BUY-SELL AGREEMENTS
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What Are Buy-Sell Agreements - The Basic Concepts

A “buy-sell agreement” is a contract that structures the terms of a future transfer of an owner’s business interest, either for a purchase of a co-owner's interest in the business, or for a sale to an outside third-party. “Buy-sell agreements,” also known as “business continuation agreements,” “stock purchase agreements,” and “buyout agreements” are binding contracts by and between co-owners within the same business that control and guide how and when the co-owners can sell their interest, who can buy, and at what price will be paid.

The “buy-sell agreement” is not directly about buying and selling businesses; that is more properly the function of a “purchase and sale agreement,” yet the existence of a “buy-sell agreement” and what provisions it may provide have a significant impact in essentially all phases of the life-cycle of a small business including when the business is eventually sold. Whether a business owner exits by choice or by chance, a “buy-sell agreement” acts like a “business will” and allows the exiting owner or his or her estate to have reasonable expectations as to how the business will continue to provide for family, employees and partners that depend on it, or how the business or its assets are liquidated or sold.

In an economic perspective, a “buy-sell agreement” creates a market for the business when a partner or owner exits. This agreement establishes a predetermined valuation based on an agreed-upon criteria, formula or scheme for the liquidation or transition of the business interest which otherwise is generally unavailable to owners in a closely-held company for which there are no ready buyers as compared to the larger public market of securities.

Typical terms of a “buy-sell agreement” control substantive decisions in the sale or liquidation of the business that generally include limits on the owner or co-owner’s freedom to sell the business to outside parties. Such limits include:

1. Who can buy a departing member's share of the business (this may exclude outsiders or be limited to other business members);

2. What events will trigger a buyout;

3. What price will be paid for an owner's interest in the business and how that valuation is derived; and

4. How will this transition be funded.

The implementation of a "buy-sell agreement" is initiated at the occurrence of a specified "triggering event." Typical triggering events include death, disability, or retirement of the business owner or co-owner; however a growing practice is to include 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, or some other change in personal, business or family circumstances. Another is a third party offer to purchase. A seller and a buyer might enter into a contract for the transfer of the business interest by the seller or the seller's estate, which becomes such a "trigger."

There are three general types of buy-sell agreements: the more common in small, closed corporations and partnerships is a "cross-purchase plan" in which one or more of the applicable co-owners purchase the shares of the exiting co-owner or co-owners. Alternatively, a "repurchase," "entity" or "stock-redemption" plan requires the entity itself to purchase or redeem the shares. In either plan, the more frequent objective is for remaining co-owners to continue operation of the business and to keep ownership and control in the hands of the existing individuals and to compensate the exiting ownership interest. Typically, the buy-sell agreement eliminates many of the complications of having a surviving spouse (or even the entire family) become a new member within the ownership structure when the triggering event is the death of a co-owner.

A third buy-sell agreement is a "hybrid" with characteristics of both "cross-purchase" and "entity" agreements designed to resolve disputes between co-owners or where an outside party participates. Regardless what "type," the objective remains the same: a market is created for the business when a partner or owner leaves the business, and establishes a predetermined business price and procedure as to how to transfer the business interest.

The ability of the remaining owners or the company to purchase the exiting ownership interest is critical. Simplistically, the company can purchase a series of "key person" life insurance policies or establish some other reliable funding source such as investment accounts specially designated for these purposes to ensure that cash will be available when the "triggering event" occurs. More than even, buy-sell agreements are being fully or partially funded through insurance schemes, with life and disability insurance frequently used for this purpose. When properly configured, insurance helps eliminate doubts about the continuation of the business, avoid the dilemma of being in business with the partner's

survivors, and perhaps most important, provides assurance to lenders and investors of the continuity of the business, which may facilitate access to capital.

In the sale of a business, a buy-sell provision commonly referred to as a “Shotgun clause” requires a shareholder to offer a specific price per share for the other shareholder(s)’ shares. The other shareholder(s) must then either accept the offer or buy the offering shareholder’s shares at that price per share. This is also an attempt to preserve the continuity of ownership in the business with the objective of treating all parties, both buyer and seller, fairly.

Why Buy-Sell Agreements Are Important

Most business start with the best intentions, but not every entity involving multiple owners is successful. Moreover, every business, even those that have optimal internal relationships, organization and structure and are highly successful need a pre-defined exit strategy. A typical buy-sell agreement protects both sides in the transaction and structures the exit strategy in advance; it protects owners by guaranteeing that a departing owner’s shares will be transferred to an agreed-upon party at an agreed-upon price, and protects a departing or exiting owner by helping assure a fair price for their share of the business.

The death or disability of the business owner in a closely-held company is the most traditional common justification for a buy-sell agreement. Issues such as whether a sole proprietorship would be liquidated; whether a partnership or limited liability company would be dissolved; and how would corporate shareholders face the financial and legal complexities of buying the deceased owner’s shares or face the unknown of a new shareholder are typical considerations.

A properly drafted buy-sell agreement can achieve most, if not all of these goals:

1. Provide that upon a specified “triggering event,” owners are guaranteed that their interest in the business will be purchased;

2. Require that the owner’s interest must be sold either to the company, the remaining owners, a combination of the two, or sold to an outside party;

3. Provide a purchase price determination based upon pre-set criteria; resulting in a fair, reasonable purchase price agreed by and between all parties and acceptable for tax purposes while the business is vital, not when it's vulnerable and under pressure to sell, often resulting in a lower price after an owner’s death.

4. Provide a funding source so that the liquidity needs of the business or its owners is available;

5. Create a valuation of a deceased owner’s interest in the business for estate tax purposes using a fair method of arriving at an acknowledged business value for federal estate tax purposes which the IRS generally accepts if the agreement is set up properly.

6. Avoid the likelihood that there will be no unwanted owners in the business future and that the business will continue to be managed properly by those previously selected.

Liquidity

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 they lack control by virtue of their minority status and their votes are overshadowed by majority shareholders who may have entirely different ownership motivations.

The buy-sell agreement helps assure each stockholder that there will be an orderly disposition of shares with a fair price paid to the seller in an exit. In the case of a single owner, it assures the heirs who are unable or uninterested in running the business that they can sell at a price without being forced to sell at a reduced liquidation value. In the case where a participating owner dies, the decedent's estate will have liquidity by converting the business interest into cash at a fair, agreeable price. Proceeds then can be used to settle the estate and establish an income stream for beneficiaries.

A buy-sell agreement essentially sets out a strike price well in advance for the departing shareholder's stock, creates a market for the business interest and assures business continuity for the remaining active owners, employees, customers and creditors.

Taxation Issues

Upon a business owner's disability, retirement, or death, his or her family continues to need cash to pay ordinary living expenses as well as potential estate tax liability. Estate taxes are usually due nine months after the date of death; yet forcing a business sale under these distressed circumstances can result in the survivors receiving less than the fair market value. A suitable "buy-sell agreement" may be able to fix the value of the ownership interest for the calculation of federal and state estate taxes. In the absence of an agreement, the government could challenge the value used in these calculations because tax laws affecting the heirs of family businesses make it very likely that the shares will be included in the estate even though they were gifted many years earlier.

Control and Management Issues

Without a buy sell agreement, the death or disability of an owner can leave surviving business owners or heirs faced with unanswered questions regarding an uncertain future. Questions such as who will control the business; how the family of the of the deceased or disabled owner becomes involved and whether the heirs want or need to sell their share of the business for taxes or provide liquidity all create uncertainty.

