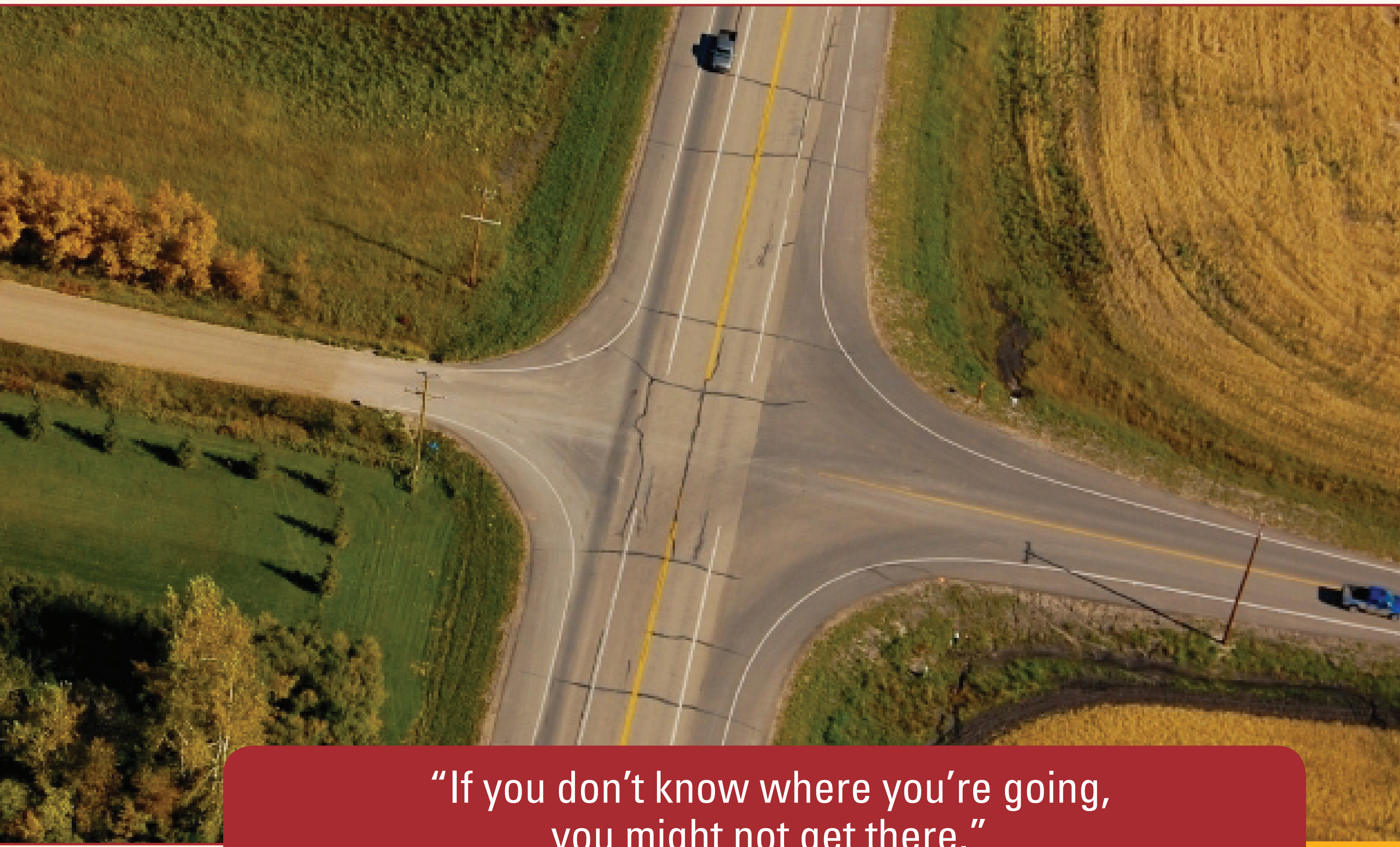
Chapter 7

A Key to Continuity



"If you don't know where you're going,
you might not get there."

Yogi Berra

CRAFT YOUR BUY-SELL AGREEMENT

This document is key to keeping the farm together.

The buy-sell agreement may be the most important tool for maintaining the integrity of a business entity in a succession planning engagement. Buy-sell agreements may also be referred to as business continuation agreements, shareholder agreements, stock redemption agreements, partnership liquidation, retirement agreements and cross-purchase agreements.

A well-written buy-sell agreement (one that has been drafted by an attorney familiar with the laws in the state of residence) will:

- Prevent inactive owners from gaining an ownership interest.
- Ensure ownership continues after death, disability, dissolution or divorce.
- Provide a ready market for a closely held business interest.

