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Business Transition in Crisis: Owner Agreements

PROFESSIONAL OPINION

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The key to the effective transition of a business upon crisis events such as death, disability, deadlock, divorce, creditor liens, mid-life crisis or chronic disagreement, is a thoughtful agreement among the owners which is in place well before the crisis event. We all know the importance of an owner agreement, whether it be an operating agreement for a limited liability company, a shareholders' agreement for a corporation (whether S or C corp) or partnership agreement for a partnership. So why do we so often fail to have an agreement, or develop a quickly drawn agreement that does not adequately address the circumstances that face the owners? It is easy to see the obstacles. The owners are starting a new venture, and they and their advisors are focused on the business, legal and tax issues of acquiring, starting and operating the business. Developing an owner agreement requires owners to be introspective about who they are and their objectives, and to be realistic about the events that could happen.

The risk of disputes among owners and family members arising from ineffective agreements is high and can last for years. Such disputes are costly in terms of actual legal costs, but also lost opportunities for the business owners as their energy is mired in the complexity of the dispute. By addressing the various events upfront in the agreement, we ensure the event can be managed effectively to maximize value for the owner and his or her family.

A major focus point is the valuation of the business itself and the owner's interest in that business, (which may be discounted). The value may also depend upon the event triggering the buyout. If an owner dies, are we trying to maximize value to the estate? If so, the agreement may value the business as a whole multiplied by the owner's ownership percentage without any discounts for lack of marketability or minority interests. However, maximizing value in this way will result in higher estate tax for New Yorkers, (over 50% of the value in excess of the estate tax exemptions) which diminishes the net available to the family, or could crush continuation of the business, even if paid by the business on an installment basis. Life insurance on the deceased owner solves the cash flow problem. Under the classic owner agreement, the business (or the remaining owners) hold the life insurance, which is then used to pay for the business at maximum value. However, the owner's estate will pay estate tax on that full value. Instead, consider having the insurance owned by an irrevocable life insurance trust or outside of

the owner's estate, but still available for the family. Then reduce the valuation for buy out purposes under the owner agreement through discounts or a valuation formula. In this way we provide the estate and the family maximum value while minimizing estate tax.

The owner agreement should address crisis events; that is, events occurring while the owners are developing the business and prior to implementing the exit strategy. The owner agreement may contemplate an exit strategy, such as a younger owner or management team taking over the business when the senior owners transition, or while the owners are building the company's EBITDA for future sale. The crisis events may be unlikely to happen, but could and do happen every day.

The true price at which the business owner will sell the business to a synergistic buyer as part of the owner's long term exit strategy may be very different than the buy-out price established in an owner agreement. Valuations established by appraisal may look at projected cash flows, but often are based on historical earnings, producing a value considerably less than the value the owners expect on sale. The owners need to be realistic in the owners agreement about the price the remaining owners should pay in light of the cash flow of the business and the loss of the strategic direction and talents of the owner whose interest is being purchased. If there is an expectation for a buy out at a higher value, life insurance can fund that difference. Again, consider the business owner acquiring the life insurance through a life insurance trust to minimize tax.

Another crisis event is if an owner prematurely leaves the business. What should the buy out price and terms of payment be under

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those circumstances? The owner agreement could include a deep price discount which may vary depending on whether or not: (i) the agreement provides for a covenant not to compete or similar covenants on the part of the departing owner, (ii) the termination of employment is by the company "for cause" or by the owner voluntarily leaving (violating the commitment expected by the owners at the onset of the business) or (iii) the owner is being forced out for no good reason. These differentiations are slippery factually, so should be carefully discussed and spelled out in the agreement.

The buy out price under an owners' agreement may vary for different trigger events. The agreement typically sets forth a process for valuation of the business as a whole, and to which a discount or premium can apply depending on the trigger event. Three main ways to establish value are by certificate of value, formula or appraisal. The certificate of value approach (everyone agrees on a fixed value) is easy, especially in the event of a death buy out to be funded by a fixed amount of life insur-ance, but like the one size fits all template owner agreement, can be a disaster if the value of the business changes over time. Business owners often do not annually review the business valuation, so the buyout price should default to either an appraisal or formula. A valuation formula, such as, a multiple of EBITDA, works where there is a valuation standard in the industry. An appraisal at the time of the trigger event is likely the fairest approach to determining value from the perspective of the departing owner, purchasing owner and the business. The appraisal process works well with respect to a real estate company where the accountant establishes the book value as of the trigger date, with the real estate adjusted to fair market value as determined by a real estate appraiser. To obtain a discount for lack of marketability or lack of control, the agreement should require a business appraisal. With respect to operating companies, it may be valuable to obtain a business appraisal periodically to provide greater certainty as to valuation.

In addition to addressing the buy out price, terms of payment and how the price will be funded, the owner agreement should contain very specific provisions outlining the trigger events (such as death, disability, deadlock, termination of employment, voluntary withdrawal or retirement), and whether a buyout is mandatory or optional, providing a series of options and "puts". The owner agreement can also cover voting rights, confidentiality, covenants not to compete and non-solicitation, "drag along and tag along rights" and clawback provisions if the business is sold within a certain time after a buyout. Templates can be used as a starting point, but there is no substitute for the owners and their advisors thinking through the scenarios that could occur, and how they should be addressed fairly for all the parties concerned, especially since no one knows for sure which, if any of the scenarios, will actually occur.

The problem is not merely to avoid the crisis, but to provide the terms for effective management through the crisis. ■

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