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Buy-Sell Planning Audit

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Buy-Sell Planning Audit

Introduction

If you own a closely held business with at least one other partner, certain steps can be taken to guard against business disruption if you or the partner unexpectedly dies, becomes disabled, or leaves the business. One of the most important steps is to create a buy-sell agreement.

A buy-sell agreement is a critical component of business succession and exit planning for business owners. This agreement sets the terms, conditions and price at which an owner's business interest can be sold to another owner (or owners) before an unexpected tragedy happens. Properly structured, it also places a value on the business for federal estate tax purposes.

Avoiding turmoil and conflicts

A business owner's unexpected death or disability can lead to turmoil and potential conflicts between the surviving partners and the deceased or disabled owner's family members. Such disorder has the potential of disrupting normal business operations, and can result in instability for employees, customers, creditors, investors and other stakeholders.

One of the worst potential scenarios is when a deceased or disabled owner's spouse becomes an unwilling partner in the business. Without a properly structured buy-sell agreement in place, the spouse could be thrown into this situation — even if he or she knows little about the business and doesn't want to actively participate in running the company.

A buy-sell agreement ensures that your heirs are fairly compensated for your business ownership interest at a predetermined price. Your partners, meanwhile, don't have to worry about your spouse (or other family members) becoming unwilling (and unknowledgeable) co-owners. And your employees will benefit from less workplace stress and disruption than would otherwise be caused if a partner dies or becomes disabled.

Types of buy-sell agreements

In most situations, a buy-sell agreement can be funded by taking on new debt or an installment note, creating a sinking reserve fund, or with a life insurance policy or a disability buyout insurance policy. When death is the primary triggering event, there are two main types of life insurance-funded buy-sell agreements:

- Cross-purchase agreement. Partners buy insurance policies on each other, using the proceeds to purchase a deceased or disabled partner's ownership shares. They receive a step-up in cost basis that may reduce taxes if the business is later sold. This option is usually preferable if there are three or fewer business partners.
- Entity purchase agreement. The business entity buys insurance policies on each partner and uses the proceeds to buy a deceased or disabled owner's shares, which are divided among surviving partners. Partners receive no step-up in cost basis with this type of agreement. This option is usually preferable if there are four or more partners, because it eliminates the need for each partner to have to buy so many insurance policies.

Consider your options for the purchase price (valuation)

Most buy-sell agreements use one (or a combination) of the following approaches to set the price:

- Negotiation between the parties;
- Valuation by one or more independent professional appraisers (either at regular intervals or after a "triggering event," such as the death, disability or departure of an owner); or
- A valuation formula tied to book value, earnings or other factors or company metrics.

To avoid ambiguity, the agreement should spell out the agreed-upon valuation criteria. Is the price based on fair market value, fair value, investment value or some other standard? Is it based on the value of a controlling interest or a minority interest? What valuation date should be used?

Typical alternatives for arriving at the purchase price

Negotiation can be a cost-effective way to arrive at a price that's fair to all concerned — so long as the parties can reach an agreement. If they can't, litigation may be inevitable. One potential solution is to provide for a negotiated price but, if the parties are unable to agree within a certain amount of time, then bring in an independent appraiser.

Independent appraisals near the date of a triggering event generally produce the most accurate results.

A professional appraiser will scrutinize your company, taking into account the special characteristics that distinguish it from other businesses in the industry and drive its value. The disadvantage of this approach, however, is that it can be costly.

To avoid this expense, many companies develop valuation formulas and incorporate them into their buy-sell agreements. Formulas are inexpensive and easy to use, but they involve more risk. Why? Because they become obsolete soon after the buy-sell agreement is signed. Book value, for example, may approximate fair market value at the time a company is established, but it quickly becomes out of date as the company generates earnings and builds goodwill.

Case in point: Two business partners had a buy-sell agreement that set the price at net book value plus $500,000. When one partner died, the surviving partner was able to acquire the deceased partner's interest from his estate for just under $1 million — even though its fair market value had grown to more than $10 million.

Some companies use formulas based on earnings multiples, but they also can be unreliable. A multiple of earnings may approximate a company's value at the time an agreement is signed, but it won't necessarily reflect the company's value over time.

Using the Buy-Sell Planning Audit Tool

Having a poorly drafted buy-sell agreement can be worse than not having one at all. It's a good idea to have your buy-sell agreement reviewed periodically to ensure it continues to reflect the business succession planning goals and objectives of owners and the company's current circumstances.

