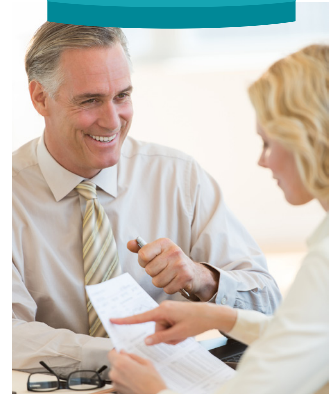
The Elements of a Buy-Sell Agreement

ADVANCED MARKETS



The following information is intended to provide a very basic understanding of the role and basic components of a buy-sell agreement. It is not intended to provide an exhaustive list of all the rights, obligations and terms that could, or should, be included in such agreements. It is also not intended as a legal opinion nor offered as legal advice.

EXECUTIVE SUMMARY

A buy-sell agreement is a written legal document that does the following:

1. Creates a market for the owner's interest in a closely held business at certain triggering events, e.g., death, disability, departure under good terms or bad, divorce, retirement, etc.
2. Facilitates a smooth transition of management and control for the surviving or remaining owners
3. Provides a mutually agreeable price and terms (so as to avoid friction and potential litigation)
4. Provides the family of the deceased or disabled owner with liquidity rather than a non-marketable business interest

For business owners who may be subject to federal estate taxes, a good buy-sell agreement will also fix the value of the business for estate tax purposes. When the owners are family members, IRC § 2703 requires certain tests be satisfied to fix the estate tax value of the business, primarily that the agreement is bona fide and doesn't transfer interest for less than full and adequate consideration.

A buy-sell agreement is most often a separate agreement, especially in the case of corporations. Partnerships and LLCs will sometimes include buy-sell provisions within the partnership or operating agreement.

A buy-sell agreement may be implemented in the form of a cross purchase plan, an entity purchase plan, or a wait and see plan, which implements elements of both. The preferred form for a given business depends on tax and non-tax issues.

An effective buy-sell agreement provides assurance to the surviving or remaining owners that their business will continue to thrive. It also provides deceased, disabled or retiring owners with liquidity to meet their needs. A properly designed agreement addresses the following elements:

- Parties
- Restrictions
- Triggers
- Valuation
- Purchase Terms
- Funding

The following pages discuss these elements in more detail.

A buy-sell agreement ensures a business will successfully survive the death, disability or retirement of one or more of its owners, bringing comfort and security to:

- Owners
- Employees
- Suppliers
- Customers
- Lenders
- Bonding agents

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The Elements of a Buy-Sell Agreement	
Form of Buy-Sell Agreement	A buy-sell agreement may be implemented in the form of a cross purchase plan, an entity purchase plan, or a wait and see plan, which implements elements of both.
Cross Purchase Plan	In the cross purchase plan, the surviving or remaining owners (shareholders, partners or LLC members) agree to purchase the interest of a deceased or withdrawing owner. • The remaining owners increase their basis to the full extent of the purchase price paid. • When the plan is funded with life insurance, each business owner will be the owner, beneficiary and premium payer of a policy on the life of each other owner. With two owners, two policies are required. Three owners will require six policies, four owners require twelve policies, etc.
Entity Purchase Plan	In the entity purchase plan, the business itself agrees to purchase the interest of a deceased or withdrawing owner. In the case of a corporation, this type of plan is referred to as a stock redemption agreement. • The remaining owners will have no increase in their basis as a result of the business buying the interest. However, in pass-through entities, any tax-free life insurance proceeds received by the business will increase the basis of all owners – typically on a pro rata basis. • When the plan is funded with life insurance, the business is the owner, beneficiary and premium payer for a policy on each of the owners. • Family-owned corporations may be subject to unfavorable taxation under a stock redemption plan due to "family attribution rules." When the business will be the owner and beneficiary of policies on the lives of owners, the Notice & Consent requirements of IRC § 101(j) should be observed to prevent the death benefit proceeds from being treated as taxable income to the business.
Wait and See Plan	The wait and see plan defers the determination of the purchaser(s) until the time of the triggering event. A typical approach is to give the company a first option to purchase, with the individual owners having a subsequent option to purchase whatever interest the company declined to purchase. Finally, the company is obligated to purchase any interest remaining after the owners' options have been exercised or declined. This structure gives the surviving or remaining owners the greatest degree of flexibility while providing the deceased or withdrawing owner the certainty of a purchase obligation. • When the plan funded with life insurance, the policies are usually owned by the business.
Parties to the Agreement	With a cross purchase plan, the parties to the agreement are the owners as individuals. With entity purchase or wait and see plans, the business itself is also a party to the agreement. If the owners are residents of a community property state, or if there is a sale obligation triggered by the occurrence of an owner's divorce, the attorney may recommend having the spouses of the owners execute the agreement.