The properly constructed Buy/Sell agreement provides the guidelines as to how the business is to proceed under a variety of circumstances and planning for the financial aspects of the transition. Doing this ahead of time can assure both business continuity and security, and create a fair market for the closely held stock, allowing the various affected stakeholders with access to liquid assets to meet estate-related

expenses. Moreover, it may be desirable to have the owner's heirs inherit cash rather than shares in a risky enterprise.

One outcome of the process of drafting buy-sell agreements is a more coherent management and ownership "team." When all "stakeholders" in the venture communicate freely about continuation of the business, a greater level of comfort can be created should one or more of the partners be unable or unwilling to continue in the venture. Buy-sell agreements between the "partners" can enable the business to not only survive and thrive, but also create an optimal scenario for a variety of exit strategies including the outright sale of the business to a third-party.

Business Credibility

One of the biggest issues in small closely held businesses is "insecurity." Within a closely held business, surviving owners generally want to ensure a continuity of ownership and management without having a departing owner's successor thrust upon them. In addition, they do not want to unduly compromise the liquidity needs of the business by funding a significant buyout, yet the owner's' survivors should be compensated fairly for their share of the business. When an owner exits, for whatever reason, many lives can change and the course of a business may be altered. Without a plan, the loss of a key shareholder may cause uncertainty among shareholders, customers and other stakeholders including creditors and lenders, resulting in possibly impaired credit. Another potential negative outcome is confusion and declining morale among employees.

A properly constructed buy-sell agreement helps promote an orderly transition into a new ownership structure. It lets the various business ownership interests agree to the terms and conditions of a future sale and can smooth the transfer of ownership interest under otherwise disruptive circumstances such as a partner's death, retirement, disability or divorce (as in the transfer of ownership to a spouse), bankruptcy, insolvency or a third-party purchase of the business. Having an agreement gives an owner a ready market for their business interest, resolves estate liquidity issues, and provides a framework for establishing the purchase price and reduces disputes.

Common Types of Buy-Sell Agreements

There are two basic types of buy-sell agreements: a "cross-purchase agreement" where each owner agrees to terms for the purchase of the shares of an exiting co-owner; and a "repurchase," "entity" or "stock redemption agreement" where the corporation is obligated to purchase the exiting co-owners shares. In either situation, the other co-owners or corporation may fund these transactions through insurance on the exiting shareholder by being both owner and beneficiary of the policies. Upon the exit or departure through death or otherwise of a shareholder, the other shareholders or corporation use the insurance proceeds to purchase the exiting owner's shares. A third version is a "hybrid agreement" which

are combinations of both cross-purchase and entity redemptions that generally put the priority for redemption with the corporation, but leave shareholders with an option of directly redeeming an exiting owner's shares if the corporation is unwilling or unable to do so.

Cross-Purchase Agreements

Under a cross-purchase type of buy-sell agreement, each co-owner individually agrees to buy a portion of the deceased or departing owner's interest. Cross-purchase buy-sell agreements funded by insurance offer several advantages in a death or disability-triggered event. (See the section on Life-Insurance schemes) Surviving owners have the funds to compensate departing owners or heirs and maintain control of the business. The departing owner or heirs receive a fair price for their interest with all of the terms of the sale decided in advance.

The life insurance proceeds received by the surviving owners are not subject to income taxation. The surviving owners such as the family of the deceased owner will 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 that can reduce the capital gain taxes on any future sale of the business interest. This presumes that the buy-sell agreement must clearly define the fair market value of the shares. A properly drawn agreement can fix the value of the business interest for federal estate tax purposes.

The corporate shareholders in a cross-purchase scheme will be entitled to a tax basis equal to the purchase price of their newly purchased shares and the stepped-up basis will likely reduce future income taxes if surviving shareholders later sell these interests. Because the proceeds are paid directly to the individual shareholders, the insurance proceeds are not subject to the corporate alternative minimum tax (AMT) and are also not subject to the claims of corporate creditors.

Disadvantages associated with cross-purchase buy-sell agreements include difficulties in administering the plan if there are numerous shareholders that must buy a plan for each other. Six owners, for example, would be required to have 30 agreements [6 * (6-1)]. If insured, this example would require 30 life insurance policies and more if disability coverage were also part of the buy-sell agreement. A significant and common error can be made where co-owners simply exchange existing policies or simply name a co-owner as a new beneficiary of an existing life insurance policy because one or more co-owners have health problems and are now uninsurable. In these cases an otherwise federal-income-tax free life insurance death benefit payment becomes fully taxable under the "transfer for value rule."

Another disadvantage is where the age of the insured creates a disparity in premiums: younger and/or healthier owners may have to incur higher premiums to cover older and less healthy owners. If the company raises compensation to cover for the higher premiums, inequities may be created if marginal tax rates are different. Also the cost of funding the buy-sell agreement will be greater if the shareholders have

a higher tax rate than the corporation and cash values accumulating in the policies are not available to the business itself since the policies are individually owned.

Stock Redemption Agreements

In a stock redemption agreement, the corporation or business entity, and not the individual shareholders, buys the exiting shareholder's interest in the company. 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.

The corporation must, however, record the net economic effect of the aggregate transaction for proceeds received and redemption accomplished on the earnings and profits of the corporation. The earnings and profits will increase with the life insurance proceeds received and decrease from the payment of the stock redemption. The corporation must consider how that might affect the dividend policy to shareholders such as having to issue dividends to avoid the accumulated earnings tax on earnings and profits, assuming that the reasonable needs of the business do not justify maintaining earnings and profits above the $250,000 credit (see IRC § 535). These added dividends would be taxed to the remaining shareholders at ordinary income rates.

The significant advantage of the stock redemption agreement versus a cross-purchase scheme is that redemption plans are easier to administer and the premium differences associated with age disparities among shareholders is essentially eliminated. The business is solely responsible for the plan's funding; yet the agreement can define the fair market value of the decedent's interest for estate tax purposes. When properly constructed, the estate or its beneficiaries will have no income tax on the purchase of the decedent's interest, as the basis of the interest will be equal to its sale price. If the agreement isn't fully funded and surviving owners borrow to fund the buyout, interest payments to the estate will be deductible on the entity's tax return.

A significant disadvantage of the stock redemption buy-sell agreement is that the remaining shareholders do not get the benefit of a step-up in basis when the corporation purchases the deceased shareholder's interest. The continuing shareholders retain their original basis in the company and may recognize greater capital gains upon the ultimate disposition of shares if made before death. After the stock is redeemed, the corporate assets are generally unchanged but each owner retains a greater percentage of ownership. Also, where a corporate entity is the beneficiary of buyout insurance, the proceeds of the policy may be subject to the alternative minimum tax.

Triggering Events and Examples

The buy-sell agreement is generally "triggered" by events such as an owner's death, disability, retirement, or termination of employment. Other events that trigger a buyout of a member's interest under a buy-sell agreement may include:

Sale to a Third-Party

An attractive offer from an outsider to purchase a member's interest in the company will significantly alter the dynamics of the company including control and financial share. This may be an excellent mechanism for the buyer to assume ownership and maintain continuity of the business, but poses substantial risks to all parties without an adequate contemplation of buy-sell agreement provisions. For example, in a case when a member sells their interest to an outsider, the remaining owners may be forced to share control of the company with an inexperienced or untrustworthy stranger. One possible outcome when that occurs could be a struggle among the variety of interests in the running of the business with someone no one wants.

