buyer of their shares for any number of reasons. Their motivations can range from the noble to the nefarious. They may want to donate their shares to a non-profit organization to finance a charity. They may have a personal need for liquidity. They may have an incomplete estate plan, or no estate plan at all. They may want to derail the current direction of the business or obstruct an upcoming board decision. Or, they may desire to sabotage the company or family by inviting a competitor to buy the family business, in whole or in part. We have seen all of these situations take place, and a range of others.

Regardless of the motivation, shareholders can legally and successfully sell or transfer their shares to an owner outside of the family, without repercussion, in the absence of a legal agreement that restricts this. This preventative agreement is called a *shareholder agreement*.

A shareholder agreement is a legally-enforceable contract that all—yes, all—family business owners ought to have in place. It is an instrument that resolves multiple concerns, protects against future potential problems, and can be customized to each family's particular situation. Consider it a good insurance policy.

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A shareholder agreement is a legal compact between owners containing a set of rules that:

- Protects the family's control of the business' equity by governing the sale, transfer, and succession of ownership
- Prevents stalemates by determining decision-making criteria and processes among owners
- Offers liquidity options, including an agreed-upon method for valuing shares upon a sale
- Determines a course of action under exceptional circumstances such as the death, incapacity, or misbehavior of an owner.

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Despite the powerful benefits of a shareholder agreement, business families too often overlook them and unknowingly put their company in jeopardy by not having one in place. Family business owners without a shareholder agreement will benefit from the overview provided in this article. But those family business owners who already have some form of a shareholder agreement in place are not exempt from examining this need. Much like any other business contract, one-size does not fit all or last forever. These families would be wise to review their current agreement periodically to ensure it is up-to-date and still fits their evolving goals. Especially as families approach a generational transition, the next generation ought to evaluate their shareholder agreement and consider whether the terms fit their reality, rather than inheriting those of the previous generation that may not reflect their worldview.

THE BUY-SELL AGREEMENT

One of the most important aspects of a shareholder agreement governs the succession of ownership. This section, called a *buy-sell agreement*, is the focus of this article.

A buy-sell agreement is a contract entered into by the owners of a family business to define the owners' rights and obligations upon the occurrence of certain "triggering" events. These events could be any number of life scenarios that would cause the owners to want to have pre-determined, legally enforceable ways to deal with the situation. They may be relationship events such as a marriage or divorce; unpredictable life events such as the incapacity or misconduct of an owner; or departing events such as retirement or death.

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Through the agreement, the owners agree to restrict their right to freely sell or transfer their equity interest in favor of providing an orderly and predictable transition of the business' ownership.

An effective buy-sell agreement answers the following questions:

- Who has the right to own a stake in the family business?
- What events will trigger the obligation to buy or to sell a stake in the family business?
- What will be the process for valuing the shares?
- What will be the purchase price of the shares and the terms of the transaction?
- How will the transaction be funded?

FIVE REASONS WHY YOU NEED A BUY-SELL AGREEMENT

There are compelling reasons to have a shareholder agreement, not the least of which is its contribution to the long-term survival of the company. One of the inherent competitive advantages of family-owned businesses is their stable ownership. Markets and management teams favor long-term stability for a company which can be achieved through long-term capital, long-term assets, ownership decisiveness, and committed, long-term owners. A shareholder agreement helps to safeguard a family's most significant asset, allowing its ownership base to remain stable, decisive, and in the family's control.

For those family business owners who have not yet included a buy-sell agreement in their planning, here are five reasons to consider doing so in the near future:

1. ***To ensure the continuity of family ownership***
   For owners who wish to maintain family ownership control and pass the business to the next generation, the agreement can assure that only lineal descendants can inherit, purchase, or ever own shares in the company. This agreement can preempt marital law, prenuptial agreements, or estate laws, ensuring that the family retains control of the business.

2. ***To create a market for the sale of shares***
   Most privately-owned family businesses lack an open market to buy and sell shares, causing their ownership interests to be highly illiquid. An effective buy-sell agreement creates an internal market that allows a family owner to enter or leave ownership, and describes the conditions and terms for owners to divest themselves of some or all of their shares. This is done while keeping ownership exchanges and control within the family.

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3. ***To define the conditions that would "trigger" the sale and purchase of shares***

   Effective buy-sell agreements define a comprehensive set of conditions that, if present, will trigger an obligatory purchase, sale, or transfer of ownership between parties. Like most estate planning issues, these triggering events are not pleasant to consider (e.g., death, disability, divorce, or misconduct), but families must evaluate the potential implications of these events in advance, rather than once they have occurred.

> A buy-sell agreement can assure that *only* lineal descendants can inherit, purchase, or ever own shares in the family business.

4. ***To generate a process for the valuation of the shares***

   One of the important functions of a buy-sell agreement is to lay out the process by which the shares will be valued at the time of a sale. There are different valuation methods that can be utilized in the agreement, including:

   - Fixed-price agreements, which set the future purchase price at a specific dollar amount
   - Formula agreements, which provide a specific formula for determining the purchase price at the time of the transaction
   - Valuation process agreements, which provide an outline of the valuation process that will take place in the future (e.g., how many appraisers to use, how to select the appraiser(s), and the timing of the appraisal)[1].

Each of these methods has advantages and disadvantages to explore before selecting a valuation method.

