The importance of buy-sell agreements.

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According to a recent article in the *Los Angeles Times,* Brad Pitt and Angelina Jolie (when married) purchased a home and a winery together. There was no written agreement between them addressing the disposition or sale of the property. In 2021, Pitt discovered Jolie had sold her half of the asset to an entity controlled by a Russian oligarch. Pitt contends that since that happened there has been no agreement on the management of the asset or its strategic direction. He now shares his personal residence with an outsider. Litigation ensues.

Perhaps Pitt and Jolie fell victim to what most people believe when getting along well—we are reasonable people who will work it out. Sometimes that happens and sometimes that does not.

When any two or more people own or will own an entity, they share "common wealth." All owners of an enterprise who share ownership of assets (and hopefully the visions and values that created them) are connected emotionally and financially to all other members of the enterprise. In a "common wealth" system, every action has a reaction. A shock to any part of the system reverberates through the entire system. With "common wealth" comes a continuing obligation and responsibility to protect yourself and each other and to make decisions about the system as a whole. Planning for the system is as important as planning for everyone in the system.

Evaluating where an owner stands in the system requires two lenses—First, what if I, as the owner, exit? What happens to me, my family, and the system? Second, what happens if another owner exits? What happens to me, my family, and the system?

There is a process to protecting the common wealth in the system and a key part of that process is the implementation of a buy-sell agreement. Think of a buy-sell agreement as a business will or a business prenuptial agreement.

When should a buy-sell agreement be implemented?

Buy-sell agreements should be implemented whenever there is more than one owner in a business. It is common to establish buy-sell agreements for professional service firms, (law firms, doctors, dentists, architects, accountants, etc.) and for any other type of business that has or may have multiple ownership (restaurants, retailers, real estate developers, tech companies, etc.).

Many families own businesses and operating entities. Over the last 20 years, estate planning has created many formal business

entities to govern and transfer assets that a family owns together (limited liability companies, family limited partnerships). Over the course of my career, I have met many families who did not believe they needed a formal agreement. But they did. The issues that face any business also face family businesses. The time to put the agreement together is when all are getting along.

What is a buy-sell agreement?

A buy-sell agreement is a legally binding agreement that governs how the business interests are treated if one owner leaves. Implementing a buy-sell agreement is a practical approach that safeguards the business, its customers, its employees, and other owners. It sets up the process which should be followed when an owner exits. Most buy/sell agreements impose restrictions on an owner's ability to freely transfer or sell his or her shares in the company.

Types of buy-sell agreements

The types of buy-sell agreements include:

- **Redemption agreement** - Company purchases the exiting owner's shares.
- **Cross purchase agreement** - Remaining owners individually purchase the exiting owner's shares.
- **Hybrid agreement** - A combination agreement that provides additional flexibility as to who will purchase the existing owner's shares, the company or the remaining owners?
- **One-way agreement** - Used when there is currently only one owner of the business.

Triggering events

The agreement should specify the trigger events. A trigger event is an event that prompts the purchase of an exiting owner's interest by the entity and/or other owners. Possible triggers include: death, divorce, bankruptcy, retirement, permanent disability, employee resignation, loss of professional license, termination of employment, pledging of an owner's interest in the business, failure to remain active in the business, and voluntary transfers.

In addition to the agreement specifying which of the trigger events should apply, it should also address who has the right

to purchase, who has the obligation to purchase, the purchase price or valuation method used, whether or not the valuation method includes discounts for lack of marketability or minority ownership, and the payment terms.

Valuation

The agreement also must address valuation. It is important to put in place a neutral procedure for determining the purchase price, as no party ultimately knows if he or she will be the buyer or the seller. When a business is starting out, it is difficult to determine its value. No one wants to pay for an expensive appraisal. Having the business valued annually sounds wonderful, but it is hard to actually make it happen. Common valuation methods include fixed price, independent appraisal, or formula approach (such as a multiple of earnings or book value). It also is important to understand when valuation should be revisited, e.g., due to industry changes, profitability, or governmental regulation.

