Exit Agreements

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Introduction

People often have a lot of their wealth tied up in a business. However when two or more people own a business, more often than not, the departure of one of the owners has not been clearly and properly dealt with in a legally binding manner.

In practical terms, an exit by one of the partners is inevitable, sooner or later. These reasons could include retirement, a disagreement or even a divorce as part of a financial settlement. So if they have to exit the business, what happens then?

The need for an appropriate legal agreement between partners may seem painfully self-evident, but some sources indicate that as many as 95% of businesses may not have the right kind of agreements in place!

This can lead to immense problems not only for the departing proprietor, but also for the business and the remaining business owner/s.

An exit agreement can be put in place to dictate the terms under which a proprietor can depart. Without such an agreement the following scenarios are unfortunately quite common:

- Departing proprietor/s are suddenly under pressure when negotiating with the remaining proprietors to sell their share of the business.
- The value of the business will be under contention because of the conflicting interests.
- The departing proprietor may be forced to take whatever is on offer. The remaining proprietors may find themselves with a new (and unwanted) partner if they don't have the first right to buy the business from the departing partner.

Whatever the situation, it is potentially fraught with emotion, cost and dangerous distractions from running the business. A significant part of someone's wealth can suddenly be at risk and can leave everyone involved unhappy with the ultimate outcome.

THE M GROUP OPTIONS

An exit agreement is an agreement between co-business owners that sets out the terms under which a proprietor can exit the business.

Exit agreements offer business owners two options. First is a non-compulsory agreement whereby one partner must give the other/s the first right of refusal to buy their share.

This type of agreement however, puts them under no obligation to buy that share.
The second option is a compulsory agreement. Under this option the departing partner can force the remaining partner or partners to buy their share of the business.
This has very quickly become the preferred option amongst business owners.

As a result of the binding nature of this agreement there are usually conditions applicable.

From a fairness perspective, most business owners agree that a "penalty" should be imposed on the owner electing to leave.

This "penalty" usually takes the form of a discount on the value of the business as well as the attractive payment terms.

The discount on the valuation acts as a form of disincentive to the departing partner. After all, they are potentially disrupting the business and putting the remaining partners under pressure.

Conversely, it also provides an incentive to the remaining partner/s to buy the shares and take on the risk of owning the whole business.

Payment terms also assist in this regard. Usually the terms agreed to are such that they allow the remaining partners to fund the buyout from the future cash flow. Again, this acts as an incentive to the remaining partner/s as it helps ensure they can fund the buyout.

These agreements are all tailored to suit the client but at a minimum the terms will include:

- The agreed method of valuation of the business at the time of departure (usually an independent valuation but it's up to the client).
- The discount to apply to the valuation as a form of compensation for the remaining proprietor.
- The payment terms applicable, both the term and possible interest payable. Again this varies by client and is usually a function of cash flow and business value.

FUNDING

The continuing partner will need to resource funds over the agreed term from which the departing partner will receive the discounted value. These funds can be obtained from their own resources or from the cashflow or value of the business.

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EXTREME CIRCUMSTANCES

If required, the agreement can also enable a shareholder to force another shareholder to transfer their shareholding to the remaining parties in circumstances such as bankruptcy, fraud, mental incapacity or non-performance.

In these cases we recommend that the purchase price be a decreased percentage of the terminating party's equity value in circumstances of fraud or bankruptcy.
This is because it usually means that the terminating party has done something illegal and/or potentially damaging to the business or its reputation and should be "penalised".

CAPITAL GAINS TAX

Capital gains tax may be payable by the departing proprietor and needs to be taken into account in the payment terms to ensure the tax can be paid as required.

IN SUMMARY...

Whenever two or more people own a business it is essential to have a well planned exit agreement in place to help ensure their investment is protected. These should ideally be implemented while neither party is under pressure to maintain equal negotiating power. Agreeing to these terms and putting the appropriate documentation in place is not an expensive or insurmountable task, in comparison to the costs associated if there is no agreement to refer to.

THE PROCESS

We will work with you to understand your requirements and advise on the best possible solutions. We will prepare a 'plain english' advice paper to help you understand your choices and decide on the options that best suit your needs. Once you have decided on your preferred options, we will liaise with you to have your legal agreements prepared.

"INVOLUNTARY" DEPARTURES

An exit agreement is used to cover the exit of a partner for "voluntary" reasons. The other possibility however, is when an owner departs as a result of a death, illness or total and permanent disablement.

Terms and conditions for these events are covered in another agreement called a buy sell agreement. Issues to be considered as part of preparing that agreement include:

- What 'events' do the owners want to trigger the agreement?
- How will they fund the buy out?
- How will they set the purchase price?
- What are the capital gains tax implications?

We can also advise on these agreements, providing the complete business succession package.

NEED SOME HELP?

For more information on exit agreements or buy sell agreements, which cover the involuntary departures of partners or equity owners, please contact us and we will work with you to develop a solution to meet your needs.

We offer a free no obligation meeting to review your situation. Call us today on 1300 204 781 and take advantage of this valuable offer.

FS360 - What does being financially secure mean?

It means assessing your personal and business goals and developing a plan to achieve these.

We have identified 12 key areas to help you become financially secure:

1. Goals & objectives
2. Estate plan
3. Risk plan
4. Asset protection plan
5. Taxation plan
6. Debt plan
7. Retirement and succession plan
8. Business plan
9. IT Plan
10. Marketing Plan
11. Superannuation plan
12. Investment plan

Setting goals and objectives and having strategies to achieve these is an essential element of becoming financially secure. Once you know what you are aiming to achieve and how you are going to get there, we then need to make sure you have a strong foundation in place to protect you, your family and other investments.

A strong foundation needs an estate plan, risk, plan, asset protection plan, taxation plan and debt plan.
With the foundations in place we can then work on the strategies to achieve your goals and objectives. It may seem out of order that we have the retirement and succession plan at number 7 rather than 12. It is important that this is considered early and a plan is put in place. This assists to plan for this financially as well as keeping the communication lines open on the topic.