Benefits and pitfalls of buy-sell agreements.

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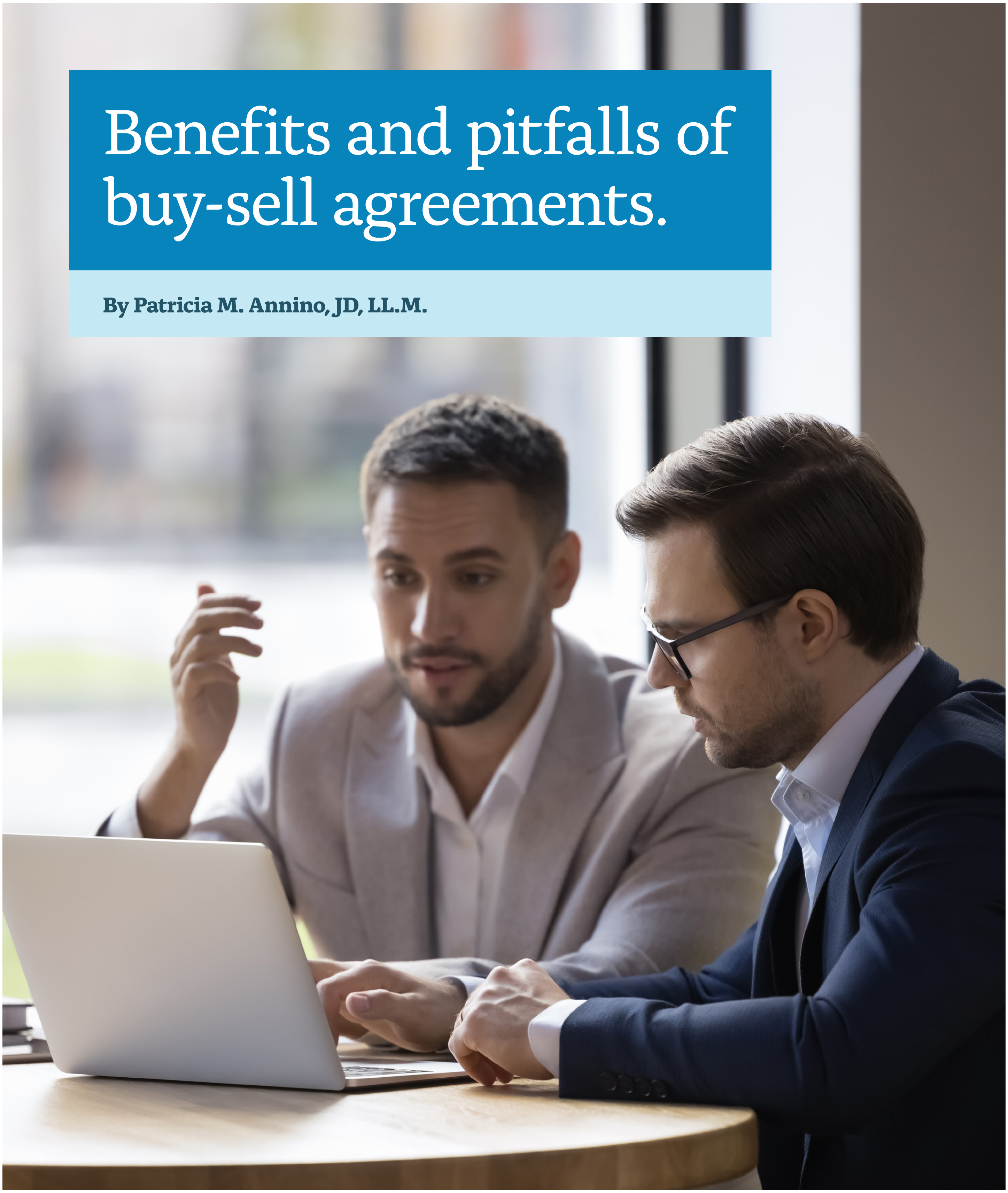

Thanks to the excellent estate planning advice lawyers and CPAs have provided clients over the past 20 years, almost every high-net-worth family has a business. Many formed family limited partnerships and LLCs to own rental or commercial real estate. However, while buy-sell agreements have become essential for conventional businesses with unrelated owners, they are less common among the growing number of intrafamily business entities. The reality is that while the patriarch or matriarch is alive and in control of the finances and the family—even if it is only de facto control—they do not consider their ownership entity to be a bona fide business and view their legal agreements as something they just put in place for estate planning purposes.

Despite what many clients would like to believe, these entities require business formalities, and advisors should encourage their clients to pay the same attention to these concerns that business owners would pay to their non-family enterprises, thus better supporting the overall estate planning goals.

Every business needs a buy-sell agreement. It is part of a prudent succession plan. It is the underpinning of strong estate planning. 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 the other owners. It establishes the process which should be followed when an owner exits the business.

