Buy-Sell Agreements

A buy-sell agreement is an agreement among the owners of an entity or among the owners and the entity itself to purchase and sell interests in the entity at a price set under the agreement upon the occurrence of a specified triggering event (*e.g.*, death, disability, an offer to purchase an owner's interest from an outside party or termination of employment).

There are numerous reasons, both tax and non-tax motivated, for owners of a business to establish a buy-sell agreement. One of the primary benefits of a well drafted buy-sell agreement is that it may alleviate disputes among the owners (a benefit that cannot be overstated in the family context). A buy-sell agreement provides certainty to both the outgoing interest holder and the remaining interest holders regarding a variety of issues, including the determination of a buy- out price, payment terms and funding, triggering events giving rise to a disposition of an interest holder's interest and restrictions against transfers.

There are essentially three types of buy-sell agreements: a cross-purchase agreement, a redemption agreement and a hybrid agreement.

The typical cross-purchase agreement provides that upon the occurrence of a triggering event (*e.g.*, death, disability or termination of employment), the continuing interest-holders will acquire the withdrawing interest-holder's interest at a purchase price that is determined under the agreement.

Under a redemption agreement, upon the occurrence of the triggering event, the entity redeems the party's interest in the entity at a price specified in the agreement.

A hybrid agreement combines aspects of both the cross-purchase agreement and the redemption agreement by giving the entity the primary right to acquire the selling interest holder's interest, and permitting or requiring the remaining interest holders to redeem the withdrawing interest holder to the extent that the primary right is not exercised. The order of priority obviously can be reversed, thereby giving the interest holders the primary right to purchase the interest.

A buy-sell agreement may be structured in a number of different ways depending upon the preferences of the business and the interest holders and the level of flexibility desired. For instance, a buy-out can be structured to be mandatory upon the occurrence of certain triggering events (e.g., death, disability, voluntary withdrawal or termination of employment) or at the option of the outgoing interest holder, the business or the remaining interest holders. There are advantages and disadvantages associated with each type of structure that must be considered.

A buy-sell agreement can be drafted to require either the business or the remaining interest holders to purchase the shares of an outgoing interest holder in certain circumstances, such as his or her death or disability. Similarly, a mandatory buy-out can be included in the form of a "put" right, which would require the business to purchase the outgoing interest holder's interest whenever that person wishes to withdraw from the

business. Obviously, a mandatory buy-out provides more certainty as to the disposition of the shares; however, it imposes more of a financial obligation on the business or remaining interest holders. Accordingly, if a buy-sell agreement is structured in this fashion for some or all triggering events, it is imperative that a mechanism be in place to provide a source of liquidity to fund the buy-out, such as life insurance on the interest holder, which is discussed below.

More flexibility, although less certainty, is provided by including an option to purchase upon the occurrence of certain triggering events. For instance, a buy-sell agreement may provide that, upon the death or disability of an interest holder, the business or the remaining interest holders have the option, but not the legal obligation, to purchase the shares of the outgoing interest holder. While this approach provides greater flexibility to the business or remaining interest holders, it can put the outgoing interest holder or his or her estate in a difficult position because there is no certainty that the shares will be purchased. This may be problematic, particularly if an estate may have liquidity concerns. In such an arrangement, a provision is often included allowing the outgoing interest holder or his or her estate to offer the subject shares to a third party. This right is often subject to a right of first refusal, which gives the business and/or the remaining interest holders the right to buy the shares at the same price and terms as any third party.

Determination of Buy-Out Price. One of the most important features of a buy-sell agreement is that it either establishes a buy-out price in the event of a triggering event or provides a mechanism for determining the buy-out price. The following discusses some of the common alternatives for determining a buy-out price.

1. Certificate of Agreed Value. A fairly common approach is one where the interest holders determine on a periodic basis (e.g., annually) the buy-out price in the event of a triggering event by executing a certificate agreeing to the value of the entity or the shares. This approach, if kept current by the parties, may be a good way to determine the value of the entity or its shares because it is reflective of all of the parties' negotiations of the buy-out price when no one knows whether he, she or it will be the one selling the shares or purchasing them. To address the possibility that the parties will not keep the certificate current, a stale certificate adjustment provision may be incorporated into the buy-sell agreement to provide for an increase in the agreed value based upon a flat percentage increase, the prior year's performance of the business or other factors. Alternatively, a provision could be included to provide for a grace period for the stale certificate to be effective and for it to expire and have no legal effect after such period. In such case, a default provision should be included, such as an appraisal provision (see below).

2. Formula. Another alternative is to determine the buy-out price through the use of a formula written into the buy-sell agreement. For instance, the buy-out formula could be based upon a multiple of earnings for prior periods that is consistent with the standard in the specific industry involved. A formula provision will provide less certainty regarding the buy-out price than the certificate of agreed value approach.

