

Buy-Sell Agreements

Impact on Business Transitions and Finance Opportunities

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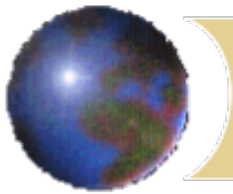
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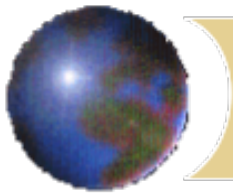




Buy-Sell Agreements

Introduction

- **What is a Buy-Sell Agreement - Basic Concepts**
- **Briefly – Some Economic Perspectives**
- **Triggering Events**
- **Why**
- **Common Types of Agreements**
 - **Cross Purchase Agreements**
 - **Stock Redemption Agreements**
 - **Hybrids**
- **Deadlocks**
- **Funding – Including Funding with Insurance**
- **Valuation**
- **Tax Implications**
- **Issues and Checklists**
- **Case Study Examples**

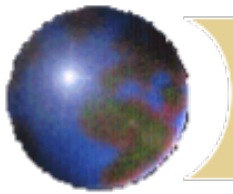


Buy-Sell Agreements

What is a Buy-Sell Agreement - Basic Concepts

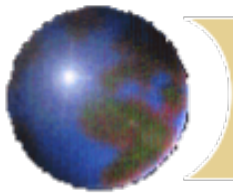
- **Binding contracts by and between co-owners within the same business**
 - Control and guide when the co-owners can sell their interest
 - Who can buy an owner's interest
 - What price will be paid
- **Contract that structures the terms of a future sale of an owner's business interest**
 - Purchase of a co-owner's interest

 - Sale to an outside third-part
- **Otherwise referred to as**
 - "Stockholder Agreements,"
 - "Partnership Agreements" and others



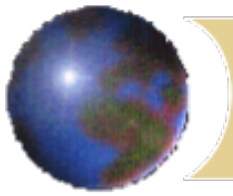
Buy-Sell Agreements Economic Perspectives

- **Buy-Sell Agreement creates a market for the business when the owner exits**
 - Establishes a pre-determined price or formula in sale of interest
 - Resolves non-public, non-marketable security interests dilemma of closely-held company – regardless of entity type
- **Buy-Sell Agreement creates limits and controls on future events**
 - Limits who is allowed to be a future owner
 - Determines what events will “trigger” a transition
 - What price and how valued
 - How the transition will be funded



Buy-Sell Agreements Triggering Events

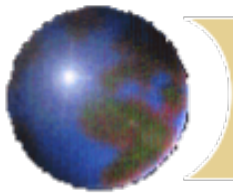
- **The terms of a buy-sell agreement are initiated at the occurrence of a specified “triggering event.”**
 - Death disability, or retirement of the business owner or co-owner
 - Divorce
 - Bankruptcy
 - Termination of employment
 - Creditor’s judgment against an owner
 - Loss of professional license
 - Reaching of a certain age
 - An acquisition or initial public offering
 - A third party offer to purchase
 - Or some other change in personal, business or family circumstances



Buy-Sell Agreements

Why

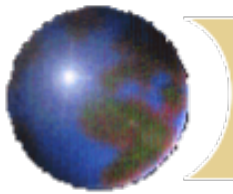
- **Every business needs a pre-defined exit strategy**
 - **Even those that have optimal internal relationships, organization and structure and are highly successful**
- **Protects both sides in the transaction and structures the exit strategy in advance**
- **Death or disability of the business owner in a closely-held company**
- **Resolve the “unknown” financial and legal complexities**



Buy-Sell Agreements

Why

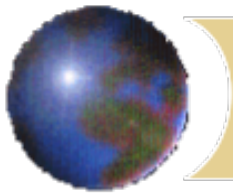
- **The primary justification for a buy-sell agreement is liquidity**
 - There is no public forum, such as the NYSE, for the selling of ownership in a closely-held company
 - Minority stockholders, partners or shareholders have a particularly difficult problem since there is a lack of control and their votes are overshadowed by majority shareholders who may have entirely different ownership motivations
 - Orderly disposition of shares with a fair price paid to the seller
 - Essentially sets out a strike price well in advance for the departing shareholder's stock



Buy-Sell Agreements

Why

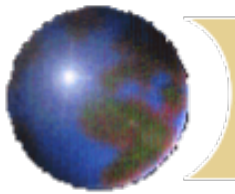
- **A properly drafted buy-sell agreement can achieve these goals:**
- **Guaranteed that owner's interest in the business will be purchased**
- **Determine who may or will buy owner's share**
- **Provide a purchase price determination based upon pre-set criteria**
 - **A fair, reasonable purchase price is established among all parties while the business is vital,**
 - **not when it's vulnerable to a lower price after an owner's death**
- **Provide a funding source so that liquidity needs of the business is met**
- **Create a valuation of a deceased owner's interest in the business for estate tax purposes**
 - **A fair method of arriving at an acknowledged business value for federal estate tax purposes**
 - **IRS generally accepts if the agreement is set up properly.**
- **Business can continue to be managed properly going forward**