Until the company has gone public or is well on its way so that shares can be readily traded, stock in a closely-held business is not a suitable passive investment. Passive shareholders such as "angels" financing a start-up venture can often be a management distraction, constantly questioning operating decisions and possibly threatening litigation. In order to allow the maximum flexibility, the business may want to have an option, and the terminating shareholder to have a "put," or mandatory sell agreement, to cause the purchase and sale of the stock. Without a "put," a terminating shareholder has no way to force a sale of his stock and may end up holding the stock indefinitely.

Divorce

A divorce settlement in which a member's ex-spouse stands to receive an ownership interest in the company creates substantial changes. In a divorce, the remaining owners may have to work with the spouse or another family member of a divorced owner. There is a substantial possibility that the family member would be inexperienced or otherwise unable to act in the best interests of the business.

Common-law property states, such as those in the northeast, equitably divide earnings during marriage and the property acquired with those earnings. In community property states, all earnings during marriage and all property acquired with those earnings are considered community property, owned equally by husband and wife. Regardless how the property is divided during a divorce, each spouse can claim a right to marital property of which interests in a business may be included. This is particularly applicable in settings where both spouses contributed or performed some functions in the business. To avoid this prospect, a better buy-sell agreement should require the former spouse of a divorced owner to sell any interest received in a divorce settlement back to the company or the other co-owners, according to a valuation method provided in the agreement.

Foreclosure and/or Bankruptcy

The foreclosure of a debt secured by an ownership interest or owner's bankruptcy might force the liquidation of the business. In the worst-case scenario, a bankruptcy trustee could liquidate the business by selling its assets and take proceeds to pay the bankrupt owner's debts. To prevent a business from getting tied up in bankruptcy, the owners can sign a buy-sell agreement that requires a co-owner who faces bankruptcy to notify the other co-owners before filing and automatically offer to sell the bankrupt owner's interest back to the other owners. The proceeds paid to the departing bankrupt owner go to the bankruptcy trustee, in which case the business can proceeds without being burdened by the bankruptcy and without the bankrupt owner's interest.

Unilateral Resignations

When a co-owner such as a partner in a partnership unilaterally resigns, without an agreement, the business might be automatically dissolved, forcing the partners to divide any assets and profits and decide whether to start a new business with the remaining business owners. If the business doesn't end, the owners may still decide whether to buy out the departing business owner's ownership interest, and for how much. A properly written buy-sell agreement could prevent the business closure.

Funding the Buy-Sell Agreement

A solidly funded buy-sell agreement demonstrates to investors and creditors, employees and customers, that the business is prepared to meet its obligations and overcome unexpected financial challenges. Proper funding plans in place can help safeguard the business from liquidity demands that might otherwise cripple or bankrupt the business. To adequately fund the business's buy-sell agreement obligations, each event that would trigger the payout provisions must be analyzed as possible scenarios that might occur immediately.

The funds to complete the transaction can come from several sources; each with particular benefits and detriments:

Personal Funds of Buyers

Most successful businesses do not keep large sums of liquid assets on hand because its money is working capital invested in the business. Consequently, liquid assets set aside for potential distribution to an exiting shareholder is 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 for purchasing the business interest. An advantage of a sinking fund is the funding is apportioned over an estimated period before dollars will be required. The principal risk is that funds set aside on a gradual basis will be inadequate if death is

premature and the time when needed is uncertain. A premature death may leave the surviving owners with insufficient assets to purchase the deceased's interest in the company.

A corporation may also develop an accumulated earnings tax problem, which could be detrimental to the business since these funds are essentially retained earnings that are either taxable corporate income or pass-through earnings to partners or sub-S shareholders. In either event, setting aside earnings for a possible future use not connected with business operations is a waste.

Borrowed Funds

The buyers as borrowers, either as other co-owners or the company itself receive the necessary funds from a lender. The seller as the exiting owner or owner's interest is paid in full at the time of sale and the borrower repays the lender over time. The primary issue with this scheme is that the business must generate sufficient cash flow to make the required payments but its ability to generate income may have required the performance of the now departed key owner. Accordingly, this loss through an owner's death, disability or retirement, could devastate the business. In such a case, the interest on a loan might be excessive, interest expense may not be deductible or it may be that the business will be unable to obtain a loan at all because the creditworthiness of the business and the other owners may be impaired.

Installment Sale

The seller or the seller's heirs essentially fund the transaction in the same or similar manner as the borrowing approach. However, this places the seller in a much less secure position. The business may fail and the payments stop. The principal and interest payments may be too burdensome. Unfortunately, the seller remains dependent upon the business but without a hand in its management.

Current Cash Flow/Earnings

Similar in many respects with a "sinking fund" except that payments from earnings are projected into the future. The shareholders take the chance that when the time comes to implement the terms of the agreement, the business will have sufficient cash flow to make the necessary payments.

The principal difficulty with this approach is that a closely-held company's ability to generate income may depend in large measure upon the efforts of a key owner. Their death, disability or retirement may substantially diminish the company's earning power and leave it with little advance planning.

Life Insurance Owned by the Buyer: either Other Co-Owners or the Company Itself

Life insurance may be the most economical means of ensuring the funds with which to purchase a deceased owner's interest. The incidence of death creates the funds needed to complete the purchase and resulting death benefits generally go to the remaining business owners untaxed, untouched and reliably on time.

There may be several key advantages to life insurance in funding a buy-sell agreement:

1. Complete financing guaranteed from the beginning;
2. Death proceeds are generally free from federal income tax;

3. Cash values can be used for a buyout due to retirement or disability;

4. It may be the most economical method in discounted dollars;

5. Credit position of the company is strengthened.

More regarding Insurance Funding in a later section.

Valuation Issues in Buy-Sell Agreements

Business valuations are detailed and varied; procedures and calculations require volumes of text and a complete discussion is beyond the scope of this article. However, when it comes to buying or selling a business, an appraisal is essential and the underlying concepts are straightforward: as long as the parties agree and the valuation technique and application is justifiable, parties can contract in whatever way the choose to arrive at a valuation. If the parties have agreed to the formula, and it is reasonable or rational and consistently applied, it is extremely unlikely that a challenge of its result will be successful. A brief summary of valuation techniques involving buy-sell agreements include:

Fixed price

The partners simply agree on a price for the business and put that number in the buy-sell agreement.

Fair market value

This is a price, expressed in terms of cash equivalents, at which the property would change hands "between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." United States v. Cartwright, 411 U. S. 546 (1973). Under this fair market value standard, a 10% interest in a company valued at $100 might be worth more or less than $10: less because lack of control or the lack of ready marketability results in a discount; more if there is a premium on the company such as intellectual property or unique market position or products.

Fair value

Fair value is typically defined by statute and case law in the state in which a company is organized and commonly interpreted as what is fair or equitable. In New Hampshire, provisions in the state's "Business Corporation Act," RSA 293-A cover the relevant definitions. In Massachusetts, MGL Chapter 156B. "Certain Business Corporations" specifies the process to determine "fair value." In some states such as Delaware, this includes discounts for lack of control or marketability. (see "Discount Issues" below). When fair value is not subject to discounts, it is typically a pro rata value of 100%. Broadly, 10% of a company worth $100 would be $10 under those fair value statutes.

