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Benefits of Buy-Sell Agreements in Multiple-Owner Groups

An article by Tony J. Allison, CPA, and Brian P. Brueggeman, CPA

In multiple-owner dealerships, ownership transition inevitably occurs. Given the unpredictability of life events, dealership owners should plan for these transitions. Such plans need to be in place before the unexpected happens.

Why Establish Buy-Sell Agreements?

Established buy-sell agreements are critical. An owners' buy-sell agreement is a legally-binding agreement by and between dealership owners that governs the situation if a co-owner dies or leaves the dealership. Additionally, buy-sell agreements are beneficial because they can:

- Provide a smooth transition and continuity of management and ownership
- Create an instant market for a business interest that might not otherwise be saleable
- Offer tax advantages
- Provide liquidity for estate taxes
- Deter disputes about succession and value with the exiting owner's family
- Give owners peace of mind from knowing that the dealership is in capable hands should they no longer be able or want to manage it

Some owners might believe that a buy-sell agreement is not necessary if they intend for their estates to receive their dealership interests. However, several factors complicate this approach, including:

- A spouse or beneficiary who dies first
- A surviving co-owner who does not want to be in partnership with heirs
- Surviving beneficiaries who might need liquidity more than a business interest in a dealership
- A potential family conflict because the asset in the estate is not liquid
- Surviving beneficiaries who might not know anything or be interested in the dealership

Types of Buy-Sell Agreements

Most dealership owners implement one of two types of buy sell agreements: a cross-purchase agreement or an entity-purchase agreement. In a cross-purchase agreement, the remaining owners buy out the interest of the withdrawing owner. In an entity-purchase agreement, the dealership buys out the interest of the withdrawing owner. Another approach is a hybrid. The agreement is structured as a cross-purchase but allows for an entity redemption should the surviving owner elect not to purchase the ownership interest from the departing owner.

After deciding on the type of agreement, the next step is determining the valuation mechanism. This determination can be difficult, but establishing the worth of a dealership is essential for the agreement's success. For example, surviving owners want to be fair to the decedent owners' beneficiaries, but they do not want to overpay. At the same time, owners want their families to receive the maximum amount possible for their dealership interests.

Selecting a method for determining fair market value of an ongoing dealership should be done carefully and with professional advice. The following three mechanisms are utilized most often:

Fixed-Price Agreements

Fixed-price agreements set the price of future purchases at a specific dollar amount by stating a value for the blue-sky of the dealership. All owners agree to a price and know what the buy-sell price will be.

Disadvantages of this approach include the fixed price becoming outdated due to the constant evolution of a dealership, owners seldom knowing the true value of a dealership and setting unrealistic prices, and different triggering events that might cause different values, such as the death, retirement, or removal of an owner.

Formula Agreements

Formula agreements establish value by providing a specific formula based on a multiple of the company's operations. Once the formula is selected, the specific calculations necessary to determine the buy-sell price are known.

One downside for this type of agreement includes the selected formula providing unreasonable or unrealistic valuations depending on the timing of the triggering event and the specific circumstances affecting the business when the valuation is needed.

Business Valuation Agreements

Business valuation agreements outline processes by which future transactions will be priced, such as defining the valuation process. They also call upon the use of one or more business appraisers for determining the price at which contemplated future transactions will occur. All parties agree what the process will entail, owners obtain a qualified independent expert opinion rather than determining the value themselves, and attorneys are familiar with the business valuation process.

With business valuation agreements, the price is not fixed and uncertainty over final value in the process can be stressful and can cause apprehension for the owner.

Dealers should consider the use of a formal business valuation as the valuation mechanism that the buy-sell agreement is based upon because the IRS can impose penalties for understating the value of an asset for estate tax purposes.

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Reap the Benefits

Buy-sell agreements are one of the most efficient means of transferring dealership interests, and they can help forge smooth dealership continuation after disruptive events. By helping prevent infighting among co-owners and family members, buy-sell agreements can help keep dealerships afloat and customer bases intact, and they can help prevent liquidity problems. The costs of buy-sell agreements are often minuscule compared to the benefits they could yield.

Learn More

Tony Allison
Partner
+1 574 236 8630
tony.allison@crowe.com

Brian Brueggeman
+1 260 487 2302
brian.brueggeman@crowe.com

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