Buy-Sell Agreements

Common Types of Agreements

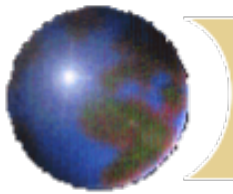
- **There are two basic types agreements***
- **Cross-Purchase Agreement**
 - Each co-owner individually agrees to buy a portion of the deceased or departing owner's interest
- **Stock Redemption Agreement**
 - Corporation is obligated to purchase the exiting co-owners shares
- ***Hybrid Agreements**
 - Which are essentially a combination of the two



Buy-Sell Agreements

Cross Purchase Agreements

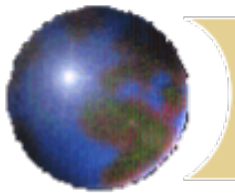
- **Features of Cross-Purchase Agreements:**
 - **Surviving owners have a tax basis equal to the fair market value of the decedent's stock at the date of death, thus avoiding income tax consequences as a result of the sale by the step-up in basis**
 - **Can fix the value of the business interest for federal estate tax purpose**



Buy-Sell Agreements

Cross Purchase Agreements

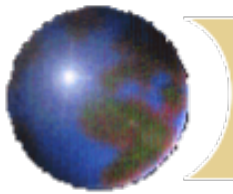
- **Features of Cross-Purchase Agreements Funded by Insurance:**
 - **Cross-purchase buy-sell agreements funded by insurance offer several advantages in a death or disability-triggered event**
 - **Life insurance proceeds received by the surviving owners are not subject to income taxation**
 - **More difficult to administer for numerous shareholders**
 - **Five owners, for example, would be required to have 20 agreements**
 - **(number of shareholders) * (number of shareholders – 1)**
 - **Five owners would require 20 life insurance policies**
 - **Age of the insured can create a disparity in premiums**



Buy-Sell Agreements

Cross Purchase Agreements

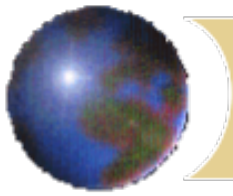
- **Features of Cross-Purchase Agreements Funded by Insurance:**
 - Insurance proceeds not subject to the corporate alternative minimum tax (AMT)
 - Insurance proceeds not subject to the claims of corporate creditors (but are for owner's creditors)
 - Purchase of policies by a surviving shareholder will create a transfer for value which may cause the proceeds to be partially subject to income taxation
 - Funds not available for business unless shareholder is willing to lend



Buy-Sell Agreements

Cross Purchase Agreements

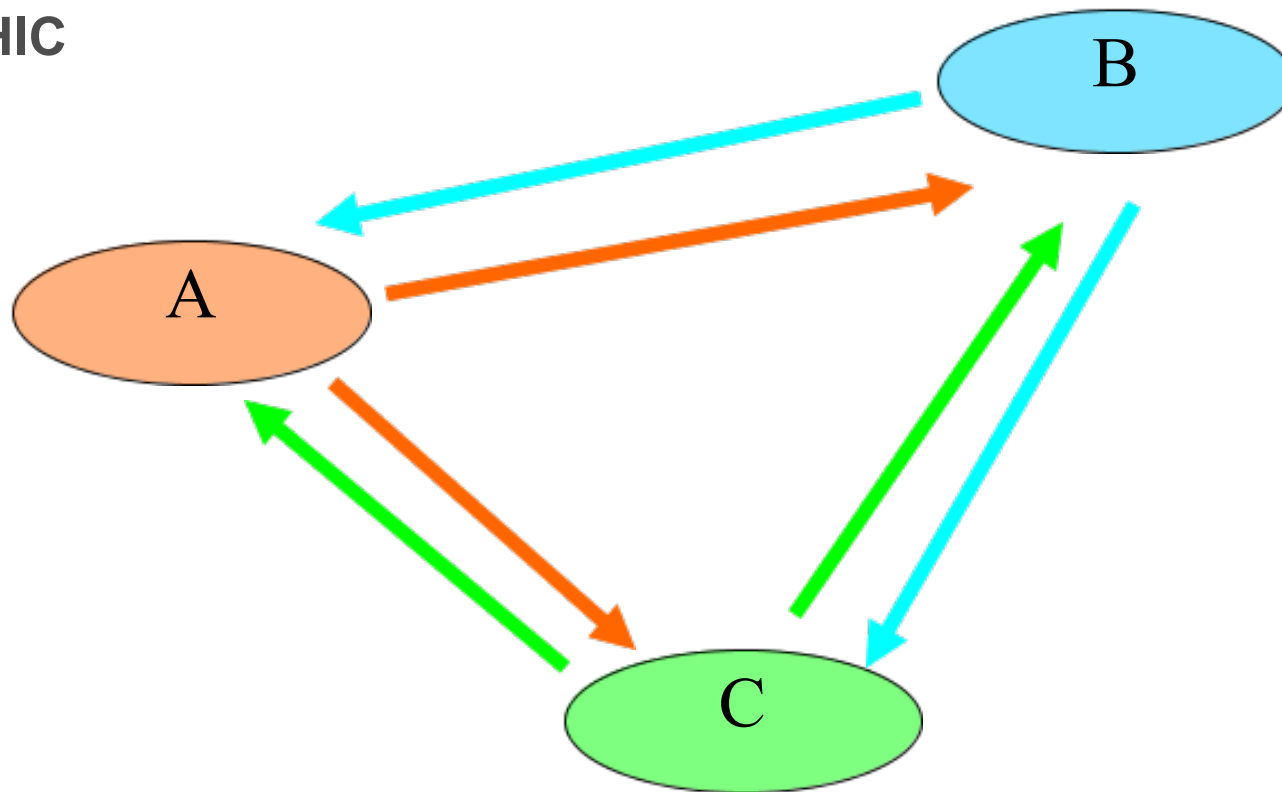
- **Features of Cross-Purchase Agreements Funded by Insurance**
 - Stockholder may allow the policy to lapse if having trouble paying the premium
 - Insurance with the same coverage may cost individuals more than if purchased by the corporation
 - Depending upon whether the corporation is in a lower tax bracket than the individuals
 - If corporation pays on behalf of a shareholder, it must be treated as additional compensation (and taxed accordingly)