Every closely held business with multiple owners should have a buy-sell agreement. It provides a ready market for selling an ownership interest, establishes a valuation method and spells out the terms/conditions of purchase without placing an owner at a bargaining disadvantage.

THE BASICS

A buy-sell agreement is a contract that restricts a business owner's ability to transfer an ownership interest. The typical agreement provides the terms, conditions, triggering events and valuation methods within which an ownership interest may be sold. It prevents unwanted transfers and may ensure a ready market for a closely held ownership interest.

All of the owners of the business agree to the trigger events that are covered by the buy-sell agreement. Common events include death, disability, retirement, dissolution, withdrawal prior to retirement and other circumstances that may cause an owner to divest of an ownership interest, such as divorce, bankruptcy or legal judgment.

Negotiating valuation methods and the terms/conditions of a purchase are important considerations in a buy-sell agreement. Common valuation methods are: establishing a fixed price; an appraisal to establish fair market value; and a formula, such as a multiple of earnings, book value, etc.

Owners must be mindful that the provisions of a buy-sell agreement can be written as an option or an obligation. In other words, each triggering event will either create an option to purchase or an obligation to purchase.

A new buy-sell agreement negotiated and written by the owners of an existing business should conform to any pre-existing legal obligations, such as the provisions of an operating agreement, articles of incorporation, subscription agreements, etc. The buy-sell agreement must not be written to violate or conflict with other pre-existing contracts, including franchise agreements, leases, notes and loans. Owners may need consent from affected third parties, including lessors and lenders, in order to implement the buy-sell agreement.

COMMON PROVISIONS

Buy-sell agreements are necessary to restrict and facilitate an owner's ability to transfer an ownership interest in the business. Restrictions are used to prevent inactive owners from obtaining an equity interest. A properly written agreement will allow for an orderly ownership transition, facilitate a buy-sell event with minimal interruption, create a ready market for an otherwise illiquid asset and detail buy-sell procedures if a triggering event happens to occur.

NOTES:

A buy-sell agreement may include the following common provisions:

- **RIGHT OF FIRST REFUSAL.** A provision granting existing owners, or the entity, a first right of refusal to buy a deceased or withdrawing owner's interest before it can be sold to an outside third-party buyer. A right of first refusal usually does not activate until the withdrawing owner receives a bona fide offer from an outside third-party buyer.

- **MANDATORY PURCHASE OPTION.** A provision obligating the entity, or the remaining owners, to purchase the exiting owner's interest if a triggering event occurs.

- **OPTION TO PURCHASE.** A provision granting the entity, or the remaining owners, an option to purchase a withdrawing owner's interest if a triggering event occurs.

- **PUSH-PULL (OR RUSSIAN ROULETTE) CLAUSE.** A provision in which owners agree to buy or sell their interest based on a tendered offer.

  EXAMPLE #1: When an owner offers to buy additional equity from another owner, or the entity, he or she must be prepared to relinquish his or her interest for the same terms/conditions as offered.

  EXAMPLE #2: An owner makes an offer and specifies the terms/conditions. The other owners then have a certain number of days to respond by selling their interests or buying out the offering owner's interest at the same price and terms/conditions. This provision guarantees that the price and terms/conditions remain reasonable because an owner does not know whether he or she is the buyer or the seller.

- **TAG-ALONG.** A provision that requires a purchaser to buy minority interests in the farm business for the same price and terms/conditions as a majority interest. This provision protects minority shareholders from selling their interests at less than a favorable price and terms/conditions. It protects majority owner(s) by requiring a minority owner to sell if a buyer wants 100% ownership.

TRIGGERING EVENTS

The provisions of a buy-sell agreement can be written to activate based on various triggering events. The owners of an operation must establish, usually through negotiation, the events that will be covered by the agreement. Among the most common events are: death, disability, retirement, withdrawal from the business, divorce, dissolution, disagreement and adverse legal action.

- **DEATH.** The sudden death of an owner will create an extreme disruption to any family business. Without proper planning and a well-written buy-sell agreement, a deceased owner's heirs may become unwanted participants in the business. Even worse, the heirs may be forced to sell their interest to raise capital to pay the estate taxes and other transfer obligations.

  To minimize risk and maintain the ownership integrity of the farm operation, most buy-sell agreements call for a mandatory purchase of a deceased owner's interest in the business.