Formula pricing

The appeal of formula methods is that they are objective and inexpensive to determine, but may miss subjective factors that influence the fair market value. Companies using a formula price should

revisit the formula periodically to make sure it remains representative of business valuation and the owner's intentions.

Book value

Book value is net value of the company's assets minus its liabilities as shown on its most recent year balance sheet based on the business's records, tax returns or under generally accepted accounting principles (GAAP). Values are not typically indicative of fair market value and are likely to be significantly lower, especially in a thriving business, because goodwill is not recorded. In addition, since conventional accounting practice is based on an historical cost principle, most assets remain on the entity's books at historical cost regardless whether they gain value or not.

Multiple of book value

As noted, if a business has been operating successfully for several years, its real value is probably greater than its book value. The multiple-of-book-value method takes into account intangible assets such as intellectual property that add to a company's worth such as patents, copyrights, brand names and trade names.

Value based on insurance proceeds

Simply stated, this is the amount of an owner's life or disability insurance policy proceeds. However, like "book value," this simple method may not appropriately reflect fair market value and differences may cause tax consequences for the redeemed owner.

Capitalization of earnings

Applying this method determines a company's value by multiplying the average earnings or cash flow for a given period by a specified capitalization rate with adjustments for extraordinary items and excess compensation to owners. Calculations based on its past profits may work better for established companies with a solid financial history and are usually based on a weighted average of cash flow to take into account earnings trends. The capitalization rate used as the multiplier is based on the rate of return a hypothetical investor would expect elsewhere in an investment with comparable risk such as the "cap rate" or sales price for comparable companies in the same or similar industry or sector.

Alternative Approaches

Hybrid agreements include so-called "wait-and-see" agreements, which combine attributes of other formulas and require some definitive response from an interested or participating party. One example is where the issuing business has the first right of refusal to buy the ownership interest, with other owners holding the second option to buy. This order of consideration is important because if the corporation uses accumulated earnings and profits to assume a shareholder's obligation to purchase another's stake in a business, the IRS may impute a constructive dividend to the shareholder and reclassify the proceeds as a dividend distribution, which causes a tax consequence for the shareholder who received this benefit.

Discount Issues

Unlike the large marketplace of public securities, there is no a ready market for interests in closely held businesses. As a result, buy-sell agreement valuations frequently apply a “lack-of-marketability” discount when determining the value. If the interest is not controlling, a minority-interest discount also may apply. The combined discounts typically range between 20% to 40%, and as high as 60%.

The IRS may disallow a minority-interest discount and apply a swing-vote premium. For example, if a 2% interest in a business is being valued for gift tax purposes and there are two other shareholders each owning a 49% interest, the fair market value of that 2% interest may have significant and valuable controlling aspects and consequently not be discounted. The IRS requires an appraiser look at eight elements: the business’ nature and history, estimates of risk and future returns, economic and industry conditions, book value and financial condition of the company, earnings capacity, dividend-paying capacity, goodwill and other intangibles, and previous stock sales of not only the company but comparable firms.

Buy-Sell Funding with Insurance

A buy-sell agreement is often funded with life insurance on the life of each owner and may be structured as a redemption, in which case the company owns the insurance policy, or a cross-purchase, in which case each owner holds life insurance on the life of each other owner in amounts sufficient to pay for the specific business interest. The primary advantage of using insurance as a funding mechanism is that the proceeds of life insurance are not ordinarily subject to income tax. Otherwise, if there is no insurance, the funding will come from either after-tax income of the remaining owners or corporation. Each situation will be different, so individuals and businesses are advised to seek the advice of a tax or insurance specialist to fully explore available strategies. This article presents a summary of the issues only.

Choice of Whole Life or Term Insurance

Premiums for whole life are level throughout the coverage period while premiums for term life insurance increase. Owners, therefore, must weigh the escalating premium structure of term insurance against the early returns that might be realized by purchasing less-expensive term insurance and investing the premiums saved.

Whole life insurance with cash value buildups has advantages such as becoming a supplement to pension benefits or partial funding for shareholder buyouts when policies are held for a significant number of years. The policy’s cash value is a liquid asset of the corporation that may also help secure advantageous loan terms for the company due the security of this insurance asset.

Term insurance offers an advantage relative to the choice of investment. The money saved as a result of the lower early premiums may be invested in the company instead to either reduce debt or

promote growth. In most cases, the return on investing in the business should be greater than the earnings attributed to the cash value of the whole life policy because the rates of return from investing in the business will be better. In addition, although unfortunate, the possibility of premium savings in the event of a premature death and the excess expected returns on premium differences invested are advantages for term insurance.

The ability to maintain life insurance throughout a shareholder's life is important. If the covered shareholder dies in the first few years of coverage, the cost of term insurance as noted will be less than the cost of whole life insurance. Whole life insurance policies grant coverage until death that may not be cancelled by the insurance company. Conversely, the cost of term life may be much greater than whole life if an individual exceeds the life expectancy used for underwriting the whole life insurance policies. However, term life insurance offerings have been modified so that policyholders can purchase term life with the same benefit, accomplished with either a guaranteed insurability option or lengthy policy terms of between 20 to 30 years. These choices will increase the cost of the term insurance, but the increased premium will still likely be lower than whole life premiums in the beginning years.

With time, the value of a successful corporation will grow. Assuming the buy-sell agreement ties the purchase price to fair market value, owners should ensure that additional life insurance could be acquired over time to keep pace with the increasing value of corporate shares. Typically, guaranteed insurability options available on either term or whole policies should allow the policyholder to acquire additional life insurance at timed intervals.

An alternative to purchasing additional insurance would be to use term life insurance to fund the buy-sell agreement by purchasing term insurance as joint tenants with rights of survivorship. The value of a term life policy is normally equal to the unearned premium for the year of death, usually very small in comparison to whole life insurance. The insurance policies may then transfer from the deceased shareholder to the surviving shareholders without triggering the recognition of income upon the death of the insured.

Cross-Purchase vs. Stock Redemption

Funding a cross-purchase agreement through insurance requires each owner to purchase a life insurance policy covering the life of every other owner. Each owns the policies they buy and are the beneficiary of their policies. The total amount of insurance approximates the value for the insured's share of the business. When a shareholder dies, the policies insuring this interest for the remaining shareholders will carry beneficiary designations, generally family members. With whole life, the family inherits the cash surrender value of the policies. With no continued business purpose, and as a courtesy to the surviving shareholders, the surviving family beneficiaries may choose to cash out the value of the policies.

Under a cross-purchase approach, the death of a corporate shareholder will not diminish the value of the enduring corporation. Because individuals and not the corporation hold the life insurance policies, the receipt of death benefits or cash values by the policy beneficiaries do not alter the assets of the corporation. This may, however, create a funding issue for the remaining shareholders because any remaining cross-purchased policies will likely not cover the continuing value of the business and as a result, the surviving shareholders may need to purchase additional insurance if other funds are not readily available. The disadvantages of a cross-purchase agreement include the added complexity of administration as the number of owners changes over time. Also as noted, a potential difference in the cost of life or disability insurance may exist among owners who are of different ages and health profiles in which young partners may pay very high premiums to cover older, less healthy owners.