3. Appraisal. A buy-sell agreement could also provide that the buy-out price will be

determined based upon an appraisal to be obtained by the parties following the occurrence of a triggering event. The agreement could provide for a specific appraiser or the business's regularly engaged certified public accountant to perform the appraisal, for the parties mutually to select an appraiser or for each of the parties to obtain separate appraisals and to take the average of the two values determined. Additional issues that might be addressed in the buy-sell agreement in connection with the appraisal are whether the appraiser should take into account factors such as minority and marketability discounts, control premiums and goodwill. In addition, the buy-sell agreement could specify the type of valuation methodology that the parties believe to be most reflective of the industry and should be applied in preparing the appraisal (e.g., discounted cash-flow method, net asset value method or capitalization of earnings method). As with the formula approach, the appraisal approach will provide less certainty than the certificate of agreed value approach.

Payment Terms. It is also critical in structuring a buy-sell agreement to set forth clearly how payment will be rendered for the purchased shares.

1. Lump Sum Payment. A buy-sell agreement will often provide for a lump sum buy-out in the event of the death of an interest holder, which will be funded by the business or the other interest holders with life insurance proceeds. Under this arrangement, the business (in the event of a redemption) or the other interest holders (in the event of a cross-purchase) will obtain a policy (or policies) of insurance on the life of the insured interest holder naming the business or the interest holders, as the case may be, as both the owner(s) and the beneficiary(ies) of the policy. Upon the death of the insured interest holder, the business or other interest holders will receive the life insurance proceeds that will be used to fund the buy-out of the decedent's shares from his or her estate or post-death revocable trust.

> **EXAMPLE:** A and B own a corporation and enter into a buy-sell agreement, which provides, in part, that, upon the death of one of the shareholders, the surviving shareholder may purchase the deceased shareholder's stock at fair market value, which is to be determined by an appraiser. In order to ensure that each shareholder will have sufficient liquidity to purchase the other shareholder's interest in the corporation, A takes out an insurance policy on B's life, while B takes out an insurance policy on A's life.

In the preceding example, because neither A nor B has an ownership interest in the policy on his or her own life, the proceeds will not be includible in the estate of either of them, even though the policies were purchased pursuant to a reciprocal agreement. See Rev. Rul. 56-397, 1956 C.B. 599. Even if the decedent was the controlling shareholder of a corporation owning a policy of insurance on his or her life, the value of the policy proceeds payable to the corporation will not be attributed to the decedent to the extent payable for a valid business purpose so that the net worth of the corporation is increased by the amount of such proceeds. Consequently, the insurance will be reflected in the value of the decedent's stock interest when it is valued for estate tax purposes. Treas. Reg. § 20.2042-1(c)(6). The same result should be reached in the

partnership context. See *Knipp Est. v. Comm'r*, 25 T.C. 153 (1955), *acq. in result*, 1959-1 C.B. 4.

➔ **Planning Point:** If your client is the insured as well as the owner of the insurance policy, you may be able to prevent the insurance proceeds from being included in the insured's gross estate if you can establish that the insured's retention of incidents of ownership was due to a mistake by the agent who sold the policy. See *National Metropolitan Bank v. U.S.*, 87 F. Supp. 773 (Ct. Cl. 1950); *Watson v. Comm'r*, T.C. Memo. 1977-268 (1977). Alternatively, if the proceeds are included in the insured's estate, the value of the decedent's interest in the entity should not include the amount of the insurance proceeds. See *Mitchell Est. v. Comm'r*, 37 B.T.A. 1 (1938); *Tompkins Est. v. Comm'r*, 13 T.C. 1054 (1949).

An issue that should be clearly addressed in the buy-sell agreement is how the balance of the buy-out price is to be paid in the event that the life insurance proceeds are insufficient to fund the purchase entirely (e.g., in the event that the interest holders updated the Certificate of Agreed Value to reflect a higher value but never increased the amount of life insurance to fund the buy- out). In such a case, a buy-sell agreement might provide for deferral of payment of the balance over a specified period of time.

2. Deferred Payment. Another alternative is to provide for the purchase price to be paid over a term of months or a cash down payment and payment of the balance over a term of months (e.g., 60 months). This type of arrangement might be included in a buy-sell agreement for certain types of triggering events, such as a voluntary withdrawal or termination of employment, where there are no readily available sources of funds such as life insurance proceeds to provide the necessary liquidity to fund the buy-out. In such a case, the business or the other interest holders would typically provide a promissory note to the outgoing interest holder in exchange for the purchased shares. To provide security to the outgoing interest holder or his or her estate, the purchased shares might be pledged pursuant to a stock pledge agreement that would provide that if the business or remaining interest holders default on the promissory note, the outgoing interest holder or his or her estate can take back the pledged shares.