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## Considerations When Drafting Buy-Sell Agreements

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Dear Clients and Friends:

A “buy-sell agreement” is an arrangement among the owners of a business entity for controlling the ownership and transfer of equity interests. A buy-sell agreement often serves as the linchpin between a business succession plan and the estate plans of the owners in transferring ownership and control. The terms of a buy-sell agreement can be included in an operating agreement of a limited liability company, a partnership agreement, or in a shareholders’ agreement for corporations. A buy-sell agreement may indirectly affect the income from a business entity, but more directly affects control and equity ownership.

***Types of buy-sell agreements.*** A buy-sell agreement is generally an *entity redemption* or a *cross-purchase* or a hybrid of these two. These agreements become operative upon the occurrence of a stated triggering event. A *redemption* gives the entity the opportunity to purchase ownership. *Cross-purchase* agreements are among the owners. *Hybrid* agreements give the entity the first option to purchase, but if impediments exist to the redemption the owners have the option to purchase. Use of a particular approach depends on the number of parties and funding concerns. When the entity has fewer than three owners, a cross-purchase agreement is often preferable. When there are more than three, or when life insurance is the preferred method of funding, an entity redemption arrangement is more common.



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***Mandatory purchase vs. gifts.*** Some trigger events require 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. The sales price can be determined as a percentage of adjusted book value, a multiple of adjusted earnings, a weighted formula of these two, an appraisal, or simply by agreement.

***Trigger events.*** Typically, trigger events include death, retirement, bankruptcy, divorce, disability, and termination of employment. A divorce between a shareholder and spouse often will be subject to the buy-sell agreement. A transfer that would invalidate an “S Corporation” election can also be a triggering event. The definition of “disability” is often one of the more contentious issues involved in drafting the agreement. The termination of employment is usually distinguished between *voluntary* and *for cause*. The definition of “cause” should 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 can depend on how the termination is classified. A donative transfer for the benefit of family usually does not trigger the purchase option.

***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. A drag-along right enables the majority shareholder to compel the minority shareholders to sell their shares at the same price and terms offered to the majority shareholder.

***Insurance funding.*** Many companies fund their buy-sell obligations with life insurance. The cash value of a policy can also fund the purchase of the shares on the retirement or disability of a shareholder. When the company is the policy owner, the requirements of the Internal Revenue Code must be followed so that the proceeds remain excluded from income taxation. When the owners use a cross-purchase arrangement, each party owns policies on the lives of the others. These agreements generally provide that on an owner’s death, the others have the right to purchase the policies on their own lives from the decedent’s estate.

***Sinking fund alternative.*** An alternative to life insurance funding would have the entity create a separate fund to be used only to purchase ownership interests under the company’s buy-sell obligations. The unanimous consent of all owners is required before the fund can be used for any other purpose. The fund is subject to the claims of the general creditors, but the unanimous consent requirement limits the opportunities to dissipate the fund.

***Transfer tax considerations.*** The IRS regularly challenges values fixed under the terms of the agreement as not being bona fide arms-length market prices. Internal Revenue Code section 2703 will permit the IRS to disregard any buy-sell agreement *unless* it is a bona fide business arrangement; and it is *not* a device



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to transfer property; and its terms are comparable to similar arrangements. Structuring and updating a proper price formula is therefore essential.

*Conclusion.* A buy-sell agreement may be useful to prevent undesired transfers and may also establish the value of the business for federal estate tax purposes. The method of determining the purchase price under the agreement should be based on commercial practices at the time the parties entered into the agreement and the agreement should be enforced in every instance.

Please feel to call with any questions or comments you may have.

Very truly yours,

JOHN A. HARTOG, INC.