BUY/SELL AGREEMENTS
A Primer

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Introduction to Buy/Sell Agreements

The buy/sell agreement, sometimes referred to as a "buyout agreement," provides business owners and businesses a method for ensuring their business interests are protected in the event of death, divorce, and a number of other triggering events. A well-drafted buy/sell agreement takes into consideration the relationships of the shareholders, the current and long-term financial viability of the business to which it relates, and the tax implications of the manner in which the agreement will be funded. This article provides a primer for understanding how buy/sell agreements work, alternative methods for funding them to ensure their dictates are carried out, and why buy/sell agreements may be an appropriate part of a business succession plan.

How Buy/Sell Agreements Work

Buy/sell agreements are agreements between business owners that dictate how an exiting owner's interests will be divided upon a specified triggering event. They work by conveying rights to the remaining partners, the company, or both, to purchase (or redeem) the interests of the exiting owner. They are desirable to many closely held business owners because they protect the remaining owners from "outsiders" obtaining an ownership interest in their company.

The three (3) most common types of buy/sell agreements are entity purchase agreements, cross-purchase agreements, and hybrid purchase agreements.

- **Entity Purchase Agreements** are intended to create a right in the company to purchase the interests of a deceased owner. In this instance, the company purchases the interests of the deceased owner. The decedent's estate "redeems" the shares in exchange for payment made by the company. Here, the rules of Section 302 of the Internal Revenue Code[1] may apply to determine the tax consequences of the redemption.[2] The redemption can be treated as an exchange (which will trigger capital gains and net income investment tax) or a distribution (which will require adjustments to the basis of the corporation's stock[3] and will create different tax consequences depending on the earnings and profits of the company), with differing tax consequences for each. The buy/sell drafter will need to be sure to consider potential tax consequences during the course of drafting.

- **Cross-Purchase Agreements** are intended to create a right in the remaining members to purchase the interests of a deceased owner. In a typical cross-

[1] 26 U.S.C. §302.
[2] *See also,* 26 U.S.C. §754 for election options regarding basis adjustments for partnership redemptions.
[3] *See*, 26 C.F.R. 1.302-2(c).

purchase agreement, the surviving owners are offered the interests of the deceased owner in proportion to their respective interests in the company. The primary tax advantage of a cross-purchase agreement is that the purchaser obtains a stepped-up basis in the interest equal to the amount paid.[4]

- **Hybrid Purchase Agreements** are agreements between the owners that, upon the triggering event, the exiting owner will offer his interests to the remaining owners or to the company. Under this arrangement, typically the owners have the right to purchase the interests of the exiting owner for a specified number of days. If, during that time, they do not purchase the interests, the company has the right to redeem the interests. If neither the remaining owners, nor the company, has purchased the interests after the specified period of time, the exiting owner may offer the interests to a third party.[5] Hybrids are sometimes desirable because they offer flexibility in terms of deciding what tax consequences are more desirable for themselves, the company, and the exiting partner.

Triggering Events

Buy/sell agreements must contain triggering events, to signify when the rights under them become effective. The most common triggering event is death of an owner, but most buy/sell provisions contain additional triggering events, such as bankruptcy or divorce of an owner. This protects the company and remaining owners from having a bankruptcy trustee or a prior owner’s former spouse as a partner in the business.

Other triggering events might include long-term disability, incompetence, or retirement of an owner-employee. Upon the happening of a triggering event, the remaining owners, or the company, as the case may be, have the right to purchase the interests of the exiting owner pursuant to the "buyout" provisions of the buy/sell agreement.

It is often desirable that there be more than one triggering event. For example, if death is the only triggering event, then what happens when an owner is divorced? Are the remaining owners amenable to having the exiting owner's spouse as a partner? What about bankruptcy? Who wants to be a partner with a bankruptcy trustee? These are considerations that need to be made in the drafting stages to ensure the company and the remaining owners are protected from unwanted or unknown co-owners, whose ideas about operating the company may differ significantly from the existing management.