Without business formalities and legal agreements, issues will ripple under the surface which, in many instances, may only come to light years after formation. For example, you may have a client who is a car dealer. The business entity is probably owned by one or two members of the family. The commercial real estate the dealership is located on may be owned in an entity (typically a family limited partnership or LLC) by more family members than those who own the operating business. Frequently, clients will address what happens to the ownership of the operating business when an owner departs, but they do not focus on what happens to the real estate entity. The glue between the operating business and the commercial business entity is the lease. Who determines the rent? What expenses are paid by which party? The price and terms of the lease are important estate planning techniques. When there is a lease between the two entities in effect, the owners of the underlying real estate entity receive an income flow as an inheritance, not a cash out.

Without an agreement that contemplates an exit of ownership from that entity down the road (typically past the death of the founder/key owner of the operating business), the situation may lead to tension and disagreements. The passive owners in the real estate entity may feel that the rent is not high enough or want to cash out. A buy-sell agreement establishes a reasonable process for discussion and resolution.

Forms of buy-sell agreements

There are different forms of buy/sell agreements. The most common are:

- Redemption agreements - business entity buys out exiting owner.
- Cross purchase agreements - other owners purchase interest of exiting owner.
- Hybrid agreements - combination of redemption and cross purchase agreement.
- One way buy-sell agreements - one owner with future owners contemplated.

Reasons to establish buy-sell agreements

Business owners should establish buy-sell agreements for many reasons. They can:

- Provide a process to maintain business continuity and protect ownership (the agreement can preempt marital law, prenuptial agreements, and estate laws).
- Set forth a process to mitigate the chances of a future dispute.
- Protect against public litigation (by including an arbitration/mediation clause for dispute resolution).
- Set forth a process for the inclusion of future owners (new partners, children, grandchildren, estate planning trusts).
- Provide an organized exit strategy.

- Preserve entity tax status (Subchapter S election).
- Create a market for the departing owner's interest in the business when, without such an agreement, there is no market.
- Mitigate a break in management or voting control.
- Create stability for the remaining owners and non-owner employees.
- Ensure that the survivors of a deceased owner are compensated for the deceased owner's interest (without this it is possible to keep the deceased owner's family in ownership illiquid status).
- Enable other stakeholders to act quickly when the shareholder dies to prevent prolonged probate and eliminate the possibility of the personal representative of the decedent voting during the interim process.

Buy-sell trigger events

A trigger is an event that prompts the purchase of an exiting owner's interest by the entity and/or other owners. It is important to consider what should trigger a buy-sell agreement. Possible trigger events include:

Death – The owner's spouse or children may have unrealistic expectations of their loved one's contribution or the value of the business. There are choices to make about death as a trigger. For example, should the agreement state that death of an owner triggers a buy-sell or should the agreement state that transfer at death to family members/trusts is an exception? Every business and family differ on this.

Divorce – Without a buy-sell agreement, attachment is possible. Agreements often allow the divorcing owner to have the first option to purchase his/her interest from his/her soon to be ex-spouse and often include a provision that if the divorcing owner does not exercise this right, then the remaining owners and/or entity have the option to buy. It is important to understand the link between this trigger and valuation. A family predator, like the soon to be ex-spouse, can have the asset valued in a divorce proceeding, which may thwart overall estate planning.

Bankruptcy – Lawsuits, gambling, creditors, or debt can make the other owners vulnerable. The goal is not to have a bankruptcy trustee own an interest in the business.

Permanent disability – If the agreement includes this, it is important to have disability defined.

Retirement – If the owner retires, a buy-sell agreement can define the process to transfer ownership to the next generation or to key employees taking over active management, while the buyout funds the owner's retirement.

Employee resignation or termination – If an owner who is an active employee resigns or is terminated, the other owners may wish to acquire the ex-employee's interest to preserve harmony within the business.

Loss of professional license – If an owner's contribution to the active business depends on maintaining a professional license (e.g., dentist, CPA, lawyer), a buy-sell agreement can address whether this person's ownership interest should be reacquired if that license is suspended or terminated.

Pledging of an owner's interest and voluntary transfers – The outright transfer of an owner's interest to a third party, or placing that owner's interest at risk of forfeiture by pledging it as security or collateral, runs the risk of bringing in a new owner whose interests are not aligned with the remaining owners. A buy-sell agreement can provide that such transfers are void and/or subject to a right of first refusal by the other owners/the entity to acquire this interest.

Buy-sell agreements should address these common trigger events as well as provide guidance for questions such as who has the right to purchase, and who has an obligation to purchase.

Valuation

The agreement also must address valuation, but when a business is starting out, it is difficult to determine its value. No one wants to pay for an expensive appraisal, and having the business valued annually sounds nice, but it is difficult to actually make happen. However, it is important to put in place a neutral procedure for determining the purchase price, as no party knows if they will ultimately be the buyer or the seller. The agreement should specify the purchase price or valuation method used and whether the valuation method should include discounts for lack of marketability or minority, the payment terms, and tax considerations.

Common valuation methods

Buy-sell agreements should contain an outline of the valuation process that will take place in the future, describing how many appraisals will be done, when they should be done, and how an appraiser will be selected.

