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Why are Buy-Sell Agreements Important?

By Carl Holborn

The term "buy-sell agreement" means any legally enforceable arrangement by and among a business entity or its owners prescribing limitations on the ability to own and to transfer equity interests. It is the linchpin between a business succession plan and the estate plans of the owners in determining the future ownership and control of a business. The terms of a buy-sell agreement can be included in an operating agreement of a limited liability company, a partnership agreement for general and limited partnerships, or in a close corporation agreement for corporate entities.

Most often the terms of a buy-sell agreement are set forth in a separate written document by and among the shareholders of a corporation and the corporation itself. This article focuses on buy-sell agreements involving corporations, even though many of the concepts apply to other types of business entities.

When entrepreneurs are forming a business entity, or a new investor becomes a shareholder, the parties are optimistic that they will all benefit from the financial success of the enterprise. Introducing the topics of death, disability, termination of employment, and other negative possibilities is comparable to negotiating a prenuptial agreement for a couple about to be wed. Unfortunate but foreseeable events need to be addressed as soon as possible before irreversible commitments are made.

A buy-sell agreement is an integral part of a shareholder's personal estate plan. The creation of a market to liquidate an otherwise nonmarketable asset is crucial to many estate plans. The shareholder's will and trust must contain directions to the fiduciary to comply with and to implement the terms of the agreement. These documents may also direct the fiduciary to accept the provisions of the agreement (such as the valuation method) without the necessity or duty to inquire as to the validity of the data on which the sale is based or the process by which it is made.

Control and ownership

In discussing business succession planning, it is advisable to focus on three separate elements:

(1) Income
(2) Control
(3) Equity ownership

While a buy-sell agreement may indirectly affect the income from a business entity, the arrangement more directly affects control and equity ownership.

The company's capital structure and organizational documents determine the control of the enterprise through the election of the board of directors. The managers of the business and perhaps the other shareholders, however, do not want family members who happen to inherit stock to be involved in the management of the business. The separation of control from the equity ownership of the business and the extraction of the value of the equity ownership of the business should be agreed on in writing by the shareholders.

Who is the purchaser?

Buy-sell agreements are generally identified as one of the following types:

- Entity Redemption
- Cross-purchase
- A hybrid

A redemption gives the corporation the right or option to purchase stock on the happening of stated trigger events. Cross-purchase agreements are merely agreements by and among the shareholders themselves to purchase the stock on the happening of trigger events. Hybrid agreements give the corporation the first option to purchase the shares, but if there are legal or financial impediments (such as bank covenants) then the shareholders have the option to purchase the shares.

The decision to use a particular type of agreement depends on many factors. The most important factors are the number of parties to the agreement and the type and complexity of funding. If there are fewer than three shareholders, a cross-purchase agreement is often preferable in giving the purchasers a stepped-up basis. If there are many shareholders and life insurance is the preferred method of funding the obligations, an entity redemption arrangement is more easily implemented.

Mandatory purchase or options?
Will a trigger event require the purchase of the shares or merely give a party an option? Does the shareholder have an option to "put" the shares? Some trigger events can call for a mandatory purchase and sale, while others can result in cross puts and calls. The purchase price and the terms of the sale can differ depending on the trigger event itself.

Transfers to third parties
A buy-sell agreement generally provides that if a shareholder attempts to sell or give his or her shares to a third party, the corporation or the other shareholders have a right of first refusal to purchase the shares for a given period. The optionees have the option to purchase the shares either at the price set forth in the agreement or at the price to be paid by the proposed transferee. If the corporation does not exercise its option to buy the shares, the other shareholders are generally allowed to purchase the stock pro rata.

Permitted transferees
In implementing an estate plan, an owner may wish to transfer shares to or for the benefit of his or her family. Should such a donative transfer trigger the right-of-first-refusal in the corporation or the other shareholders? If the transfer is allowed, will the shares still be subject to the arrangement on the death of the transferor? If the transferee dies, who has the right to purchase those shares—the transferor, the corporation, or the other shareholders? If the shareholder wishes to fund a living trust, the agreement should provide that the trustee is bound by the terms of the buy-sell agreement. Suppose a shareholder transfers shares to his or her spouse, and the couple subsequently divorces. Should the transferred shares be subject to the buy-sell agreement and thus purchased? Should the other shareholders purchase the shares, or should the divorced shareholder have the right to purchase the shares from his or her former spouse before the other shareholders?

