Nothing Succeeds Like Succession

Buy-sell agreements can provide a defined course of action and peace of mind for business owners.

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It is often the case that owners of a closely held business devote their time to building and growing the enterprise itself without devoting any time addressing what would happen in the event of the death or the withdrawal of one of them. If a closely held business does have a buy-sell agreement in place, many owners or partners are unaware of what it may provide if death or departure occurs.

In the event of the death, disability or withdrawal of a partner, the remaining partners could find themselves in business with the surviving spouse or children of the deceased partner. In the case of the attempted withdrawal or disability, the withdrawing or the disabled partner may have no market to sell their interest. The business, meanwhile, may have no procedures to require a partner to retire despite disability.

It is therefore critical that owners of a closely held business have an effective buy-sell agreement in place in order to govern exactly what would occur in the event of the death, disability or attempted withdrawal of a partner.

There are, of course, a number of different ways to structure a buy-sell agreement, depending upon objectives of the parties. In addition, estate tax issues also must be considered when drafting a buy-sell agreement to ensure that the deceased stockholder's estate is not burdened with additional estate tax liability. In discussing these issues, we use the term "partner" to mean a partner, member or stockholder, and the term buy-sell agreement to include buy-sell agreements, stockholders' agreements, partnership agreements and LLC operating agreements.

Types Of Buyout Arrangements

Two popular types of buy-sell agreements are implemented in connection with a closely held business. The first is a cross-purchase buy-sell agreement, in which the surviving partners individually purchase the shares or interests of the outgoing partner. The second is a redemption agreement, in which the entity itself purchases the interests of the outgoing partner. From a tax standpoint the cross-purchase agreement may be more advantageous than the redemption agreement, as the purchasing partners, rather than the purchasing entity, will be able to obtain a tax cost basis in the acquired shares. In the case of a redemption agreement, the purchasing entity will not be able to obtain the tax cost basis. If the parties cannot decide on which approach to use, an alternative is the wait-and-see approach. A wait-and-see buy-sell approach is a hybrid arrangement combining features of both the redemption agreement and the cross-purchase arrangement. A wait-and-see buy-sell arrangement generally gives the entity the option (or right of refusal) to buy any portion of the deceased owner's interest within a certain time period after the owner's death. If the entity does not fully exercise the option, the remaining owners have the second right of refusal. Finally, if the remaining

owners do not exercise their right of refusal, then the entity must redeem the balance of the deceased owner's interest.

Funding The Buy-Sell

A common way to ensure that the remaining partners or the entity have liquidity to purchase the deceased partner's interest is for life insurance to be acquired on the life of each partner. The insurance would be structured so that the partners or the entity itself owns it. Where several individuals are involved, a trust with an independent trustee can be used to own one insurance policy on each person, avoiding the need to have several policies. The trustee can act as fiduciary to ensure that the transaction is completed in a timely manner. When a partner dies, the insurance proceeds would be used to purchase the interests or shares from the deceased partner's estate. With a cross-purchase arrangement, each of the surviving partners would receive the insurance proceeds and would use them to purchase the deceased partner's interest. With a redemption agreement, the business would obtain these proceeds and use them to purchase the interests.

Typically, insurance is obtained when a buy-sell agreement is first established. As the value of the entity increases over time, perhaps significantly, the buyout price for a deceased partner's interest, if determined by a formula, may increase and the life insurance proceeds may not cover the purchase price. To account for this, it is important that a buy-sell agreement contain a provision that governs how the remaining balance will be paid. Typically, a buy-sell agreement will provide that if the insurance proceeds are insufficient the partners or the entity will pay the balance with installment payments over a term of years.

If the purchase price is more than the insurance proceeds on the deceased partner's life, the liquidity shortfall could put a strain on the deceased partner's beneficiaries and the business's remaining partners. From the entity's or surviving partner's standpoint, an obligation to buy out the deceased partner's interests could present a significant drain on cash flow. From the standpoint of the deceased partner's beneficiaries, delayed payment of a portion of the deceased partner's interest in the company could result in financial strains. Aside from needing the funds to support the surviving spouse and children, federal and state estate taxes may be due shortly after the deceased stockholder's death.

Because of these difficulties, the best solution is to ensure that each partner has sufficient insurance. The buyout price included in most buy-sell agreements is a floating price based on a formula. In such cases it is important that the partners revisit this issue on a fairly regular basis (every two or three years) to ensure that the level of life insurance on each partner is adequate. Additionally, when obtaining such life insurance, it is critical that the policy issued on each partner's life not be owned by that partner or paid to that partner's estate because the cash would be in the wrong hands. That also would result in the inclusion of those insurance proceeds in the deceased partner's estate.

Buy-Out Price Formulas

There are various ways to determine the purchase price under a buy-sell agreement. These include a buyout formula, a certificate of agreed value or an appraisal-based buyout.