Funding Buy/Sell Agreements

Not many closely held businesses have the liquidity to buy the interests of an exiting owner outright. For this reason, the buy/sell agreement should contain provisions for how the company, or remaining owners, will fund the purchase of the exiting owner's

[4] *See*, 26 U.S.C. §1012(a).
[5] Business owners must be wary of violating securities regulations when offering securities to the public where the purchaser will not assume an active role in the business, *See, e.g. Williams v. Tucker*, 645 F.2d 404, 422-424 (5th Cir. 1981).

interests. There are two (2) common types of funding methods for funding the "buyout" of the exiting owner: life insurance and debt.

Funding with Life Insurance

Naturally, funding the purchase with life insurance presumes that one of the buy/sell's triggering provisions was death. The primary question about how the buyout should be structured is determining who will own the life insurance policy. With a cross-purchase buy/sell, the co-owners purchase life insurance on the remaining co-owners, whereas with an entity purchase buy/sell, the entity is the owner of the policy.

The tax consequences of funding with life insurance offer both benefits and drawbacks. The premiums are not tax deductible, but the proceeds are generally income tax free.

Another consideration in determining whether life insurance is appropriate is the administrative task of how the life insurance will be managed. Does each owner buy life insurance on each of the others? If so, what if there are six (6) owners? Do they each really want to maintain six (6) policies? Are the owners even insurable? Cross-purchase life insurance funding is usually best left to companies having only a few owners, leaving debt funding or redemption more appropriate for those with a number of different owners.

Funding with Debt

There are two (2) methods for funding a buy/sell with debt: debt to the exiting owner or debt to the bank. Generally speaking, co-owners prefer not to borrow from a bank to purchase the interests of their co-owners upon exiting the company. This is especially true if they can simply issue a low-interest promissory note to the exiting owner. At the drafting and negotiating stage, no one knows who will be the first to exit. Everyone being at equal odds for being the first to leave, most owners prefer to issue debt instruments to their co-owners rather than borrowing from a bank to purchase the exiting owner's interest.

However, this determination becomes especially important in an entity purchase buy/sell. Banks almost *always* require personal guaranties for closely held companies. As such, the "bank debt" form of buy/sell is typically not desirable for the owners - why would they go in debt for the company to purchase the interests if they could have simply negotiated to purchase the interests themselves when drafting the buy/sell? As such, most owners prefer the issuance of a debt instrument to the exiting owner in an entity purchase buy/sell agreement.

The debt terms must be carefully drafted into the buy/sell to ensure both the exiting owner is fully compensated for the fair market value of the interests, and to ensure the company or remaining owners have the wherewithal to back the debt. Some buy/sells simply attach a copy of the promissory note as an exhibit, and incorporate it into the buy/sell as the agreed instrument for the purchase of the exiting owner's interests. Others, however, simply spell out the terms of the debt, including a method for determining fair market value, amortization period, payment frequency, and default provisions. Whichever method is utilized, these provisions should be thoughtfully considered in any buy/sell because they should be designed to succeed for the benefit of the exiting owner, the company, and the remaining owners.

Fully Funded

However it is funded, the buy/sell should be *fully* funded - that is, the funding method should be sufficient to cover the full fair market value of the interests being purchased at the time of the purchase. The buy/sell should explain in detail how the full fair market value of the purchased interest will be paid. Of course, if the buy/sell is debt-funded, the exiting owner will take back debt to equal the fair market value of the interests. However, if the buy/sell is funded by life insurance, and the value of the interests exceeds the life insurance paid, the buy/sell should provide a "way out" for the exiting partner. Typically, this would be done through the issuance of debt to the extent of a deficiency. Likewise, if the life insurance proceeds should exceed the fair value of the owner’s interest, the buy/sell should clearly state who keeps the excess proceeds.

Closing Comments

Buy/sell agreements are a very useful tool in business succession planning, and can be used in a variety of ways to protect the interests of the owners of a company. Drafters should be cognizant of the goals of the owners in determining the proper type of buy/sell, as well as the proper funding method and tax consequences.