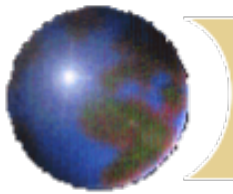


Buy-Sell Agreements

Cross Purchase Agreements

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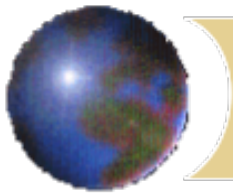




Buy-Sell Agreements

Stock Redemption Agreements

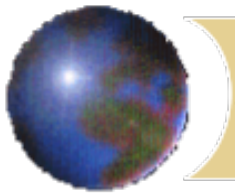
- **Also known as “Corporate” or “Entity” Buy-Sell Agreements**
- **Features of Stock Redemption Agreements**
 - Surviving stockholders own a larger percentage of the outstanding shares
 - *But...* Surviving stockholders basis in the stock remains unchanged, causing a higher capital gain at a later sale of the stock
 - **Variety of funding options:**
 - The corporation is responsible for financing the purchase, which may be funded by the immediate use of the business’s resources (such as corporate savings), a financing arrangement defined by the agreement, remaining owners’ personal savings or life or disability insurance on the life of the departing owner



Buy-Sell Agreements

Stock Redemption Agreements

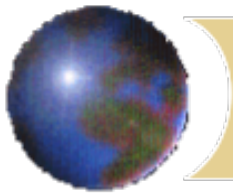
- **Features of Stock Redemption Agreements Funded by Insurance**
- In an insurance-funded scheme, the business owns the policies on the lives of the shareholders
 - Business is owner, beneficiary and premium payer
 - Need only one policy for each shareholder (no multiples of agreements & policies)
- When a shareholder dies or departs, the corporation pays the survivors with the insurance proceeds
- The corporation does not recognize income when it receives the insurance proceeds for tax purposes



Buy-Sell Agreements

Stock Redemption Agreements

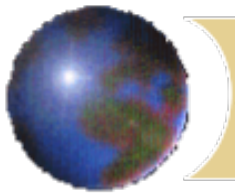
- **Features of Stock Redemption Agreements Funded by Insurance**
 - Cash values and proceeds generally available to creditors
 - Premium payment is “pooled” – averaging discrepancies based on age, etc
 - Life insurance proceeds included in adjusted current earnings for purposes of AMT
 - *But...* state laws may require redemptions only made from surplus
 - *But...* total redemption of a decedent's stock could be treated as a taxable dividend
 - (IRC § 318 “Family attribution rules)
 - *But...* voting control could be alerted undesirably
 - A with 30% and B with 30% combined control; C at 40% has no control
 - if A departs; C will now have 57% and control



Buy-Sell Agreements

Typical Hybrid – “Wait and See”

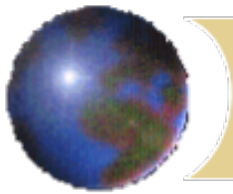
- **Scenario One:**
 - Surviving shareholders have the option to purchase the shares
 - Collect insurance proceeds or buy the shares
 - Business has the obligation to redeem the shares that are not purchased by the shareholders
 - If shareholders initially pass, later purchase by business will likely be a taxable dividend
- **Scenario Two:**
 - Surviving shareholders collect insurance
 - Lend proceeds to the business in exchange for interest-bearing note
 - Business redeems the shares