As a law firm that is exclusively focused on the needs of entrepreneurs (and having helped hundreds of companies with their buy-sell planning), we at WTLG believe that having a poorly drafted buy-sell agreement can be worse than not having one at all. Therefore, it's a good idea to have your buy-sell agreement reviewed periodically to ensure it continues to reflect the business succession planning goals and objectives of shareholders and considers the company's current or changing circumstances.

With this in mind, we encourage you to complete the *Buy-Sell Planning Audit*, which follows this introduction, and leverage its results to have an open and frank conversation with shareholders about your buy-sell planning areas of concern. We estimate that the survey will take about 15-30 minutes to complete.

If you would like to schedule a 90-min complimentary consultation to discuss your Buy-Sell Planning Audit results with us or have us review your existing buy-sell, shareholder's, or operating agreement on a compliemntary basis, please contact us today at (949) 482-3992 or bizexperts@watsontaxlaw.com. We can help.

Next Steps

WTLG is committed to helping business owners achieve their long-term buy-sell planning goals and objectives and to maximizing the value of the business for all stakeholders. If you would like to schedule a 60-min complimentary consultation to discuss your *Buy-Sell Planning Audit* results with us or have us review your existing buy-sell, shareholder's, or operating agreement on a complimentary basis, please contact us today at (888) 597-WTLG or by email at bizexperts@watsontaxlaw.com. If so, you can fax a copy of your *Buy-Sell Planning Audit* results to (888) 517-3960 or email it to us at bizexperts@watsontaxlaw.com. We can help.

We invite you to learn more about Watson Tax Law Group, APC, and our services for entrepreneurs at www.watsontaxlaw.com in the meantime.

Tell us about your company

Please complete the contact information below, if you would like to share your *Buy-Sell Planning Audit* results with us and/or with your advisory team.

Shareholder Information

Your Name

Address

City		State	Zip/Postal Code
Home Phone	Cell Phone	Fax	E-mail

Business Information

Business Name/Title

Address

City		State	Zip/Postal Code
Phone	Fax	E-mail	Website

What does your company do?

Business Type	Tax Form Used
☐ Sole Proprietorship	☐ Schedule C ☐ Schedule F
☐ Partnership ☐ General Partnership ☐ Limited Partnership ☐ Limited Liability Partnership (LLP)	☐ Form1065
☐ Limited Liability Company (LLC)	☐ Form1065 ☐ Form 1120
☐ Corporation ☐ C Corporation ☐ S Corporation ☐ Professional Corporation	☐ Form 1120 C Corporation ☐ Form 1120 S Corporation

If a Corporation, type of stock issued:

☐ Common ☐ Preferred ☐ Voting ☐ Non-Voting ☐ Phantom

If a Corporation, what is the corporate tax bracket?

Do you own any related businesses? ☐ Yes ☐ No

To help us and/or your advisory team assess your buy-sell planning goals and objectives, please indicate how you feel about the following statements.

Buy-Sell Planning Objectives

*We have the following **objectives** for our buy-sell planning:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Keep stock away from undesirable parties	☐	☐	☐	☐	☐
Establish fair mechanism for valuing stock of a departing shareholder	☐	☐	☐	☐	☐
Ensure smooth transitions of control and ownership issues as shareholders enter or depart the ownership group	☐	☐	☐	☐	☐
Ensure a private capital market for shares at appropriate exit points	☐	☐	☐	☐	☐
Ensure expulsion rights of the ownership group	☐	☐	☐	☐	☐
Ensure funding mechanisms and procedures	☐	☐	☐	☐	☐
Establish estate tax valuation	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Type of Buy-Sell Agreements

A buyout triggered by the agreement should be structured in the following way:	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Entity purchase (stock redemption). The company should have the obligation or option to purchase shares upon a triggering event. State whether it should be a mandatory purchase (obligation) or an option: ☐ Mandatory ☐ Optional	☐	☐	☐	☐	☐
Cross purchase. Shareholders should have the obligation or option to purchase shares upon a triggering event. State whether it should be a mandatory purchase (obligation) or an option: ☐ Mandatory ☐ Optional	☐	☐	☐	☐	☐
Wait and see (hybrid) buy-sell with shareholders having the right of first refusal. Shareholders should have the option to purchase shares upon a triggering event, followed by an obligation or option for the company to purchase shares.	☐	☐	☐	☐	☐
Wait and see (hybrid) buy-sell with the company having the right of first refusal. The company have the option to purchase shares upon a triggering event, followed by an obligation or option for shareholders to purchase shares.	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Triggering events