The common valuation methods include:

Fixed price - This method sets the future purchase price at a specific dollar amount. The risk with this method is that as the business evolves, it will require future negotiation and the dynamics of the owners may have changed. An owner may need cash, be in a divorce, or have creditor issues.

Independent appraisal - This method provides various choices: Each party retains an independent appraiser; the parties agree on a single appraiser; the parties select the appraiser or appraisal when an agreement is drafted; and the appraiser or appraisal firm can be changed if both parties agree. The agreement may set forth qualifications for the appraiser and/or appraisal standards to be followed, such those published by the American Society of Appraisers.

Formula approach - This method provides a mathematical formula to determine the purchase price at the time of the transaction such as a multiple of earnings or book value. Book value may be good when the business is newly formed and no earnings history is yet established, but it may not work as well once the company is growing.

Common mistakes and pitfalls to avoid

Some common mistakes made with buy-sell agreements include:

- Not coordinating all parties.
- Failure to select the right type of agreement.
- Not identifying all trigger events.
- Funding mechanisms that do not work.
- Failing to establish financing terms.
- Wrong or outdated valuation methodology.
- Not reviewing income and estate tax considerations from an estate planning point of view. For example, not including specific language allowing transfers to a class broader than descendants, such as a marital trust, can defer estate taxes and allow future gifting, and voting of shares in trust to be done by trustees, not the spouse.
- Not understanding that the value of the shares is not set by the amount of life insurance or what the family members agree on but must be set to comply with IRS estate tax rules on actual value. (If the valuation provisions are not recognized by the IRS for estate tax purposes, the estate may face a costly valuation dispute with the IRS and have liquidity issues).
- Not having a thorough understanding of funding mechanisms:
  - Sinking fund.
  - Conventional loan. There are risks with rising interest costs or that a bank may be reluctant to loan money to the other owners or entity if the key person is deceased or leaving the business.
  - Installment sale method. There are risks if the payment terms will not work and if the terms, amounts, and expectations are not ironed out. For example, is the down payment term and amount in line with the amount that will be due at the nine-month mark for estate planning purposes? Is life insurance for full buy out possible?
- Setting a standard that is different from industry standards.
- Not matching the ownership of the life insurance to the type of agreement in place (entity, cross purchase).
- Not revisiting the type (term to permanent) or amount of life insurance

needed for liquidity or estate taxes, or failing to insure the life of new owners as they are added.

- Not reviewing the trigger process. Who has the right to pull the trigger? Include protection in the agreement if trigger does not happen.
- Not understanding what the exit of an owner does to personal guarantees and addressing them in the agreement.
- Not understanding what the exit of an owner does to any loan covenant.
- Not addressing future changes in ownership structure or addition of other owners.
- Not addressing process if owner wishes to sell to a third party.
- Lack of coordination with estate planning documents or life insurance plan.

Other issues to consider

Other factors to consider including in a buy-sell agreement can help your clients address the following issues:

Community property – In community property states (Arizona, Idaho, California, Nevada, Louisiana, New Mexico, Texas, Washington and Wisconsin) the interest of an owner in a business is often community property. That means both the owner and spouse have an equal stake in the interest, even in divorce. Unless otherwise stipulated in a legally binding document, each spouse has a claim against all of the marriage's community property when the court divides the marital assets.

Therefore, a buy-sell agreement should grant the divorcing owner the right to buy the stock from his/her former spouse. If the divorcing spouse fails to exercise that option, the business and other owners should be given the right to buy the interest.

Bankruptcy – Consider requiring an owner to inform the other owners prior to filing bankruptcy. The company or other owners can then exercise the right to buy out the bankrupt owner's interest. The funds would go to the bankruptcy trustee and the business could continue to operate without interruption.

Non-compete clauses – Consider adding a clause that if a family member joins a competitor or starts a competing business, stock should be forfeited or repurchased over time, depending on the situation. Typically, the stock would be purchased at a lower share price.

Minority ownership – Due to the lack of marketability of a private company's shares, it is possible for shareholders who disagree with the direction of the company to feel nervous about the future value of their holdings and trapped in ownership. In a public company, there is a simple solution: sell the shares and move on. A buy-sell agreement that includes minority owners can serve as a dispute resolution method by establishing a process by which shareholders can try to resolve their differences. This can include the process to sell and the obligation to buy.

Coordinating the buy-sell agreement with estate planning documents (especially tax apportionment language) – It is important that the buy-sell agreement for any entity be coordinated with the client's other estate planning documents. Of particular importance is the clause in the will which delineates the estate tax burden—whether the taxes are to be borne by the residue or by apportionment. This must be individually reviewed in each plan and it underscores the importance of coordination between the estate planning attorney and the corporate attorney, not only when the plan is set in place, but also as the plan evolves and changes.

In conclusion, it is important that all of us who work with business owners (whether unrelated or family members) do our best to encourage our clients to establish buy-sell agreements and keep them updated.

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*.