The Legal Strategist

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Second Quarter 2008

Building on our theme of personal estate planning from the 1st Quarter of 2008, the 2nd Quarter 2008 topic will concentrate on the need for Buy-Sell Agreements (BSA) for any closely held business. As with estate planning, the BSA is designed to pre-plan for the inevitable and unexpected events every closely held business will face. The BSA is key to successful succession planning. A concise, well crafted BSA can avoid contentious, long and costly battles among partners, shareholders, family members, insiders and outsiders of the business.

As with all of our "Featured Topics" we are only presenting a highlighted overview; if you would like more information on this or any other topic previously covered in our newsletter (which can be viewed on *The Legal Strategist* tab of our web site), please contact our office to set up a consultation.

Hopefully, this quarter's topic will peak your awareness of the concept and the importance of a BSA for your closely held business. As always, we invite all comments and suggestions; let us know how we can improve or offer up a topic that you would like to see in an upcoming issue. Enjoy!

Scott Barrett

Texas Esoteric Facts

- The World's largest parking lot is located at DFW Airport.
- Seventy-five percent of the world's Snickers bars are made in Waco at the M&M/Mars plant.
- The Amarillo airport has the 3rd largest runway in the world and is designated as an alternate landing site for the space shuttle.
- In Texas, it is illegal to milk another person's cow.

Feature Topic: The Wisdom of Buy—Sell Agreements

Despite the name, A Buy-Sell Agreement (BSA) is not an agreement entered into when one purchases or sells a business; rather it is an agreement among partners, shareholders, family members, etc. that delineated the pre-agreed upon terms of when shareholders can sell their interest, who can buy a shareholder's interest, and what price will be paid. These agreements come into play when a shareholder retires, goes bankrupt, becomes disabled, gets divorced, wants to divest, terminates employment or dies. A good analogy is thinking of a BSA as sort of a prenuptial agreement between business shareholders.

From the point of view of the business and the remaining shareholders, a properly planned BSA normally will restrict the transfer of shares and provide for the orderly continuation of the ownership and control of the business. A well crafted BSA can prevent unwanted outsiders from becoming shareholders and eliminate the need for negotiations with surviving spouses and/or children; especially in a Community Property state such as Texas. A BSA may perform the role of a succession plan, providing for continuity or orderly succession of corporate management. Provisions may be made to anticipate the cash liquidity needs of the purchasing shareholders by putting in place life insurance to partly or wholly fund the future purchase.

From the perspective of the estate of a deceased shareholder, the existence of a BSA can assure the estate a liquid asset rather than an unmarketable interest in a closely held business. The planning process can provide the shareholder, while alive, with the opportunity to negotiate and obtain the fairest or best price for his or her stock. In a retirement or disability situation, the BSA provides a market for the stock and provides an additional source of retirement or disability funds.

A key consideration in developing a BSA is understanding your statement of purpose. As shareholders, you must first determine what is most important to you . Is it a sustainable income stream for retirement or will you re-invest profits into the company for the next generation? In all likelihood, the purpose of the business founders and the second and third generation will greatly differ. The key is to arrive at a purpose for the business that all parties can live with. This will determine the fundamentals of your BSA.

One essential term of a BSA is the trigger point for the agreement to come into play. As noted above, death, disability, divorce, retirement, withdrawal and even termination are common trigger points. At these junctures, a shareholder will want cash in exchange for their shares. Without proper planning, a business could find itself faced with a limited number of options, all of them bad. An effective BSA will make certain that for each trigger point, the company will have its first and best choice of options.

Another crucial expression of the BSA is the valuation of the shares. When a share buyout is triggered, it is important to have agreed beforehand on a method to arrive at an equitable estimate of the value of the business. Some closely held businesses reassess the business on an annual basis and agree to use that figure for the next 12 months. Others agree to bring in independent appraisers on both the buy and sell side and split the difference. Still others may use more sophisticated valuation formulas that factor in ratios of price to earnings or actual book value.

Buyouts can place serious strain on a business's reserves and force a closely held business into unattractive alternatives. That's why many businesses use life insurance to secure control of the company on the death of a shareholder or key employee. Essentially, if the value of a shareholder's share is estimated at $5 million, the company takes out a $5 million policy on him or her that names the company as beneficiary to fund the buyout at death.

What many buy-sell agreements fail to take into account is the far more likely scenario that an owner will become incapacitated for the short or long term. In these instances, a mere life insurance policy won't be much help.

Keys to buyout financing includes disability and death insurance, establishing a schedule of payments over time or a lump-sum payout. Estimating a payout schedule is crucial to prevent the unseemly circumstances of depleted cash flow. Also, the shareholders should consider discounts to the payout amounts for such things as lack of marketability and lack of control; after all, the company deserves some compensation for its loss of a key owner.

It is imperative to understand that BSA's can involve complex tax and non-tax issues. It is highly advisable to include the advice and analysis from your CPA and Financial Advisor in addition to using an attorney skilled in the nuances of a BSA.

The best time to develop a BSA is now. Do not gamble with the survival of your business and personal assets. If you need to create a BSA, or if you have one already in place but would like it to be reviewed to assess its effectiveness and make sure it is up to date, please contact Scott Barrett to set up a consultation