*The agreement should address the following types of **triggering events:***	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Death	☐	☐	☐	☐	☐
Disability	☐	☐	☐	☐	☐
Retirement	☐	☐	☐	☐	☐
Marital dissolution	☐	☐	☐	☐	☐
Termination of employment	☐	☐	☐	☐	☐
Sale to a non-owner (right of first refusal)	☐	☐	☐	☐	☐
Expulsion of an owner	☐	☐	☐	☐	☐
Bankruptcy	☐	☐	☐	☐	☐
Deadlock	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Purchase Price (Valuation)

*Upon a triggering event, the buyout should be **valued** in the follow manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Predetermined price. Our agreement should require that an agreed upon or predetermined fixed price be used for the buyout's purchase price. (Example: Shareholders agree to a value at a board meeting, which would be binding for a specific period of time, such as annually)	☐	☐	☐	☐	☐
Independent appraisal. Our agreement should require that an appraisal from an independent, objective third party appraiser be used to establish the buyout's purchase price. (Example: Objective third party appraisal from someone qualified from the American Society of Appraisers or someone similarly designated)	☐	☐	☐	☐	☐
Purchase price based on a formula. Our agreement should require than a formula be used to establish the buyout's purchase price.	☐	☐	☐	☐	☐
• Describe the formula that you would propose and why: (Example: Book value, adjusted book value or net asset value, liquidation value, capitalization of earnings, capitalization of net cash flow, capitalization of gross cash flow, discounted cash flow, discounted future earnings)	☐	☐	☐	☐	☐
Market approach. Our agreement should require that comparables of recently sold, similally situated companies be used to establish the buyout's purchase price.	☐	☐	☐	☐	☐
Adjustments to the purchase price based on specific triggering events. The purchase price should vary or be adjusted with certain triggering events (i.e., the purchase price for death should differ from, say, the purchase price for marital dissolution or for explusion of an owner).	☐	☐	☐	☐	☐
Minority discounts. Owners with minority interests should receive a non-discounted, pro rata value of their equity interest upon a triggering event.	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Funding *In the event of a triggering event, the buyout should be **funded** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Life insurance. Our agreement should use life insurance to fund the buyout obligation.	☐	☐	☐	☐	☐
• I understand how our life insurance policies should be owned, who our beneficiares should be, as between the company and shareholders, and am confident that the policies are (or would be) structured properly.	☐	☐	☐	☐	☐
Debt. The company should take on new term debt to fund the buyout obligation.	☐	☐	☐	☐	☐
Promissory note. Our agreement should use a promissory note (i.e., seller's note) to fund the buyout obligation.	☐	☐	☐	☐	☐
• I understand what the down payment, interest rate, and term of the promisory note should be and am confident that the note is (or would be) structured properly.	☐	☐	☐	☐	☐
• The promissory note should be secured (i.e., security for departing owner's payments in the event of a default).	☐	☐	☐	☐	☐
Sinking fund. The company should create a sinking fund to fund the buyout obligation.	☐	☐	☐	☐	☐
Employee stock ownership plan (ESOP). I am interested in learning about how an ESOP could be used to implement a tax-deferred sale of an owner's stock in the event of a triggering event.	☐	☐	☐	☐	☐
Sale or distribution of company assets. The company should sell off or distribute assets to fund the buyout obligation.	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Transfers of Ownership Interests *The buy-sell should address **transfers of ownership interests** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Blanket prohibition against all transfers. All transfers of ownership interests should be prohibited, unless approved by the other owners.	☐	☐	☐	☐	☐
Owner's family or revocable living trust as permitted transferee. The agreement should provide for transfers to an owner's family or revocable living trust, without any other owner approval required, provided the trust is subject to the terms and restrictions of the agreement.	☐	☐	☐	☐	☐

Other Restrictions and Rights

*The buy-sell should address other **restrictions and rights** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Issuing new equity. Our agreement should restrict issuing new equity.	☐	☐	☐	☐	☐
Preemptive rights. Our agreement should give owners preemptive rights when issuing new equity.	☐	☐	☐	☐	☐
Drag-along rights. Our agreement should provide drag-along rights to facilitate a sale of the entire business to a third party buyer.	☐	☐	☐	☐	☐
Tag-along rights. Our agreement should provide tag-along rights to protect minority owners if the majority owner decides to sell to a third party buyer.	☐	☐	☐	☐	☐

