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Re: Business Owners: Protect Your Equity!

Most every business owner will acknowledge that his or her equity in that business is a valuable and important asset. Many cannot honestly tell you, however, that they regularly evaluate and take active steps to legally protect the ownership of that asset. A well planned and current agreement among the owners is a most important tool to help protect that interest.

Who is this letter for?

This letter is for every owner of a business that has more than one owner. It is also for the advisors to those businesses and owners.

What are these agreements called?

The terminology can be confusing: Shareholders Agreements, Operating Agreements, Partnership Agreements…they are also sometimes referred to as "Buy Sell" Agreements. Each serves essentially the same functions and the name differences result in part from the different entities used to conduct the business: Shareholders Agreements are for corporations; Operating Agreements are for limited liability companies; and Partnership Agreements are (obviously) for partnerships. In this Newsletter we will refer to them all as "Owners Agreements."

What are the functions of an Owners Agreement?

The "buy sell" terminology reflects one of the main functions, which is to establish procedures for the purchase and sale (hence the term "buy sell") or other disposition of an owner's interest upon the severance of that owner's relationship with the company, which may result from an owner's death, disability, retirement or other reasons.

Another important function of Owners Agreements is to set forth procedures to govern any of the company's on-going management and finance issues. These issues may include:

- Capital contributions
- Ownership percentages

- Compensation matters
- Tax issues
- Restrictions on equity transfers
- Provisions for interfamily transfers for estate planning
- Limits on employment of owners' family members
- Unanimous or majority voting requirements
- Divisions of responsibility and titles
- and any other issue that could lead to a dispute if it is not discussed and resolved by agreement of the owners.

The management procedures are often more critical when the ownership allocation is anything other than two equal partners. In those cases, careful planning is required to protect and balance the interests of both majority and minority owners.

Why is a <u>current</u> agreement necessary?

While many owners enter into an agreement at the time the company is formed; many others do not. In either event, the situation should be monitored to determine when the first agreement should be adopted or when an existing agreement should be amended or replaced to cover new circumstances.

One critical reason to monitor the agreement is to make sure that the buy out price for a departing owner's interest (whether stated in dollars or a formula) fairly represents the value of that interest. In other words, as the value of a business grows or shrinks the owners should make sure that any previously determined buy out price is adjusted to reflect the change. This can be especially critical in a challenging economy like the one we face today.

A closely related reason is whether, and to what extent, the buy out price should be funded by insurance.

Likewise, changes of owners and/or ownership percentages would call for a new or up-dated agreement.

Often the owners of a start up business simply do not have the time or the inclination to devote substantial thought and effort (not to mention legal fees) to a comprehensive agreement. However, as time goes by and businesses grow, and as owners' families change, the need for a comprehensive and well planned agreement becomes more obvious.

When should the Owners Agreement be reviewed?

It is difficult to enumerate hard and fast rules as to when an agreement should be reviewed to determine whether changes are advisable. However, some events may more clearly call out for a review:

1. Whenever the value of the business grows or shrinks substantially (e.g. more than 25%) since the last time the buy out price was agreed upon.

2. Whenever there is going to be a new owner or when one of the existing owners is leaving.

3. When there has been fundamental change in the allocation of management responsibility among the owners.

4. When any of the owners reaches an age or when other factors (e.g. changes in health or marital status) cause his or her estate planning needs to change or to become a more important issue.

5. Whenever the company's accountant or other significant advisor suggests that a review is in order.

6. When substantial time (e.g. three years) has passed since the last time the agreement was reviewed.

What should a company do?

Any company that has two or more owners should have an Owners Agreement. This is especially true when there are majority and minority owners; or when there are more than two owners, because that enables a voting majority. The agreement should be reviewed by counsel and other advisors on a regular basis and whenever any extraordinary event (like those listed in the previous point) takes place.

Richard H. Waxman, P.C. will answer your questions about Owners Agreements and other legal matters that affect companies and professional practices; and we will help you prepare or review the necessary documents, all for a reasonable fee.

Very truly yours,

Richard H. Waxman

If you wish to learn more about our Business Law practice, visit the Business Law section of our website at: www.waxmanlaw.com.

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