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Business Succession Planning: **Buy Sell Agreements in Closely Held Businesses**

In closely held businesses owned and operated by multiple individuals, buy-sell agreements are a common way to address a variety of business succession issues. Usually contained within the governing instruments of the business (e.g., the Operating Agreement of an LLC), they allow the owners to express their goals with respect to future transfer of business interests institutionally. By defining some key concepts in advance of a triggering event, Buy-Sell provisions often help to limit or avoid disagreements that could be both personally and professionally disruptive. A common example would be the death of an owner (herein referred to as a partner going forward). Fundamental tensions often arise when individuals who are not involved in the business obtain a partnership interest; as a partner, that individual would have access to company financials, the right to dissent to certain business activities, and in some cases the right to force the business into dissolution.

There are any number of reasons that a buy-sell event could be necessary, and they can be categorized as planned and unplanned exits. A planned exit is typically a retirement. How will equity and cash exchange hands? Likely on an installment basis but who determines the equity allocation. An unplanned exit is typically one of the three Ds- death, disability or disagreement.

Many of the problems that can arise in any such event can be solved for or avoided through a well-crafted buy-sell agreement. Some of the considerations to think about when contemplating the creation of a buy-sell agreement between partners in a closely held active business:

Triggering Events

What are the triggering events for a buy-sell transaction?

- Death
- Disability (how defined)
- Voluntary retirement
- Age of attainment (e.g., a partner reaches the age of 65 – more on this below)
- Involuntary separation (e.g., termination of a partner “for cause,” which causes would be defined in the business’s governing instruments)
- Voluntary separation (e.g., partner decides to go work with a competitor)

Rights or Obligations

If a triggering event occurs, is the buy-sell automatic or at someone’s option? If the latter, whose option is it? The answer could be different based on different triggering events.

- Example 1: if a partner reaches an age of attainment, but everyone agrees that the partner should have the right to remain (and the partner wants to remain and continues to be productive), then they could unanimously agree to postpone the buy-sell, and that could be an annually renewable option.
- Example 2: if a partner dies, does the partnership have an obligation to purchase the deceased partner's interest from his estate/heirs? If the surviving spouse wants to continue to maintain the income stream, do they have an obligation to sell? Generally, the answer to both would be yes, but it's always worth asking the question.
- Example 3: if a partner leaves to go to a direct competitor, the operating agreement (or a separate employment agreement) might have non-compete language. In theory the two components could be structured to cancel each other out upon agreement by the departing partner and the partnership. In other words, the departing partner could ignore the non-compete by surrendering their partnership interests.

There are numerous hypothetical scenarios that could arise in the context of events that might trigger a buy-sell arrangement, but these are among the more commonly recurring examples.

Valuation

How will the partnership determine the value of the shares to be acquired from the departing partner?

- An EBITDA multiple
- A multiple on top-line revenue
- A formal valuation by an independent third-party qualified business valuation expert
- Any other agreeable valuation method
- Generally, the valuation in an event of a partner's death would be binding for estate tax purposes as well

Funding the Buy-Out

How will the payout be funded? In the event of a death or disability, life insurance could and probably should play a role. The easiest and usually most cost effective method, term life insurance can be employed to help provide the immediate liquidity needed to fund some or all of the buy-out.

- The amount of the death benefit will be a fixed amount at the time it is acquired, so careful consideration of projected future value will be necessary.
- The duration of the term will be case dependent, but 10 and 15 year term is probably most common (and cost effective).
- The ownership of the policy can either be an "Entity Purchase" arrangement or a "Cross Purchase" arrangement. Many factors play a role in this decision, but a simple rule of thumb is that the greater the number of partners, the more likely it is that a Cross Purchase arrangement would become too cumbersome.

In addition to life insurance, there may be a reason to consider financing a balance of the buy-sell through a lump sum and/or promissory note structure. That is common when the insurance death benefit doesn't cover the entire value of the shares being purchased (e.g., when the business

value grew past the point where the life insurance amount funds the entire value). In such an instance, there are elements to how the balance of that payment should be structured – single bullet payment or installment/note?

- If a note over lump sum is considered, would the buyer be given a discount to the full amount for paying off early?
- If a note, how will the interest rate be determined? Current APR? Current 10 year treasury? SOFR plus a modest hike?
- As for the duration of a seller note, a good rule of thumb for the outer limit of a note term is 5 years. The reality is that both parties will want to have finally resolved this within 5 years, and a well structured buy-sell arrangement should provide the liquidity to make 5 years more than enough time to have company distributions satisfy any remaining balance.

Greater detail on the mechanics of funding the buy-sell will be the subject of a subsequent article focused on this component specifically.

Additional Considerations

- The partnership interests set out in the cap table of the operating agreement might change over time; how do partners dilute themselves to add new partners? The same valuation questions would apply for any point where new partners are added and/or existing partners' interests are altered.
- Should exceptions be made in the event a partner wants to introduce a child or grandchild into the business?
- Tax efficiency is a key aspect to the terms of the buy-sell. In our wealth management business, we talk about how the only two truly predicable forms of alpha are both negative, and they are (i) taxes and (ii) fees. It's not what you make; it's what you keep. In the same vein, it will be important to engage your tax professional to make sure that the transaction is structured to be tax efficient (for all parties, and especially the partnership).

In Summary

At the end of the day, there are three important elements to a well-conceived Buy-Sell arrangement in a privately owned partnership:

- 1) What do the Buy-Sell provisions in your Operating Agreement say about what can happen / must happen to the shares of the departing or deceasing partner (i.e., right v obligation),
- 2) How are the shares going to be valued at the time of a triggering event, and
- 3) Which funding method(s) will the surviving partner(s) use to fund a purchase of shares at that time.

It might sound simple, but it's not. Everyone who has an interest likely has an opinion, and there are plenty of specific decisions that require careful consideration. Please let us know if we can help shepherd your business through this complex succession planning topic.



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