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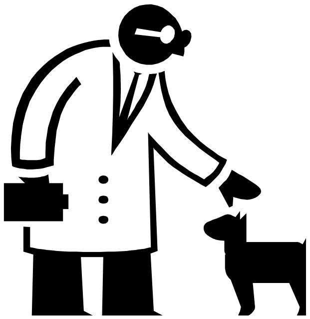
BUSINESS SUCCESSION PLANNING

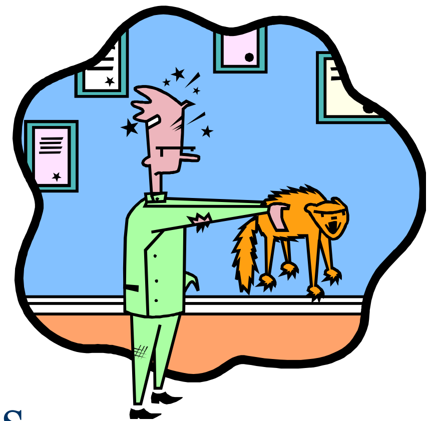
Agenda

A. Importance of Business Succession Planning
B. Benefits of Business Succession Planning
C. Business Succession Plan Considerations
D. The Buy/Sell Agreement
   1. What is it?
   2. Why a Buy/Sell Agreement
   3. Types of Buy/Sell Agreements
   4. Provisions of the Buy/Sell Agreement
E. Questions



A. Importance of Business Succession Planning

1. Planning for Unanticipated Events
   - Premature death.
   - Serious injury or illness.



2. Risks at Stake
   - Family vulnerable to sever income loss.
   - Banks may stop lending.
   - Loss of customers and key staff.
   - Management disputes over control.
   - Liquidation of business within 12 months.

A. Importance of Business Succession Planning

Minnesota Statute Section 156.11 - FIRMS NOT TO PRACTICE.

(a) It is unlawful in Minnesota for any firm, other than one organized pursuant to chapter 319B, to practice veterinary medicine, or to hold itself out or advertise itself in any way as being entitled to practice veterinary medicine, or to receive compensation derived from the practice of veterinary medicine or the performance of veterinary services by any person, whether that person is licensed to practice veterinary medicine or not. Any firm violating the provisions of this section is guilty of a gross misdemeanor and must be fined not more than $3,000 for each offense. Each day that this section is violated is a separate offense.

(b) Notwithstanding section 319B.08, a veterinary medical practice firm has 12 months after the death of an owner before all of the owner's ownership interest must be acquired by the practice, by persons permitted to own the ownership interest, or by some combination.

B. Benefits of Business Succession Planning

1. Secures family's finances.
2. Assures banks for continuation of credit.
3. Assures staff for their continuation of employment.
4. Avoids delays and disputes with management transition.

C. Business Succession Plan Considerations

1. Life Insurance: Why? How Much?
   - To provide a financial cushion to the practice during a transition period.
     - Amount needed depends on the size of the current obligations and other cash revenues.
     - Six months of production may be an appropriate starting point.
   - To buy the deceased owner's interest.
2. Identify Your Successor
   - Key personnel will know in advance who will be your replacement.
   - Assures lenders, customers, and staff.
   - Utilize a corporate resolution that the successor will be able to use immediately upon the event occurring.
3. Implement a Buy/Sell Agreement

D. The Buy/Sell Agreement

1. What is it?
   - A Buy/Sell Agreement is an agreement between the owners of the practice, or between the owners and the entity, to purchase and sell interests in the practice at a price set or determined under the agreement upon the occurrence of a triggering event.
2. Why a Buy/Sell Agreement?
   - Protects owners in advance by defining when and how owner can leave the practice.
   - Prevents unwanted 3rd parties from acquiring an ownership interest.

D. The Buy/Sell Agreement

2. Why a Buy/Sell Agreement (cont.)?
   - Specifies what will happen to an owner's interest in the event of an owner's death
   - Provides a method of funding the buy-out of a withdrawing or deceased owner's interest and the terms of payment.
   - Can specify under what circumstances an owner can be forced out of the business.
   - Can be used to void transfers of ownership that would result in termination of practice's professional firm status.
   - Can enable a smooth transition in the control or ownership of the practice.