Uninsurable Shareholders

Some shareholders may not be insurable in which case the only alternative may be to use an existing policy of the uninsurable shareholder. In the better circumstances, such shareholders own whole life insurance policies on their lives that have appreciated in value and can surrender the cash value by transferring it to either the business or the other co-owners or shareholders. However such a shareholder will typically expect to be compensated for the cash surrender value in this case.

Tax Implications

The deceased party's estate typically receive any life insurance proceeds tax-free. The proceeds of those life insurance policies are not includable in the decedent's estate. The agreement may or may not be acceptable to the IRS as it applies the fair market value of the decedent's business interest for estate tax purposes. If it is, the estate or its beneficiaries will have no income tax on the purchase of the owner's interest, as the basis of the interest will be equal to its sale price.

However, an important consideration in determining which party buys what policy is the tax treatment when the insurance proceeds are ultimately received. Depending upon which scheme is selected and how the valuations are derived, IRC § 2703 "gifting valuations" may invalidate an agreement that undervalues the business interest for estate-transfer purposes. If the corporation purchases the policy, the insurance proceeds are not taxable; but if the shareholders purchase the policy, the insurance proceeds are taxable. The shareholders must therefore weigh the tax advantages of the corporate stock redemption against the tax advantage of a cross-purchase.

If a policy must be purchased because there is an uninsurable shareholder, the shareholders that have purchased the uninsurable shareholder's policy must now pay taxes when the proceeds are received. Although the insurance proceeds will be nontaxable to the corporation when the life insurance proceeds are received, the remaining shareholders must also weigh this benefit against not receiving a step-up in basis upon the death of the non-insurable shareholder. As the percentage of stock owned by the

uninsurable shareholder increases, the likelihood that a stock redemption buy-sell agreement is preferable also increases.

Disability or Death

The risk of disability is much more prevalent than a business loss due to death. A common mistake is a buy-sell agreement that is triggered upon disability, but the company or shareholders rely solely on life insurance to fund the agreement. In such a case, the business may be forced to fund the buy-sell agreement directly. Disability insurance and/or critical illness insurance may be better alternatives but with certain restrictions. For example, generally, critical illness insurance has nothing to do with business income history but where disability insurance generally does. Likewise, critical illness insurance only pays out on the diagnosis of a specific set of illnesses but disability insurance is broader and generally a better coverage for buy-sell agreement funding.

Survivorship Life Insurance

In situations that involve generational transfers in estate planning, survivorship insurance can reduce the significant liquidity problems in transitioning a closely-held business run by a husband and wife from a surviving spouse to the children. The unlimited marital deduction at the first death means all assets, including business interests, would pass to the surviving spouse with no federal estate tax burden. But when that spouse passes on, and when most of the family wealth is tied up in the family business, insurance as a death benefit when the second named insured dies could provide liquidity precisely when it is needed most.

Why Not Insurance

Actuaries typically base premiums on a relatively low rate of return to the insured. As noted, investing in the business should yield substantially greater returns than those offered through life insurance, especially in early growth years. If it were not for the favorable tax treatment provided by life insurance proceeds, life insurance would not be the better investment. Thus, risk-seeking shareholders may reason that if they live at least as long as their actuarially determined life expectancy, the return on capital invested should be greater for funds invested in the business.

Combination Funding

A portion of the buy-sell agreement can be funded with life insurance to guard against premature deaths, with the remainder funded by accumulated earnings and corporate profits. The funding of the agreement can then change annually, with the corporation assuming responsibility for purchasing any incremental increases in shareholder value as the corporation grows. This approach eliminates the need for shareholders to increase the amount of life insurance over time and also provides assurance to the shareholder's family that it will receive a minimum amount whether or not the corporation can generate the funds needed for the buy-sell arrangement.

The combination approach may be especially appropriate for family corporations and in business purchases by outside third parties. Specific provisions of the tax code, such as IRC § 303, limit the amount of stock that can be classified as redemption instead of as a dividend to the estate and limit inheritance expenses that are allowable as deductions to the estate of the deceased. The share value in excess of this limitation may be purchased with life insurance proceeds. A family member may then choose to exercise a right to purchase remaining shares, as determined by the IRC § 303 limitations as long as the taxpayer is not be obligated to purchase the stock.

Seek Professional Help

Each situation will be different, so individuals and businesses are advised to seek the advice of a tax or insurance specialist to fully explore available strategies.

Summary of Selected Tax Implications for Buy Sell Agreements

A full review of the tax implications of every buy-sell agreement is beyond the scope of this summary. However, the basic concepts are relatively straightforward: whether funds received in exchange for stock are taxable hinges on which party pays, which party receives, the valuation technique applied and the amount of control retained.

Transfers of Basis in Valuations

As noted in another section, the significant advantage of buy-sell agreements generally is the valuation of the departing shareholder's interest for estate tax purposes. When properly constructed, the estate or its beneficiaries will have no income tax on the purchase of the decedent's interest, as the basis of the interest will be equal to its sale price. If the agreement isn't fully funded and surviving owners borrow to fund the buyout, interest payments to the estate will be deductible on the entity's tax return.

Cross-sell agreements in particular provide the buying shareholder or shareholders a step-up in basis; not so, however in stock redemption buy-sell agreements where the remaining shareholders do not get the benefit of a step-up in basis because the corporation purchases the deceased shareholder's interest. The continuing shareholders retain their original basis in the company and may recognize greater capital gains upon the ultimate disposition of shares if made before death. After the stock is redeemed, the aggregate corporate assets are generally unchanged but each owner retains a greater percentage of ownership. Also, where a corporate entity is the beneficiary of buyout insurance, the proceeds of the policy may be subject to the alternative minimum tax.

Estate Tax Implications and Control Issues

Improperly structured buy-sell agreements can produce unintended results with unnecessary taxes. Proceeds from the life insurance in a cross-purchase plan are not included in the deceased shareholder's estate. The deceased is not the owner of the policy and, therefore, the insurance proceeds payable at death are not included in the estate. However, estate tax consequences can become more

pronounced in a stock redemption when the deceased shareholder has a controlling interest. A shareholder who owns more than a 50% interest either directly or indirectly is deemed to control a corporation under IRC § 267. In this situation, the shareholder is deemed to have an ownership interest in the life insurance policy due to the shareholder's ability to designate a beneficiary. The fact that control exists over the policy in majority ownership instances would result in the proceeds being includable in the deceased's estate. In these cases, the cross-purchase option may be preferable to the redemption option.

A common unfavorable tax outcome from the life insurance proceeds that may be subject to both estate tax and income tax is where the decedent is deemed to possess an ownership interest in the policy. Including the value of life insurance proceeds in the buy-sell valuation price may result in an unsatisfactory after-tax return.

Another common error involves violations of IRC § 302, which requires a substantial reduction in ownership interest of an exiting corporate shareholder. While redemption agreements, for example, can call for a sale of less than 100% of a shareholder's interest in a company, § 302(b)(2) will disqualify the tax benefits of a stock redemption when the selling shareholder retains a 50%-or-greater interest in the combined voting power of all classes of stock entitled to vote or retains an interest in the voting stock equal to, or in excess of, 80% of the voting stock held before the redemption. The result on failing the § 302(b)(2) requirements is that the redeeming shareholder's limited interest redemption distribution will be taxed as dividend income.