Board of Directors, Shareholder Compensation, and Employment Issues

*The buy-sell should address the **board of directors, shareholder compensation and employment issues** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Board of directors. Our agreement should include a mechanism to help ensure the proper balance and make-up of the board of directors.	☐	☐	☐	☐	☐
Compensation. Our agreement should include provisions relating to shareholder-employee compensation.	☐	☐	☐	☐	☐
Noncompetition. Our agreement should provide for the noncompetition of a covenant not to compete provision for departing owners.	☐	☐	☐	☐	☐
Nondisclosure. Owners should agree to not directly or indirectly disclose confidential information about the company at any time during or after an owner departs the business.	☐	☐	☐	☐	☐
Nonsolicitation. Our agreement should provide for the nonsolicitaion of customers, employees, and/or suppliers in the event of a buyout.	☐	☐	☐	☐	☐
Intellectual property. Our agreement should provide for the protection of the company's intellectual property (i.e., copyrights, trademarks, patents, trade secrets) at any time during or after an owner departs the business.	☐	☐	☐	☐	☐

Key Employees and Managers

*Our buy-sell should address **key employees and managers** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Continuity of management. The company has procedures in place to ensure continuitity of management during a transition.	☐	☐	☐	☐	☐
Equity buyin for employees. Certain employees or key managers should have an opportunity to purchase equity in the company in the future.	☐	☐	☐	☐	☐
Non-equity altenratives for employees. I would like to explore ways to attract, reward, and retain key employees or managers using equity like alternatives, such as phantom stock, stock appreciation rights (SARs), and/or non-qualified deferred compensation.	☐	☐	☐	☐	☐

Taxes

*Our buy-sell should address **taxes** in the following manner:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Profit distribution. Our agreement should provide for minimum profit distributions to cover quarterly estimated taxes for owners.	☐	☐	☐	☐	☐
Income tax consequences. I understand the income tax consequences of a future buyout, both at the company and shareholder level (i.e., whether the departing owner's gain will be treated as ordinary income or capital gain).	☐	☐	☐	☐	☐
Deemed gift or estate taxes. I am confident that the buyout will not trigger a deemed gift or estate tax consequence, especially in a family business context.	☐	☐	☐	☐	☐
S corporation status. If the company is an S corporation, our agreement should include a provision that restricts the transfer of equity to ensure that the company does not become disqualified from it's Subchapter S status.	☐	☐	☐	☐	☐

Other Terms & Conditions

Our buy-sell should address ***terms and conditions*** *specific to the company, including the following subtopics:*	Strongly Disagree	Disagree	Uncertain	Agree	Strongly Agree
Personal guarantees and bank debt. Our agreement should include a procedure for handling personal guarantees, existing bank debt, and compliance with loan covenants.	☐	☐	☐	☐	☐
Shareholder debt. Our agreement should include a procedure for the disposition of loans between the departing shareholder and the company.	☐	☐	☐	☐	☐
Special assets. Our agreement should include special protocol for unique assets on the company's balance sheet, such as intellectual property or real estate. (Example: Licenses, patents, trademarks, real estate).	☐	☐	☐	☐	☐
Dispute resolution. Our agreement should include dispute resolution procedures for resolving disputes among owners.	☐	☐	☐	☐	☐
Deadlock. If there is a possibility of deadlock (i.e., 50-50 ownership), our agreement should have a procedure to resolve a potential deadlock.	☐	☐	☐	☐	☐
Other:	☐	☐	☐	☐	☐

Contact Us

In the meantime, please do let us know if you have any questions with this application or with the Startup Lab. You can contact us by phone at (888) 597-WTLG or by email at bizexperts@watsontaxlaw.com. We invite you to learn more about Watson Tax Law Group, APC, and our services for entrepreneurs at www.watsontaxlaw.com.

Disclosures

This information is provided for educational or illustration purposes only. The information contained herein is not intended to be legal advice and should not be construed as legal advice. This document is not intended to be, and does not represent, a comprehensive review of your buy-sell agreement and, as such, should not be used as a substitute for a consultation with a licensed attorney.

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