Trigger events
In addition to voluntary transfers, the events that cause the terms of a buy-sell agreement to be implemented are generally:

- Death
- Retirement
- Involuntary transfers such as bankruptcy, foreclosure, and divorce
- Disability
- Termination of employment

Death. A shareholder's death generally triggers a mandatory purchase of shares. Cross puts and calls give the parties the choice of continuing the equity ownership while allowing the successors to liquidate the holdings at a predetermined price and terms.

Involuntary transfers. Even if the shareholder is not an employee or otherwise involved in the operation of the business (e.g., a director or officer), any involuntary transfer due to judicial actions must be restricted. Bankruptcy trustees, creditors, and ex-spouses are never welcome as shareholders. The shares will be purchased at the lowest prices and severest terms that are conscionable.

Disability. For a shareholder who is also an employee, disability is often defined as the inability to perform the services that have been associated with the position for at least six months.

Termination of employment. The termination of a shareholder's employment is classified as:

- Voluntary
- Involuntary for cause
- Involuntary without cause

The definition of "for cause" must be included in the agreement. Retirement can be defined as the voluntary termination of employment after attaining a given age. The price and terms on which a sale takes place depend on how the termination is classified. While the issue of competition may be included in the buy-sell agreement, it is preferable to include noncompetition, nonsolicitation, and nondisclosure issues in a separate employment agreement. The owners of closely held businesses often confuse the relationship between stock ownership and employment. The obligations of employees, such as the duty to maintain confidential information, should not be related to stock ownership. The duties of shareholders often overlap those of employees, but the remedies available to the entity in enforcing its rights should be contained in separate agreements.

S corporation considerations

Any transfer, voluntary or involuntary, to an ineligible transferee that would negate the ability of the corporation to be taxed as a "small business corporation" under Section 1361 must be prohibited. For example, if the transfer of the shares would violate the rules restricting the number of shareholders or if the shares would pass to an ineligible trust or person, the buy-sell agreement can negate the transfer.

Price

The price at which a sale takes place can be determined in several ways, including:

- Percentage of adjusted book value
- Multiple of adjusted earnings
- Weighted formula of the above two
- Appraisal
- Agreed value

If a balance sheet-based formula is used, the parties often agree to adjust the book value to fair market value of the assets. Life insurance death proceeds are often excluded from the value of the business, but the cash value of any policy is generally included. Adjustments to income statement-based formulas could include add-backs for excessive compensation.

The parties may agree to set the value periodically. If a trigger event occurs within a specified time period, the agreed value will apply. While this approach is attractive, most parties fail to update the value routinely, and a default value must be used.

Terms of payment

The purchase price can be paid either in cash or with promissory notes. Often the transferred shares are pledged to secure the payment of the promissory notes. The terms of payment should set forth:

- The interest rate to be paid.
- The manner of amortizing the note.
- The amount that can be paid each year, subject to state corporation laws.

If a payment would be prohibited by state corporate laws (e.g., a payment that would render the company insolvent), the payments can accrue at a predetermined rate of interest. If the selling shareholder is concerned that the purchaser may become over-leveraged, the agreement can deny the purchaser the right to increase its level of debt.

If the purchaser needs to incur subsequent debt, the purchaser should obtain prior written approval from the note holder. Any subsequent lenders would have to agree to subordinate their debt to that of the selling shareholder. If the purchaser increased its level of debt without the selling shareholder's consent, a default would occur, and the remaining payments on the note could either be accelerated or carry a premium rate of interest.

Optional liquidation
What if the other shareholders do not wish to continue the business in the absence of the deceased or withdrawing shareholder? The agreement can provide that within a given period after the death or the withdrawal of a shareholder, the other shareholders have the option to discontinue the business, liquidate the assets, and begin the winding-up process. Each shareholder would then participate pro rata in the liquidation proceeds.

Revaluation of shares
Many state laws prohibit a company from rendering itself insolvent. If the purchase of the shares by the corporation would render the entity insolvent, a revaluation of the company's book value can be undertaken to revalue the assets at market value.

Bank covenants
If the company has a line of credit or outstanding loans from a financial institution, loan covenants will generally prohibit distributions to shareholders until the bank debt is paid or the consent of the bank is obtained. Such limitations may force the shareholders to adopt a cross-purchase arrangement.

Endorsements of stock certificate
State corporate law generally invalidates restrictions on the transferability of shares unless there is a legend on the stock certificates setting forth the terms of the agreement or stating that the stock is subject to transfer restrictions and that a copy of the agreement will be provided to an assignee within a particular number of days. The terms and conditions of any restrictions on the transferability of uncertificated shares must also be made available to would-be purchasers.