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Restrictions on Transferring Interest	An important objective of a buy-sell agreement is to ensure that owners have control over who they have as business partners. Agreements should restrict the transfer of stock (or partnership interest or membership units) except as provided within the agreement. Often this is done by defining "Permitted Transfers" and "Permitted Transferees." These could include: • Other current shareholders, partners or members • The revocable (living) trust of an owner • An irrevocable trust created by an owner for the benefit of that owner's spouse and/ or children • Another closely held business controlled by an owner For S-Corps, the agreement should explicitly prohibit transfers to an ineligible trust or other entity that would cause termination of S status.
Triggers for Purchase and Sale Obligations	While a comprehensive buy-sell agreement will include a number of triggering events, the most important are death, disability and departure (under good terms or bad). Other triggers may include involuntary transfer of an owner's interest through divorce, bankruptcy or similar court action, or loss of professional license. When the agreement permits transfers to a trust established by an individual owner, or to a closely-held business controlled by an individual owner, the triggers should be worded so that any interest owned by such a trust or business is subject to the same sale obligations as the owner who created the trust.
Death	When an owner dies, his estate should be required to sell all of his interest to the surviving owners (or to the company); and, the surviving owners (or the company) should be required to purchase all of his interest. This ensures that the surviving owners have control over who they will have as business partners going forward, and it ensures that the deceased owner's surviving spouse has liquidity to meet their financial needs, instead of an unmarketable business interest. In some cases, an owner will retire from active involvement in the company but will retain his ownership interest as a source of retirement income. In that event, the agreement may call for his interest to be sold upon the later of his or his spouse's death. However, relying on profit distributions for retirement income may entail significant risk that the company does not remain consistently profitable.
Disability	When an actively employed owner becomes permanently disabled and unable to contribute to the success of the business, he should be required to sell all of his interest to the remaining owners (or to the company); and, the remaining owners (or the company) should be required to purchase all of his interest. This ensures that the remaining owners can seek a new active owner to join their efforts, and it ensures the disabled owner and his family has liquidity to meet their financial needs instead of an unmarketable business interest. The agreement should have a clear definition of "permanently disabled," including how long the disability must last before triggering the buy-sell obligation – anywhere from six months to two years. If disability income insurance is purchased to fund the agreement, the agreement's definition of disability should be made to match the definition that triggers a claim under the policy.

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Departure – Under Good Terms or Bad	When an actively employed owner leaves the business, he should be required to sell all of his interest to the remaining owners (or to the company); and the remaining owners (or the company) should be required to purchase all of his interest. This ensures that the remaining owners retain full control of the business. A departing owner may also be subject to non-compete provisions (usually contained within a separate employment agreement). The buy-sell agreement may discount the purchase price (and extend the payment terms) when an owner chooses to leave prior to retirement. When an actively employed owner is fired from the business, he should be required to sell all of his interest to the remaining owners (or to the company) and the remaining owners (or the company) should be required to purchase all of his interest. This ensures that the remaining owners retain full control of the business. If the termination is "for cause," the purchase price may be discounted (and the payment terms extended).
Involuntary Transfer	When an owner's interest is transferred to a third party due to a court action, the buy-sell agreement should require that the transferee sell all of the transferred interest to the original owners (or to the company); and the original owners (or the company) should be required to purchase all of the transferred interest. This ensures that the original owners retain full control of the business. When the transfer is to an owner's ex-spouse, often the divorced owner will be given the first right to purchase the transferred interest.
Valuation	Typically, there are three ways to value a closely held business: by an "agreed value," by a "formula value" or by "appraised value." Regardless of the method(s) specified, the owners must confirm on a regular basis that the resulting values are accurate representations of their interests in the business, and that they (or their surviving family) would be treated fairly under the terms of the agreement. **Agreed Value –** The agreement requires the owners to periodically arrive at a value that will be used to determine the purchase price when a triggering event occurs. An "Exhibit" attached to the agreement will provide spaces to record these values as they are updated. **Formula Value –** The agreement specifies a formula based on the company's financials. Examples include three-year average of net book value, adjusted book value, weighted five-year average EBITDA (earnings before interest, tax, depreciation and amortization), and multiple of earnings. The owners can create any formula they believe accurately captures the fair market value of their company. However, complicated formulas with multiple components can be difficult to interpret, can be burdensome to calculate, and can provoke disputes among parties when applied as a result of a triggering event. **Appraised Value –** The agreement specifies a process for selecting one or more independent appraisers and the standard of value to be used in the appraisals. The "as of" date for pricing should be clearly specified for each triggering event. For death, the date of death is usually the "as of" date. For disability, the "as of" date is usually upon expiration of a waiting period.

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Purchase Terms	Although the buy-sell agreement may require the purchase price be paid in full at closing, doing so can cause cash flow problems for the business and the remaining owners. Most agreements permit the purchase price to be paid in installments over a period of years, typically from three to 10. The agreement will specify payments be made monthly, quarterly or annually. A down payment is usually specified in the range of 15-30 percent. When the triggering event is death and death benefit proceeds are available, the minimum down payment may be specified as the lesser of the insurance proceeds or the purchase price. The unpaid purchase price should be evidenced by a promissory note setting forth the terms of the loan, including an interest rate. For agreements involving family members, the interest rate should be no less than the applicable federal rate. For non-family members, the interest rate is often a floating rate based on the prime lending rate (perhaps with a spread).
Funding	To purchase the interest of a deceased, disabled or withdrawing business owner, there are essentially five sources of funds: 1. The business's assets or operating profits 2. A sinking fund 3. Bank financing 4. Seller financing 5. Life insurance Using life insurance offers the following advantages: • Complete financing is guaranteed from the beginning • Death proceeds are generally free from federal income taxes • Depending on the type of policy used, the policy may be used to build a tax-deferred "sinking fund" of the business, allowing the policy's cash value to be used for a buyout due to retirement or disability • The premiums paid are usually a fraction of the death benefit, i.e., discounted dollars • The business's credit position is strengthened
Summary	An effective buy-sell agreement provides assurance to the surviving or remaining owners that their business will continue to thrive. It also provides deceased, disabled or retiring owners with liquidity to meet their needs. Overall, a buy-sell agreement gives the business's owners, employees, suppliers, customers, lenders and bonding agents comfort and security that the business will successfully survive the death, disability or retirement of one or more of its owners.

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