§ 302(b) problems can be avoided when a shareholder's death triggers the buy-sell agreement if the redemption proceeds are limited to the amount of the shareholder's estate tax and deductible funeral and administration expenses. In such a case, § 303 may treat the transaction as a sale or exchange, regardless of the ownership percentage retained by heirs or other related parties.

<u>Constructive Dividends</u>

When a cross-purchase agreement provides that continuing shareholders have a primary and unconditional obligation to buy shares on a triggering event, but the corporation instead purchases the stock under a secondary requirement in the buy-sell agreement, the purchase is treated as a constructive dividend to the continuing shareholders. In a properly structured redemption agreement, the continuing shareholders are not directly affected by the acquisition (except for an increase in their ownership percentages). To avoid this problem, the buy-sell agreement can be structured so that shareholders have an option to purchase the stock rather than an unconditional obligation to do so.

<u>Deferred Compensation</u>

A nonqualified deferred compensation (NQDC) plan is any elective or non-elective plan or arrangement between an employer and an employee or service recipient and service provider to pay and receive compensation some time in the future. NQDC plans do not provide employers and employees with the tax benefits associated with so-called qualified plans and therefore do not defer taxes.

NQDC plans typically fall into four categories. “Salary Reduction Arrangements” simply defer the receipt of current compensation and allow the participant to defer receipt of a portion of their salary. “Bonus Deferral Plans” resemble salary reduction arrangements, except they enable participants to defer receipt of bonuses. “Supplemental Executive Retirement Plans” or SERPs (also referred to as “Top-Hat Plans”) are NQDC plans maintained primarily for a select group of management or highly compensated employees. Finally, “Excess Benefit Plans” provide benefits solely to employees whose benefits under the employer's qualified plan are limited.

NQDC plans are either funded or unfunded, though most are intended to be unfunded because of the tax advantages. An unfunded arrangement is one where the employee has only the employer’s “mere promise to pay” the deferred compensation benefits in the future, and the promise is not secured in any way. The employer may simply record the deferred compensation in bookkeeping account. Likewise, the employer may invest in annuities, securities, or insurance arrangements and fund the arrangement to fulfill its promise to pay the employee. Alternatively, the employer may transfer funds into a trust that remains a part of the employer's general assets in order to help it keep its obligations to the employee. One detriment to this scheme is that the funds are subject to the claims of the employer’s creditors if the employer becomes insolvent.

To obtain the benefit of income tax deferral, it is important that the amounts are not set aside from the employer's creditors for the exclusive benefit of the employee. In that case, employee may have currently includible compensation that is taxable.

Business Purchases Through SERPs

A growing interest in structuring the financing of a business purchase is through Supplemental Executive Retirement Plans payable to a departing business owner.

In a conventional purchase, assuming the business is the ultimate source of the cash flow needed to finance the purchase, the cash flows are subject to two levels of taxation. The purchase must pay on the earnings and the seller must report capital gains over the basis in the sale of the business interest. The purchase of the business is not a deductible expense, no matter who the buyer is.

Using a NQDC SERP, the departing business owner’s payments are taxed as ordinary income but only subject to one level of taxation because the new business owner is entitled to deduct the payments so long as they represent reasonable compensation. Despite the higher taxation of ordinary income versus the lower capital gains rate, the cash-flow required to generate the funds can be substantially smaller because the company reaps the benefits of deductions. Establishing a nonqualified SERP can depress the value of the business since it is a liability, but the advantages of lower cash-flow thresholds to meet payment obligations can provide significant valuation offsets.

Notice Requirements

Care is required in establishing and administering a buy-sell arrangement to avoid "tainting" an insurance policy under "transfer for value" rules. In order to discourage a practice where large companies would purchase insurance low level employees without their knowledge or consent Congress enacted IRC § 101(j) which provides that a portion of the proceeds of certain "employer-owned life insurance contracts" are taxable as ordinary income. Closely-held companies must provide notice to the insured and the insured must consent before the policy can be issued. Under these rules, failure to give notice and obtain consent (a simple detail) will taint the policy and cause the proceeds to be taxed as ordinary income. As a practical matter, this rarely happens among smaller companies but is worth noting.

Buy-Sell Agreement Issues and Checklists

Typical buy-sell agreements specify the type of the agreement whether cross-purchase, redemption or some hybrid combination, as well as triggers that cause a mandatory or an optional buyout, the valuation imposed by the agreement, the payment terms, methods by which the agreement will be funded and other limitations and restrictions as the circumstances require such as non-compete agreements and permitted and prohibited transfers of an owner's interests.

The devil is in the details, and discussion points between the parties may include but are not limited to:

1. How to update and renegotiate agreements among the owners.

2. Taxation Issues: whether the IRS accepts the valuation as fair market value

If the value is based on a formula price rather than the standard of fair market value, the value may not be conforming for federal estate tax purposes. If an agreement fixes the value of a decedent's interest and the estate is redeemed for that price, the IRS can challenge the amount and assess estate tax on, which may be higher than the contractual buy-sell amount. Therefore, It may be prudent to include a provision in the buy-sell agreement that requires the purchase price on the death of an owner to be no less than the value of the shares "as finally determined for federal estate tax purposes."

Other relevant issues that must be considered:

3. Whether the agreement anticipates the funding requirements;

4. Whether the valuation provisions don't provide an incentive for new shareholders to cause a triggering event and be bought out.

5. Inclusion of a penalty for leaving the business or for misconduct. To dissuade shareholder employees from leaving the company, some buy-sell contracts give individuals who leave voluntarily or for misconduct as defined by the agreement less than they would otherwise receive.

6. Require purchase of a spouse's ownership interest resulting from a divorce.

7. Limit the resources required to purchase a terminating shareholder's stock.

8. Establish other limits as required:

a) personal guaranty of other shareholders or security interest in the assets

b) terms of any outside financing requires

c) limitations on mergers and acquisitions

d) limitations on the disposal of assets, change of operations, etc

9. Whether to empower business or owner rights of first refusal to sell to an outsider. This right is often first given to the corporation and then to the remaining shareholders. The agreement typically requires the person exercising the right of first refusal to purchase on the same terms as the terms on which the buyer would have purchased the stock.

10. Whether to maintain the status if an S corporation so that no shareholder can terminate its status.

11. Close the books on any transition date to prevent an unfair allocation of income to the shareholders.

12. Allow stock to be transferred to family members or trusts for estate planning purposes.

13. Provide for transfers by operation of law where a judgment creditor or divorce should trigger the right of the company and other shareholders to purchase the stock.

14. Provide each shareholder's stock certificate include a legend reciting that the stock is subject to the provisions of an existing buy-sell agreement.

15. Distinguish between ownership and employment. This may be especially in the early stages of a company's growth and development when the lines between ownership and employment are often blurred.

16. Ensure the agreement is very specifically detailed regarding what happens when one of the following events occurs:

a) death of a shareholder

b) disability of a shareholder

c) voluntary and involuntary departure

d) divorce

e) non-competition and non-disclosure agreements

f) deadlock among owners

Often overlooked, but critically important:

Deadlock. If equal owners come to a major disagreement, the business can become "deadlocked," unable to further conduct normal operations. In this case, the business may have to be liquidated and the buy-sell agreement should anticipate this possibility with various options:

Texas shoot-out. Each party sends a sealed all-cash bid to an umpire stating the price at which they are willing to buy out the other party. The sealed bids are opened together, and the highest sealed bid "wins", and that bidder must then buy (and the "loser" must sell) the other half share in the business.