Formula Approach: The deceased or outgoing partner's interest is valued based on a set formula that reflects standards that are acceptable in the specific industry. A buyout formula is useful in that it provides for some objective standard to be agreed upon by the parties in advance, when no one knows who is going to be paying or receiving the funds. Negotiating the price and terms of the buyout is best done well in advance to ensure that the terms will be negotiated fairly and without bias.

Certificate of Agreed Value Approach: The parties agree to set the value of the company, and therefore the percentage interest in the company owned by the outgoing or deceased partner. Typically, an agreement using a certificate of agreed value approach will provide that the parties will review it on a regular basis, typically every one or two years. As with the formula approach, the partners mutually agreeing to revisit the company's value on a regular basis provides a basis upon which to establish that the buyout price set in the certificate of value reflects current fair market value. It is unknown who will be paying the price and who will be receiving the price, ensuring that the agreed upon price reflects fair market value. Obviously, the deceased partner would want the buy-out price to be sufficient to ensure that his beneficiaries receive adequate funds for his interest. Conversely, the surviving partners or the entity would want to ensure that the buy-out price reflected a fair price and that they are not overpaying.

Another concept that typically is incorporated with a certificate of agreed value is a so-called "stale certificate" provision. Typically, this provision would provide that if the parties do not revisit the value and update the certificate of agreed value as required, then the certificate of agreed value may still be enforceable for purposes of the buy-sell agreement for a limited period of time, such as six months. After the grace period is over, then the value will no longer be determined by the certificate of agreed value; the parties may agree to a buyout price as determined by a mutually selected valuation appraiser.

Appraisal-Based Approach: The parties do not provide a formula or a certificate of agreed value, but agree that upon the death or withdrawal of a partner the remaining partners or the entity and the outgoing partner's representatives will agree to hire a mutually selected valuation appraiser who will determine the fair market value of the partner's interest. It is important to include in the buy-sell agreement whether the valuation appraiser will or will not take into consideration minority and marketability discounts when determining the value of the outgoing partner's interest, as this may make a difference of up to 35% of the buy-out price.

Estate Tax Considerations

In addition to ensuring a smooth transition of business interests and providing an agreed-upon purchase price in the event of a partner's death or departure, it is also critical that a buy-sell agreement be respected by the IRS for federal estate tax purposes. Maintaining the buy-sell agreement, negotiating its provisions and respecting the requirements in the agreement (for

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example, regularly updating a certificate of agreed value) also help ensure that the buy-out price is respected for federal estate tax purposes. A value that is ignored by the partners or an artificially low buyout price may not be respected for federal estate tax purposes. This is especially the case with entities that are more than 50%-owned by family members. It is critical that the buyout price established in the buy-sell agreement also establishes the value for federal estate tax purposes, although this is not always the case. However, if the buyout price is not respected by the IRS for federal estate tax purposes, the results can be devastating for the deceased partner's estate, burdening the deceased partner's beneficiaries with the obligation to pay estate tax on the additional value calculated by the IRS. In other words, the deceased partner's estate may be entitled only to $x under the buy-sell agreement, but may have to pay estate tax on $2x if the IRS revalues the interest.

For instance, assume the buy-sell agreement sets a buy-out price of $1 million for the deceased partner's interest in a company, but the IRS revalues that interest at $3 million for federal estate tax purposes. The deceased partner's estate would have to pay the IRS roughly $1.5 million (based on an estimated federal and state estate tax rate of 50%) but would receive only the $1 million. Therefore, not only would all the money received by the estate under the buy-sell agreement have to be paid against estate taxes, but the estate would have to pay the balance as well. In order to avoid this estate tax disaster, it is critically important that the buyout price set in a buy-sell agreement is also respected for federal estate tax purposes. In large part, the likelihood of the value being respected will be significantly increased by the stockholders doing the following:

- Negotiating the terms of the buy-sell agreement, preferably with separate counsel, rather than having one partner controlling the arrangement.
- Respecting the formalities and the boilerplate requirements under a buy-sell agreement, such as updating of the certificate of agreed value every two years as required and maintaining a record of the negotiations that took place in determining the value. To the extent that the buy-sell agreement requires notice or other conditions in connection with withdrawal of a partner, all formalities should be followed in accordance with the agreement.
- Consistently applying the requirements of the buy-sell agreement—the agreement should not be applied strictly for one partner but ignored for another.

The importance of having a properly drafted buy-sell agreement, maintaining that agreement and having the agreement adequately funded with life insurance cannot be overstated. Upon the death or withdrawal of a partner, a properly prepared and funded agreement will provide for a smooth transition and for certainty in connection with that transition. In addition the agreement will provide for certainty well in advance as to the buy-out price or means to determine the buy-out price, while all the partners are engaged in the business. This certainty will help avoid disputes as to valuation in the event of a partner's withdrawal or death and provide for an agreed-upon method to buy out a partner, and also will permit the partners to arrange well in advance for the funding of the buy-out, typically with life insurance. However, the time to address these issues in connection with the buy-sell agreement is now, while all the partners are alive and insurable and when the terms of the buy-sell agreement can be negotiated fairly and without bias.

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