- **DISABILITY.** The disability of an owner can have a crippling effect on an otherwise healthy farm operation. Owners must be careful and specific when describing what is considered a disability in a buy-sell agreement. The language of disability is subject to interpretation, so the triggering event must be clearly defined. Disabilities can be permanent or temporary, long-term or short-term, physical and/or mental, accidental or a gradual infirmity.

■ **RETIREMENT AND/OR WITHDRAWAL FROM THE BUSINESS.** Including retirement and/or withdrawal from the business as a triggering event in the buy-sell agreement may protect the remaining owners (and hence the integrity of the operation) by restricting ownership. The agreement may provide an option, or first right of refusal, to existing owners and it should specify the price and terms/conditions for a buyout.

An option is usually tied to a specified time period, and a right of first refusal allows the remaining owners to wait and see if the retiring or withdrawing owner receives a bona fide offer from an interested third party.

■ **DIVORCE.** In most cases, business ownership (even a partial interest) is the largest asset in a household. In a divorce settlement, ownership may be divided between spouses or awarded to an inactive and otherwise unintended spouse in the property settlement. A well-written buy-sell agreement will protect the ownership integrity of the operation by allowing the owners, or the entity, to purchase the contested ownership interests.

■ **DISSOLUTION, INSOLVENCY OR BANKRUPTCY AND DISAGREEMENTS OR DISPUTES.** To avoid trouble and mitigate an adverse judgment, a buy-sell may use a push-pull clause (as mentioned on the previous page) for disputes, etc.

■ **ADVERSE LEGAL ACTION.** If a person can no longer perform the duties and obligations of ownership due an adverse legal action, the remaining owners must have an option to mitigate the undesirable fallout. The buy-sell agreement should provide for an optional buyout and may even call for a lower price because of unforeseen circumstances and the tarnished reputation of the family and operation.

NOTES:

CHAPTER 7 EXERCISE

BUY-SELL REVIEW

When periodically reviewing your buy-sell agreement, use this tool to identify those areas that should be included. Caution: Legal documents should be drafted by a licensed attorney familiar with the laws in the state of residence.

CASH NEEDS

Check the box.

	YES	NO	N/A
1. Are all owners, including spouses in community property states, and the business entity included?			
2. Are there any provisions conditioning ownership/acquisition based on family relations or other factors?			
3. Have the spouses agreed to accept the terms of the agreement with regard to community property/marital interest?			

METHOD OF VALUATION

1. If appraisal:

	YES	NO	N/A
a) Are the appraiser qualifications specified?			
b) Is the appraiser selection method specified?			

2. If formula:

	YES	NO	N/A
a) Is the formula method clearly explained in the agreement?			
b) Using the capitalization method, is it appropriate to add back the owners' salary and benefits?			
c) Does the agreement provide for arbitration to resolve disputes to avoid a costly litigation?			

TRIGGERING BUY-SELL EVENTS

1. Bona fide third-party offer

	YES	NO	N/A
a) Do the other owners retain first right of refusal?			
b) If a right of refusal exists, can it be partially exercised, or does the selling owner's entire interest have to be acquired?			
c) Must the offer and exercise of first rights of refusal be in writing within a specified time limit?			

You can also find this tool at *www.FarmJournalLegacyProject.com.*

Check the box.
YES NO N/A

2. Dissolution due to disagreement

a) Should it include a provision allowing an owner to offer to purchase the interest of another?

b) If so, should it be conditional or a push-pull requiring the owner to sell or match the offer and purchase the other owner's interest?

3. Owner's death

a) Does the agreement clearly state that the sale/purchase of an owner's interest is required or optional?

b) Is there a provision for funding options (life insurance, promissory notes, sinking fund, etc.), and does the provision include conditions and deadlines?

4. Owner's disability

a) Has disability been adequately defined (or are you using a common definition, such as Social Security) or contained in a disability insurance policy?

b) Does the agreement clearly state that the sale/purchase of an owner's interest is required or optional?

c) Is there a provision for funding options (disability insurance, promissory notes, sinking fund, etc.), and does the provision include conditions and deadlines?

5. Other potential buy-sell triggers for discussion

a) termination of employment

b) involuntary disposition (bankruptcy or insolvency)

c) divorce of non-owner spouse

MISCELLANEOUS CONSIDERATIONS

1. Will the IRS accept the conditions or your buy-sell agreement?
2. Do stock certificates reflect ownership/transfer restrictions?
3. For an S Corporation, does the agreement restrict ownership to eligible parties?
4. Does the agreement contain a provision binding heirs and legal bequests to the conditions of the agreement?
5. Does it include a non-compete clause for departing owners?