D. The Buy/Sell Agreement

3. Types of Buy/Sell Agreements
   - Traditional buy-sell planning typically involves choosing between a stock redemption agreement, often using life insurance owned by the entity, or a cross purchase agreement, often using insurance owned by the business owners.
   - Redemption Agreement: In a redemption or entity purchase agreement, the entity is obligated or has an option to purchase a withdrawing or deceased owner's interest in the practice.
     - Advantage: When using life insurance, there is the simplicity of having only one life insurance policy per owner.
     - Disadvantages:
       - The practice's ownership of the insurance policies means that any policy cash values are subject to attachment by the practice's creditors
       - No step-up in basis for the other's owners

D. The Buy/Sell Agreement

3. Types of Buy/Sell Agreements (cont.)
   - Cross Purchase Agreement: In a cross purchase, the other owners of the practice are required or are given the option of purchasing a withdrawing or deceased owner's interest in the practice. To fund this obligation, each owner often owns a life insurance policy on the life of each of the other owners.
     - Advantage: Purchasers can obtain a full basis step-up by buying the stock directly from selling owner or the selling owner's estate.
     - Disadvantage:
       - When using insurance, each owner must own a policy on each other owner, so multiple policies are required if there are more than two owners.
       - When using insurance, there is an imbalance in the premium allocation between younger/healthier owners and older owners.
   - Hybrid Agreement: A hybrid agreement combines redemption and cross purchase requirements or rights.

D. The Buy/Sell Agreement

4. Provisions of the Buy/Sell Agreement
   a. Parties to the Agreement.
      - Owners entering agreement are identified by name
      - If entity has redemption or other obligations, it must be a party to the agreement.
   b. Restriction on Transferability
      - Establishes the owner's ability to transfer or sell his or her ownership interest
      - Sets forth any transfers that are permitted or preapproved.
   c. Definition of Transfer
      - Agreement should define the word transfer.
      - Definition should include a variety of voluntary and involuntary actions and events.

D. The Buy/Sell Agreement

4. Provisions of the Buy/Sell Agreement (cont.)
   d. Triggering Events
      - Events that give rise to purchase and sale rights or obligations under the Buy/Sell Agreement
      - Examples of Triggering Events
        - Retirement
        - Death
        - Disability
        - Voluntary Transfer (*e.g.* receiving a bona fide offer from a 3^{rd} party for purchase of owner's interest).
        - Involuntary Transfer (*e.g.* Bankruptcy or Divorce).

D. Buy/Sell Agreement

4. Provisions of the Buy/Sell Agreement (cont.)
   e. Determination of the Purchase Price
      - Fixed Purchase Price: Owner's agree to a fixed purchase price.
        - Advantages
          - Easy to understand.
          - Inexpensive – easy for attorneys to draft; no appraisers required.
        - Disadvantages
          - Fixed prices are seldom updated, so the price is likely not reflective of realistic value.
          - Easy to set initial price but may be difficult to reset as time passes.
          - If value is unrealistically low, you are betting the other guy will die first and you get to buy at a low price.
          - If value is unrealistically high, you are betting that you will be the one to leave the business first so you and your family will benefit.
          - Why take the chance that you will be on the wrong end of the bet?
        - Possible Fix to Out-of-Date Fixed Price: Update the price annually.

D. The Buy/Sell Agreement

e. Determination of the Purchase Price (cont.)

- <u>Formula</u>: Owner's establish formula to calculate purchase price.
  - Advantages
    - Easy to understand and negotiate
    - Can be inexpensive option – no appraisal required
  - Disadvantages
    - Difficult to set formula that can provide a reasonable/realistic valuation over time.
    - Difficult to derive one formula that accounts for both balance sheet and income statement changes in the practice over time.
  - Possible Fix to a Formula Agreement: Calculate the price based on the formula every year so you know what the price would be if a triggering event occurred.

D. The Buy/Sell Agreement

e. Determination of the Purchase Price (cont.)

- Appraisal: Owner's agree to let business appraiser set the price for the agreement when a triggering event occurs.
  - Multiple Appraisers
    - Agreement calls for selection of two or more appraisers
    - Example: One appraiser selected and paid for by purchaser, one appraiser selected and paid for by seller, and those two appraisals are averaged.
    - Process can be consuming, cumbersome, and expensive.
  - Single Appraiser
    - Agreement calls for the selection of one appraiser whose conclusion forms the basis for the final price.
    - Key: Name the appraiser at the time of the agreement so all parties have a voice and can sign off on the selection.
    - Key: Chosen appraiser provides a baseline appraisal at the time of agreement.
    - Advantages: Selected appraiser viewed as independent; process is known in advance; appraiser's process is seen at the outset.

D. The Buy/Sell Agreement

4. Provisions of the Buy/Sell Agreement (cont.)
   f. Payment of the Purchase Price - Funding the Buy/Sell Agreement.
      - Life Insurance
      - Cash
        - Life Insurance
        - Corporate Assets
        - External Borrowings
      - Promissory Note
      - Combination of Cash and Promissory Note

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