AN EDUCATIONAL BUSINESS SERIES FOR SUCCESS: SETTING IN PLACE AN EXIT STRATEGY WHEN THE TIME COMES AND MINIMIZING THE POTENTIAL FOR CONFLICT

In our last article, we reviewed why creating a buy-sell agreement can protect the owners of a company and help guide the process of a business succession plan. In this post, we will review how to create an exit strategy and minimize conflict when it comes time to begin to transfer the business.

PART 2 – SETTING IN PLACE AN EXIT STRATEGY WHEN THE TIME COMES AND MINIMIZING THE POTENTIAL FOR CONFLICT

Whether it's in personal relationships or business, the old song is right: "Breaking up is hard to do." Sure, you go into the company with starry eyes and big dreams, but you also must be a realist and know that things could go south quickly and unexpectedly — and splitting up can get ugly fast.

The best way to ensure a smooth transition when the time comes is to devise an exit strategy that will minimize the potential for conflict. A well-designed buy-sell agreement can act as your road map for how the business's owners will act and respond in the case of certain triggering events. Think of it as a prenuptial agreement but in the business world, and keep your focus on the goal of making the breakup go as smoothly as possible.

Although a buy-sell agreement makes it sound like someone is buying and selling a business, what it really does is sets out the circumstances under which the business's owners can sell their interests, who can purchase them, and the value of the interest. Let's take each of those aspects separately and delve deeper.

Triggering Event

When a business owner can sell his or her interest is generally called the "triggering event." Just as its name implies, the triggering event is what sets the buy-sell agreement in motion, and it generally occurs with the death, illness, disability, retirement, divorce, or bankruptcy or insolvency of an owner (partner or shareholder). Alternatively, an owner just may simply want out of the business for personal reasons, or you may want to terminate the employment of one of the business's owners within the company. A buy-sell agreement can cover any, some, or all of these events, depending on the preferences of the company's owners.

Who Can Purchase the Interest

One of the best parts about being involved in a closely held company is that its owners get to decide who their co-owners are – usually other stockholders. A solid buy-sell agreement maintains this owner freedom by specifying who may purchase an outgoing owner's interest in the business. For instance, the owners may agree that their spouses or children will always have first dibs on their ownership interests.

Valuation

The importance of placing a value on the ownership interest while in calm, non-volatile times cannot be overstated. When a triggering event occurs, emotions can run high, and depending upon the circumstances, so can animosities and other unflattering and unproductive feelings. In other words, this is not the time you want to be haggling over the price of an owner's interest in the business. Leaving the price open until that point could result in different owners wanting to use different valuation formulas or disagreement on selecting a professional appraiser.

Accordingly, to avoid problems regarding valuation, the best course of action is to have it determined before any kind of triggering event and while everyone is still working collaboratively toward common goals. This value then gets memorialized in the buy-sell agreement, and once it must go into effect, owners don't have a lot of room to complain about it. However, since the value of a business will change annually, so should the value be updated annually. If such value has not been updated for 18 (or 24) months prior to the Triggering Event and is not covered by a formula which automatically updates the value, then the value should be obtained by an appraisal of the business by an appraiser qualified to handle such job.

Just as with a prenuptial agreement, a buy-sell agreement is tailored to fit your individual needs. Just like no two marriages are alike, your buy-sell agreement should not simply have boilerplate language either. While you may be able to find templates online, a buy-sell agreement should reflect the specific needs and circumstances of an individual business to avoid the risk of facing legal challenges later.

The main goal, after all, is always to put in place an agreement among business partners as to what the end of a relationship will look like and leave as little room as possible for conflict, especially in terms of litigation, the costs of which could hamper, or even destroy, what's left of your business. Besides, at the end of a relationship — business or personal — no one needs added stress, and that’s exactly what a properly drafted buy-sell agreement can help eliminate.

Check out our next article in our business series explaining how ownership interests can be transferred if one or more of the owners can no longer or do not want to continue in the business.

If you have questions about your company’s succession, please contact a member of our Estate and Business Succession Planning team.

Other articles in this series:

- An Educational Business Series for Success: Why Buy-Sell Agreements are Necessary Even if You Don’t Plan to Sell Your Company Soon