Benefits of buy-sell agreements

Establishing, updating, and maintaining a buy-sell agreement provides significant benefit for the owners and the business entity. It maintains business continuity, protects company ownership, sets forth a process that will mitigate the chances of a future dispute, establishes an organized exit process, protects against public litigation (by including arbitration/mediation clauses), and sets up a process that contemplates generational dynamics and allows the process for adding new owners (children, grandchildren, estate planning trusts). The agreement preserves entity tax status (Subchapter S election), creates a market for the departing owner's interest in the business when without such an agreement there is no market, can mitigate a break in management or voting control, create stability for the remaining owners and non-owner employees, and can ensure that the survivors of a deceased owner are compensated for the deceased owner's interest. Without a binding agreement, it is possible to keep the deceased owner's family in ownership illiquid status.

Special rules pertaining to family members

Special rules apply if the agreement is among family members. Internal Revenue Code Section 2703, added in 1990, and

its regulations must be adhered to. An agreement among family members does not necessarily set a value for gift, estate, or generation-skipping transfer tax purposes. If the IRS determines that the buy-sell agreement is a device to transfer property to family members for less than full and adequate consideration, it can redetermine the value of the transferred interest for gift, estate, and generation-skipping estate tax purposes. The IRS also may challenge the value established in a buy-sell agreement when it appears the decedent was attempting to transfer property for less than full consideration (as a partially disguised gift) to a non-family member. There are three requirements that must be met:

1. The agreement must be bona fide;
2. The agreement must not be a device to transfer property to members of the decedent's family for less than full and adequate consideration; and
3. Its terms must be comparable to similar arrangements entered into by persons in arm's length transactions.

An agreement is deemed to satisfy all these requirements if more than 50% of the value of the property subject to the restriction is owned directly or indirectly by individuals who are not members of the individual's family. This applies only if the interests owned by non-family members are subject to the same restrictions as the property owned by the transferor. Members of the transferor's family include the transferor's spouse, ancestors of the transferor or of the transferor's spouse, and any other individual who is a natural object of the transferor's bounty.

Funding the buy-sell agreement

It is important in the agreement (whether between family or unrelated parties) to address the funding of any buyout. This may be done outright or through an installment method, conventional financing, life insurance, or a combination of these methods.

A risk with conventional financing is that interest rates are rising and banks and financial institutions may be reluctant to lend money if a key stakeholder is exiting.

Life insurance is frequently used to fund buy-sell agreements at death. Many owners make a common mistake by setting the purchase price by the amount of life insurance they decide to put in place. However, the purchase price must be the fair value and the price at which the owner's interest would be sold if the owner was alive or the owner was deceased.

It is prudent to put in place on each owner's life at least enough life insurance to cover the estate taxes that will be due (nine months after the date of death) if payments are to be made on an installment basis. That provides the deceased owner's estate with enough liquidity to pay the estate taxes and not be subject to interest or penalties. It is important to remember that the business valuation must be adjusted as the value of the entity increases or decreases. A regular review is important. As additional owners are added (new partners or, for estate planning purposes, children, grandchildren or trusts), additional life insurance policies may be required.

Conclusion

It is important for all businesses to establish a buy-sell agreement. And like all other estate planning and business succession documents, it should be subject to regular review. Changes will happen—owners may quit, be fired, retire, become ill, die, divorce, or have debt issues. For estate planning purposes, ownership may shift to the spouse, the next generation, or trusts. The market may change and the value of the business may change because of internal, market, or external factors such as governmental regulations or unforeseen events. The challenge for business owners is to pay attention to this now, while everyone is getting along, despite the many other distractions that seem more important. All of us would rather be Scarlett O'Hara: "Why worry about this now? After all, tomorrow is another day." Yet the risk of waiting until tomorrow far outweighs the benefits of establishing a buy-sell agreement today, and continuing to monitor and amend it as life marches on.

About the author.

Patricia M. Annino is a partner in Rimon PC's Trust and Estates Group where her practice focuses on all aspects of private client work including estate planning, will and trust planning, incapacity planning, prenuptial and postnuptial agreements, estate litigation, advising executors, trustees and beneficiaries, and administration of estates and trusts. A nationally recognized authority on estate planning and taxation, prolific author, and frequent public speaker, Ms. Annino has been quoted extensively in a wide variety of national publications including *The Wall Street Journal, Barron's, MarketWatch, Investors.com,* and *Women's Business Journal.*

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