5. ***To establish a funding mechanism to facilitate the transaction***

   Ultimately, if at the time of the transaction, the obligated buyer (either the business or other shareholders) is unable to pay the purchase price, the buy-sell agreement has failed its primary objective to ensure an orderly transition of ownership. In such a case, specifying the source of funding for the purchase is among the most critical, yet overlooked sections of a buy-sell agreement. Numerous funding mechanisms exist, which include life insurance policies, an installment sale, liquidating accumulated corporate assets, or borrowing external funds. Determining which option, or combination of options, will best serve a family's needs depends upon their goals and unique financial situations.

[1] Mercer, Christopher. "Buy-sell agreements for Closely Held and Family Business Owners." Peabody Publishing, 2010. Pages 71-73.

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SITUATIONS WHERE BUY-SELL AGREEMENTS HELP

Below are examples of common situations that family business owners face which may result in ownership challenges that an effective buy-sell agreement can alleviate. While this list is by no means exhaustive, it demonstrates the diversity of issues that can be addressed by such an instrument to protect families and companies.

Estate Planning Situations

- ***Valuation of Shares for Estate and Gift Tax Purposes***

  Upon the death of an owner, the valuation process outlined in a buy-sell agreement can establish the value of the deceased owner's shares for gift and estate tax purposes. In the United States, for example, the IRS tends to examine valuations in transactions between relatives with far greater scrutiny. The IRS often turns to the valuation provisions within a buy-sell agreement to determine whether the prescribed value of the decedent's shares approximate the fair market value[2]. Accordingly, families and their attorneys should make sure to involve qualified appraisers in the drafting of the buy-sell agreements to avoid potentially catastrophic tax consequences.

- ***Providing Liquidity when Estate Taxes are Due***

  The family business often represents a highly illiquid asset that may comprise a majority of the owner's net worth. Consequently, for many owners and heirs, paying the associated gift and estate taxes can seem like a crippling prospect. For those owners who have not engaged in adequate tax planning, their fears may be recognized, forcing them to liquidate the business to cover the tax exposure. The solution is to integrate the preparation of a buy-sell agreement into the owners' estate planning process. By doing so, families and their attorneys coordinate these effective techniques which help to minimize the future estate tax burden while simultaneously establishing a funding mechanism to help cover any remaining taxes due.

Personal Situations

- ***Divorce***

  All buy-sell agreements should include a provision that enables other shareholders or the family business to purchase shares from an owner who is going through a divorce. The absence of such a provision could result in shares being awarded to the non-owner spouse through a property settlement decree, causing some control over the company to rest in the hands of a potentially unfriendly ex-spouse.

[2] "Planning for the Transition of a Real Estate Business: A Primer on Buy-sell agreements" by J. Robert Turnipseed, Esq., and Shelby L. Wilson, Esq. Tax Management Real Estate Journal V. 31, 8, p. 233, 2015.

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This is especially important in the U.S. in community property states, where an ownership interest in a business is likely to be classified as belonging jointly to the married couple, entitling each spouse to an equal stake in the ownership interest. An effective buy-sell agreement can preempt the divorce proceedings and prevent an ex-spouse from receiving voting rights over the business.

- ***Bankruptcy/Creditor Protection***

  What happens if a shareholder is embroiled in a bankruptcy proceeding? Can his/her creditors or the bankruptcy trustee end up as an owner of the company? Unfortunately, without a proper buy-sell agreement, they actually could.

  In order to prevent the family business from being embroiled in the personal bankruptcy proceedings of an owner, make sure to include a provision in the buy-sell agreement that requires owners to notify their fellow owners before filing for bankruptcy. The remaining owners or company will then have the opportunity to purchase the bankrupt owner's shares at the already-agreed upon price. Ownership and control of the business will remain protected from creditors and the funds received from the purchase should satisfy the bankruptcy trustee's interest in the company.

Governance Situations

- ***Captive Minority/Non-Voting Owners***

  Due to the lack of marketability of a private company's shares, it is possible for shareholders who disagree with the direction of the company to feel nervous about the future value of their holdings and trapped in their ownership. In publicly-traded family companies, the solution is simple – if a shareholder does not agree with the direction of the company, he or she can sell the shares and move on. However, it is not so easy in a privately-owned family business where a natural market to sell the shares may not exist.

  In situations like this, a buy-sell agreement can serve as a dispute resolution instrument, dictating a process that the shareholders must undergo to try to resolve their differences. One outcome may be the purchase of the dissatisfied shareholder's ownership interest according to the process outlined in the agreement.

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Misconduct Situations

- ***Removing a Detrimental Owner***

  Occasionally, the actions of an owner can be so detrimental to the company that it becomes untenable for the owner to remain connected to the family business. Examples of this level of malfeasance could include engaging in fraudulent business practices, assisting a competitor, or significantly violating the family's deeply-held values. For these scenarios, an effective buy-sell agreement can help to outline the conduct standards expected of owners and dictate the terms of a forced sale by the detrimental owner. This type of forced sale often incorporates a penalty to the valuation of the ownership interest to avoid unjust enrichment by the breaching owner.

BUY-SELL AGREEMENTS AND MULTIGENERATIONAL LONGEVITY

Often times, business families expect that their familial ties and shared heritage will sustain them through difficult moments as owner-partners, and in the best of cases, they will. Having strong family relationships, a shared history, common values and goals, and a number of other ingredients *do contribute* to an effective and strong family ownership team. But both foreseeable and unexpected life events are likely to occur and may create negative implications among owners. Families should not put one of their most sacred and significant assets at risk by neglecting to put the right legal agreements in place to protect it.

A well-drafted buy-sell agreement can go a long way toward ensuring the multigenerational longevity of a family business and can help to protect the family too. Implementing and periodically updating a buy-sell agreement is a wise practice for family business owners, and can provide peace of mind about the future.

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