Dutch auction. This variation on the Texan shoot-out features another set of sealed bids indicating the minimum price at which the owners would be prepared to sell for their share. Whichever sealed bid is the lowest "wins" and that bidder then sells to the "loser" at the price indicated in the loser's sealed bid.

Russian roulette. A draconian solution to a deadlock where one of the deadlocked parties serves a notice on the other party, and the serving party will name an all-cash price at which it values a half interest in the business. The party receiving the notice then has the option to either buy the other party out, or sell out to the other party, at that price.

Disagreement among multiple unequal owners.

If ownership is unequal and in a major disagreement, a minority shareholder could be forced out of active participation by the purchase his or her interest. This possibility should be considered in any buy-sell agreement.

Default.

In most closely-held corporations, the individual shareholders must personally guarantee corporate loans from banks and/or contribute payments to the bank or business. In the buy-sell agreement, there should be a provision whereby if a shareholder defaults, a buyout is triggered for his or her interest.

More considerations appropriate in drafting buy-sell agreements include:

1. Should the buy-sell agreement apply to current shareholders or to all new shareholders as well?

2. Any revised buy-sell agreement should supersede all other existing agreements to redeem stock or purchase stock executed by the shareholders.

3. Whether a death of a shareholder results in an automatic buy-out of their interest, or will the next of kin be allowed to become a shareholder?

4. Will all of the death buy-out amount be funded by insurance, or just part of it?

In the event of the death of a shareholder, what will be the disposition of shareholder receivables or payables?

5. What will be the price paid to an employee shareholder who resigns or is fired from the corporation?

6. In case an employee shareholder resigns or is fired from the corporation, will a covenant not to compete be involved, and if so, what is the scope of protection?

7. How many days should the corporation have in which to pay off a terminated, disabled, or deceased shareholder? In short, any number of variables must be considered to reflect the circumstances and possible outcomes of the many variety of events.

LLC Buy-Sell Agreements

The form and structure of buy-sell agreements for limited liability companies (LLCs) differ from those of corporations. A total survey of these distinctions is beyond the scope of this summary, but the

more significant difference is the recognition of the tax basis in the acquired shareholder's asset and the mutual obligations of the various parties. LLCs can step up the basis in their assets when they purchase members' interests, and therefore it is more common for LLC buy-sell agreements to designate the LLC, rather than the other members, as the purchaser of the retiring, deceased, or disabled member's interests.

Corporate buy-sell agreements typically give the other shareholders the right to purchase shares of stock subject to a transfer and impose the obligation to purchase the shares of a retired, deceased, or disabled shareholder on the other shareholders. Having the other shareholders make the purchase results in their acquisition of a tax basis in the purchased shares equal to the purchase price paid. This increased tax basis limits the amount of gain the shareholders must recognize when they sell their shares or when the corporation is liquidated. If the corporation purchases the shares, there is no increase in the tax basis of the corporation's shares.

Tax basis is less of a concern in the context of an LLC under IRC § 734 that permits an LLC taxed as a partnership to adjust the tax basis of its assets to reflect the purchase price paid for a member's interest. If the LLC makes an election under §734, the tax basis of its asset will often be increased when the LLC purchases the interest of the departing member in connection with a retirement, death, or disability of the member. This increased tax basis will reduce the gain that is passed through to the members when the LLC eventually sells these assets. This tax treatment, however, does not affect the LLC's other assets, so any gain realized by members on a sale of their individual interests or on liquidation of the LLC will be taxed accordingly. The increased tax basis in the newly acquired LLC' assets can also increase the amount of depreciation and amortization deductions that can be passed through to members.

Having the LLC make the purchase has the following advantages:

1. The LLC is typically the source of the cash to make the purchase, and having the LLC make the purchase avoids the need make arrangements for the LLC's distribution of cash to members to enable them to fund a purchase;

2. If an installment purchase is made, the LLC is generally in a position to deduct the interest paid, whereas interest paid by members may be nondeductible under IRC § 163(d) and (h) relating to investment and personal interest;

3. A purchase of a member's interest by the LLC isn't counted for purposes of determining whether there has been a sale or exchange of 50 percent or more of the members' interests in a 12-month period, which triggers a termination of the LLC for income tax purposes under IRC § 708; and

4. If the buy-sell agreement is funded with insurance, the LLC can purchase a single life or disability policy, avoiding the multiple policies needed if the other members are required to make the purchase.

Another difference between corporate buy-sell agreements and those of LLCs relates to the form of the agreement. Corporate buy-sell agreements are generally separate from the corporation's organizational documents. Putting buy-sell provisions in a separate agreement protects minority shareholders against loss of their rights if the majority amends the corporation's organizational documents and also avoids cluttering the corporation's articles of incorporation with buy-sell provisions. Although LLCs can have stand-alone buy-sell agreements, most LLCs incorporate buy-sell provisions into their operating agreements along with the other provisions defining the rights and obligations of their members.

Corporate buy-sell agreements also typically require notice of their transfer restrictions to be included on stock certificates, whereas LLC buy-sell agreements don't concern themselves with notice to third parties. The distinctions flow from the application of state corporation law and the Uniform Commercial Code, which in part provide that purchasers of shares are not bound by restrictions of which they had no notice. Although LLC members' economic interests are transferable, transfers of voting or management rights are ineffective under most state LLC statutes unless the other members agree to accept the transferee as a substituted member, and interests in LLCs are not typically represented by certificates or other documents.

LLC buy-sell agreements should impose transfer restrictions even though state law will limit members' ability to transfer anything but their rights to profits and to distributions made by the LLC. (see generally NH RSA 304-C “Limited Liability Companies;” Mass. G.L. c.156C “Limited Liability Company Act”) Restrictions exists because small businesses generally reinvest a large percentage of their profits or cash flow into the business, and a third party who acquires a member's economic rights may try to force the LLC to make larger distributions. In states including Massachusetts, New Hampshire and Delaware, a transferee of a member's interest who is dissatisfied with the operation of, or return being received from, the LLC may petition a court cause to dissolve the LLC. (see also Del. Chapter 18. “Limited Liability Company Act”).

Buy-Sell Agreement Dispute Fact Pattern Examples and Relevant Cases

<u>Fact Pattern 1</u>

The husband had a 50% interest in each of three businesses. He and his partner did not have a buy-sell agreement, which could have made it clear how the value of the firms would be determined. They had not purchased life insurance on each other to cover buying out the other’s interest. They had not had professional business appraisals done. The friend’s husband became terminally ill and died in January. The three businesses turned out to be worth about $400,000, but the widow was shocked to learn that she was getting $30,000 for her half. Unbeknownst to the woman, her husband of 25 years—who most

recently had been earning $100,000 annually—had agreed at one point that $30,000 would be paid for his share when he died.

Fact Pattern 2

The client thought his manufacturing firm was worth $10 million, but a trusted business advisor was doubtful and sought bids from brokers, who put its value in the $4 million to $6 million range. The attorney; CPA and advisor then worked with the client to find ways to increase the business' profit margins. They identified jobs that required less labor and would have fewer chances of returns from defective parts. They also look at ways processes could be automated. The client made the changes, was able to increase his profit margins and eventually sold the business for $12 million. The proceeds from the sale are managed through a customized, tax-efficient, managed portfolio that generates income and capital growth for the client, who is now retired.