What if the seller does not sell?
The shareholder has a contractual obligation to sell after a trigger event. What if the seller refuses? What if the seller alleges fraudulent inaccuracies in the financial statements on which the appraisal is based? What if the agreed price is so old as to render it unconscionable? While the litigation is pending, who votes the shares? Can the family of a deceased shareholder that holds a majority of the shares operate the company and oppress the remaining minority shareholders?

Little guidance exists as to whether the holder of a deceased shareholder's stock has the right to vote the shares or receive dividends pending the sale. Can the agreement dictate the voting of the shares after the trigger event? Would state laws involving voting trust agreements be applicable? Arguably the seller holds the stock in a constructive trust for the benefit of the buyer. Court proceedings in which such matters are disputed take years to resolve. While binding arbitration is an alternative, the proceedings can often be lengthy. During that time, the actual owner of the shares can undermine the value of the company by revealing company secrets and otherwise operating the company in an inappropriate manner.

To avoid these results, the agreement can provide that the shareholders can transfer ownership of the shares to a third-party trustee or escrow agent. The trustee or escrow agent can then hold the shares and purchase proceeds until the closing. Alternatively, the agreement can provide that each shareholder will hold the shares in transfer-on-death form with either the company or the other shareholders named as transferees. The agreement would contractually obligate the transferee to pay the former shareholder or a designated beneficiary the price on agreed terms. Rather than having the buyers chase the seller to force a sale, the designated beneficiary is forced to seek payment from the company or the remaining shareholders.

Tag-along and drag-along
The terms of the buy-sell agreement often contain “tag-along” and “drag-along” rights.

- A tag-along right prevents oppression of minority shareholders by giving them the power to force a sale of their shares at the same price and terms as a selling majority shareholder.

- If a majority shareholder receives an offer to sell his or her shares but the offer is contingent on the purchaser buying all of the outstanding shares, the majority shareholder can “drag-along” the minority shareholders and force them to sell their shares at the same price and terms.

Insurance funding
Many companies choose to fund their obligations under a buy-sell agreement with insurance on the lives of the shareholders. Buy-sell agreements often require the company to use the insurance proceeds received on the death of a shareholder as payment in full or as a down payment for the purchase. The cash value of a policy can also fund the purchase of the shares on the retirement or disability of a shareholder. If the company is the owner of the life insurance policies, the requirements of Section 101 must be followed to assure that the proceeds are exempt from income taxation.

If there are many shareholders, it is generally preferable to cast the buy-sell agreement as an entity redemption. The company can then purchase a policy on the life of each shareholder. The policies are, however, assets of the company and can be reached to satisfy the claims of creditors. If there are few shareholders, it may be preferable to consider a cross-purchase arrangement where each shareholder owns policies on the lives of the other shareholders. The agreement should provide that on the death of a shareholder, the other shareholders have the right to purchase the policies on their own lives from the deceased shareholder’s estate or trust.

Sinking fund alternative
As an alternative to life insurance funding, a corporation can create a separate fund that can be used only to purchase shares under the company’s buy-sell obligations. The unanimous consent of all shareholders is required before the fund can be used for any other purpose. While the fund is subject to the claims of the general creditors, the unanimous consent requirement assures that the fund will be intact when needed.

Professional corporations
State licensing requirements allow only professionals to own the stock of certain corporations. For example, agreements covering medical practices limit the ability of nonprofessionals to own stock in the professional corporation. Can the nonprofessional family member own the shares of the corporation pending the closing of the sale? What rights does the successor have as an owner of the corporation?

Transfer tax considerations
The IRS has historically viewed buy-sell arrangements for family-owned businesses with suspicion as being testamentary substitutes. The IRS regularly challenges values fixed under the terms of the agreement as not being bona fide arm's-length market prices. For all transfer tax purposes, any option, agreement, right, or restriction on the transfer of a business interest is ignored for valuation purposes unless:

(1) It is a bona fide business arrangement.
(2) It is not a device to transfer property to members of the decedent’s family for less than full and adequate consideration in money or money’s worth.
(3) Its terms are comparable to similar arrangements entered into by persons in an arm’s-length transaction.

Income tax considerations
In a cross-purchase situation, the seller generally receives capital gains and installment sales treatments for the sale proceeds, and the purchasers obtain a step-up in the tax basis of the purchased shares equal to the purchase price. An entity redemption may not be eligible for capital gains treatment under some

circumstances. At the present time, the tax on dividends, as well as the capital gains tax, are the same. If the transaction is not eligible for capital gains treatment, the benefit of any basis of the seller's share is lost.

Conclusion

Business owners are often reluctant to negotiate a buy-sell agreement because it raises too many unpleasant issues. However, the two great motivators, fear and self-interest, can be used to provoke business owners to take action and address these issues while everybody is healthy and in agreement.