Buy-Sell Agreements

Typical Hybrid – “Wait and See”

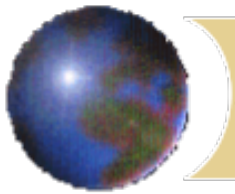
- **Scenario Three: *derivation of first example***
 - Business has first option to purchase shares at set price or formula
 - Collect insurance proceeds or buy the shares
 - If business fails to exercise option, shareholders have 2nd option
 - Business is required to buy whatever shares are remaining



Buy-Sell Agreements Deadlocks

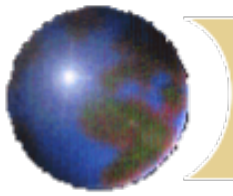
- **Texas shoot-out: *highest sealed bid “wins” right to BUY***
 - Each party sends a sealed all-cash bid to an umpire
 - Sealed bid states the price at which they are willing to buy out the other party
 - Sealed bids are opened together
 - High bidder must then buy (and the “loser” must sell) the other half share in the business.

- **Dutch Auction: *highest sealed bid “wins” right to SELL***
 - Each party sends a sealed all-cash bid to an umpire
 - High bidder must then sell (and the “loser” must buy) the other half share in the business



Buy-Sell Agreements Deadlocks

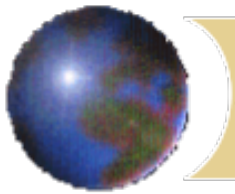
- **Russian Roulette: *one survivor***
 - One of the two deadlocked parties serves notice on the other
 - Serving party names all-cash price of half interest in the business
 - Party receiving the notice has option *at that price*
 - To either buy out the other party
 - Or sell out to the other party



Buy-Sell Agreements

Triggering Events

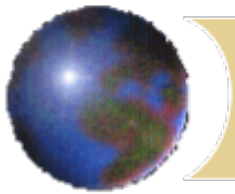
- **Death**
- **Disability**
- **Divorce**
 - A divorce settlement in which a member's ex-spouse stands to receive an ownership interest in the company creates substantial changes
- **Foreclosure and/or Bankruptcy**
 - Notify other co-owners before filing and sell the bankrupt owner's interest
 - Buyout money goes to the bankruptcy trustee
 - Business continues, but without bankrupt co-owner



Buy-Sell Agreements

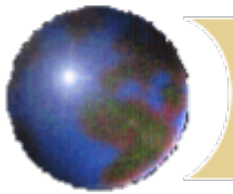
Triggering Events

- **Unilateral Resignations**
 - Option to buy out the departing business owner's ownership interest
- **Default**
 - A shareholder defaults, a buyout is triggered for his or her interest
- **Disagreement among owners**
 - In that case, it would probably make sense to purchase a minority shareholder interest forced out of active employment



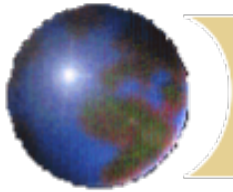
Buy-Sell Agreements Triggering Events

- **Outside Third-Party Purchase**
 - An attractive offer from an outsider to purchase a member's interest in the company



Buy-Sell Agreements Funding

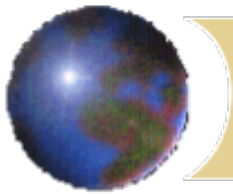
- **A solidly funded buy-sell agreement demonstrates the strength of the business to investors and creditors while assuring its employees and customers that the business is prepared to meet unexpected challenges.**
- **Proper funding plans in place can help safeguard the business from liquidity demands that might otherwise cripple or bankrupt the business**



Buy-Sell Agreements Funding

- **Personal Funds of Owners**
 - Successful businesses do not keep large sums of liquid assets on hand
 - Money is working capital invested in the business
 - Wasteful unless it earns substantially greater returns than would have resulted in an investment in the business.

- **Sinking Fund in the Business**
 - Funds are accumulated over time and specifically set-aside
 - Advantage is the funding is apportioned over an estimated period before dollars will be required
 - Risk is that funds will be inadequate if death
 - Corporation may develop an accumulated earnings tax problem



Buy-Sell Agreements Funding

- **Borrowed Funds**

- **Co-owners or the company funds from a lender**

- Seller is paid in full at the time of sale.
- Borrower repays the lender after that transaction over an extended period of time
- Business must generate sufficient cash flow to make the required payments.
- Ability to generate income may have required the performance of the now departed key owner,
- Creditworthiness of the business and the other owners may be impaired.
- Interest on a loan might be excessive,
- Loss of a key person may impair the credit-worthiness of the business and other partners and shareholders
- Interest costs may be excessive and interest expense may not be deductible.