Fact Pattern 3

Parents give equal shares in a business to their four children, but only one ends up working in the business. The other three eventually decide the business is providing them with no economic benefit because they get no dividends and there's no market for their minority interests. The disgruntled shareholders settle the dispute in a courtroom and need a business appraisal. Applying New Hampshire, Massachusetts or other state law could result in no action or liquidation of the company depending upon the state law, business agreements and causes of actions selected by the disgruntled minority owners.

Fact Pattern 4

She is 90% owner of a beauty-related business in which she's worked for 27 years. Her sister, who doesn't work in the business, owns 10%. The parents left them the firm, and there was a verbal understanding that the 90% sister would buy out the 10% sister.

The majority owner did make an offer, but her sister is asking for seven times the offer.

First need is to hire a valuation firm to come up with a realistic price. The minority owner has threatened to sue her sister—as well as all of her advisors.

Fact Pattern 5

Assume three partners own equal shares in a business; each owner's share is valued at $100,000.

Owner #1 and Owner #2 each purchase a $50,000 policy covering Owner #3.

Owner #2 and Owner #3 each purchase a $50,000 policy covering Owner #1.

Owner #1 and Owner #3 each purchase a $50,000 policy covering Owner #2.

Each business owner/partner owns the policies he or she buys covering the lives of the others, and is the beneficiary of those policies.
If an owner dies, the surviving owners use the life insurance proceeds to purchase a share of the deceased owner's interest.
Interest of each surviving business owner remains the same in relation to the other owners.

Fact Pattern 6
If the relationships are unequal, they remain unequal after the death.
A owns 60%; B owns 30% and C owns 10%.
C dies, A's interest is still twice that of B:
Ash now owns 66-2/3%; B now owns 33-1/3%

Fact Pattern 7
Bob, Joe, and Dave run a successful widget business together as partners.
They diligently put a buy-sell agreement in order to protect both their respective shares of the business as well as the company as a whole.
Joe becomes disabled and can't do his job and is no longer contributing to the success, growth, and maintenance of the company due to his disability.
Joe's shares are purchased by the other owners or sold back to the company, with the purchase funded with a special type of Buy-Sell Disability Insurance.

Fact Pattern 8
A, B and C are three equal partners and the total value of the partnership is $750,000. Each partner own policies on the lives of the other two in the amount of $125,000.
The premium payment options have caveats:
Premiums paid by individuals are not tax deductible; but if a corporation pays the premiums, they may be deductible but, if so, will be considered compensation income to the shareholder- employees on whose behalf they are paid. The corporation's payment of premiums could also be treated as dividends to the shareholders, in which case the premiums would not be deductible by the corporation but could qualify for the special 15% tax rate on corporate dividends paid to individuals. Death proceeds are generally received federal income tax-free.

Fact Pattern 9
All shareholders of ABC Corp., including the newest owner "A," were party to a buy-sell agreement. Owner "A" had purchased his interest directly from the company based on a negotiated price tied to ABC

Corp.'s GAAP book value. The negotiated price took into consideration a combined discount for lack of control and lack of marketability. However, terms of the buy-sell agreement included a buyout provision under certain triggering events using the term fair value. Several months later, in the midst of a disagreement with his co-owners, "A" realized the buyout agreement's language would let him obtain more for his shares than he had paid for them. " A" caused a triggering event to occur and for his shares subsequently received "fair value," which was finally determined to be a pro rata value of 100% of ABC Corp. "A" had effectively received a premium price over his negotiated buy-in price of only a few months prior.

Morale to story: Don't give shareholders an incentive to sell without a good understanding of the difference between the value specified in a buy-sell agreement and true economic value, parties to a buy-sell contract may unwittingly provide shareholders a financial incentive to cause a triggering event and get bought out.

Fact Pattern 10

A and B are equal shareholders in A-B Consulting, Inc. Under the terms of their cross-purchase buy-sell agreement, if either individual dies, retires, or becomes totally disabled, the other shareholder is required to purchase the shares, thus becoming the sole shareholder. This is an example of a cross- purchase agreement.

A becomes a disabled corporate employee who cannot be carried for very long in a small business. A-B Consulting, Inc. uses a disability buy-out period of between three and six months. In other words, if one of the employee shareholders becomes totally disabled for a period of three months, on the first day of the fourth month, the corporate employee's stock is automatically sold back to the corporation at a disability buy-out price.

Fact Pattern 11

The corporation needs to discuss the possibility of one of the shareholders finding a non related third party to buy his stock. Does the corporation want shareholders to have the right to sell on the open market to any third party or only have the right of first refusal? Or does the corporation want to restrict rights and only allow the shareholders to sell back to the corporation itself. There is quite a danger in allowing for unrelated third parties to make offers on stock of closely held corporations. Obviously a competitor could make an offer, making it hard to tell if it was a bona fide offer or just a ploy to drive the stock price up so that the remaining shareholders would have to pay a higher price to repurchase the stock.

Information in this article is general in nature and should not be construed to be formal legal advice or the formation of a lawyer/client relationship. Consult an attorney to address specific legal issues. In

accordance with I.R.S. Circular 230 we advise you that any tax advice in this article is not intended or written to be used, and cannot be used, by any recipient for the avoidance of penalties under federal tax laws.

About the author:

Rob's professional focus is on business formation and organization, operations and financial management, restructurings, "turnarounds," bankruptcies, business mergers and acquisitions, sales and liquidations, and commercial real estate transactions.

Rob is admitted to the New Hampshire Bar, the New Hampshire U.S. District Court Bar, the Commonwealth of Massachusetts Bar, the Massachusetts U.S. District Court Bar and ECF Certified at the US Bankruptcy Court in Massachusetts. He also holds an FCC First-Class Engineer Certification and Wind Energy Technical Certificate from the University of California at Davis. Professional affiliations include the New Hampshire Bar Association, the Massachusetts Bar Association, the Boston Bar Association, the Energy Bar Association and the American Bar Association Law Practice Management Section in addition to the Turnaround Management Association, New England Business Brokers Association, and other business trade groups. Rob is a Notary Public in Massachusetts and Commissioner of Deeds in New Hampshire and has successfully completed his Certified Turnaround Professional examinations.

Prior to becoming an attorney, Rob Wolf dedicated over twenty years in broadcasting with career highlights that included affiliations with NIKE in developing media coverage of running events in the early 1980's, culminating in owning a radio station group in northern New England. Rob earned his BS in Communications at Boston University and JD law degree cum laude from Franklin Pierce Law Center. His graduate business studies included the University of New Hampshire Whittemore School for Business and the Sawyer School at Suffolk University in Boston where he earned his MBA in Finance.

Rob is an avid skier, sailor, kayaker, biker and hiker, and member of the Appalachian Mountain Club. Born in Brazil to Swiss parents, he is a naturalized US citizen and resides north of Boston. On weekends, you'll find him either at work, out sailing, or up at his farm in Ascutney, VT. Reach Rob at either the Portsmouth office or at his office in Faneuil Hall, Boston.

"I can provide a swift yet effective review of a business from top to bottom to uncover possible legal, financial, marketing and operational issues that can have a direct impact on the ability of the business to maximize value."