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## **The Importance of Buy-Sell Agreements (and Why They Are Worth It)**

**How these agreements can benefit businesses and their owners and why thoughtful planning and preparation is important to obtain the desired results.**

Any number of situations can arise that will put business owners at odds with one another or, even worse, the Internal Revenue Service (IRS) or a third party who may claim a right to a business owner's interest. These situations can come about because of business reasons—for example, disagreements over business plans, termination of employment of an owner, or an owner's desire to sell his interest—or more personal reasons—death, disability or divorce of a member, to name a few. This can lead to disputes and lawsuits that seriously impact the operation and value of the business.

The best time to resolve these potential disputes is before they occur. Unfortunately, too many business owners either do not consider the possibility of these pitfalls or think the costs of addressing them outweigh the benefit of doing so.

The reality is that once business owners are at odds with one another, the economic and emotional costs to resolve the problem (often through litigation) can be exponentially higher where there has not been proper advanced planning.

This Client Alert provides an overview of how buy-sell agreements can help resolve problems before they arise, addresses the various component parts of a buy-sell agreement, discusses the important role that professional advisors have in crafting and implementing a buy-sell agreement, and explains why having a buy-sell agreement is worth the cost and effort.

### **What is a Buy-Sell Agreement?**

A buy-sell agreement is an agreement between the owners of a business entity that obligates (or in some instances provides the option to) some or all of the owners to sell their interest to the other owners or the entity under certain circumstances at a price established by a pre-determined method. Very generally, buy-sell agreements have four (4) necessary components:

1. Triggers—One or more events that will subject an owner's interest to the rights of others to purchase it;
2. Pool of Buyers—Identification of the person(s) that have a right to purchase the subject ownership interest upon the trigger event—either the business entity itself (through redemption), some or all of the other owners (through cross-purchase), both the entity and its owners (through a hybrid arrangement), or even a third party;
3. Price Mechanism—A pre-determined price, or method for determining the price, for the subject ownership interest; and
4. Payment Plan—A pre-determined method, or options, for the payment of the purchase price.

A buy-sell agreement may also contemplate other issues, such as noncompetition and nonsolicitation provisions and permitted and prohibited transfers. However, any effective buy-sell agreement will have the four features mentioned above.

### **Purposes Served Will Determine Triggers**

Buy-sell agreements can serve one or more of a variety of purposes, including the following:

1. Maintaining Closely-Held Status and/or Control Groups. Buy-sell agreements can ensure that business ownership does not expand outside of an agreed-upon group of individuals or entities, thereby ensuring that existing owners have control over the persons with whom they want to be in business. Additionally, buy-sell agreements can consolidate ownership and control within groups of owners, such as within a family.
2. Creating a Market for a Business Interest. Buy-sell agreements can preserve the value of, and create liquidity for, an owner's interest by creating a market for that interest where one might not otherwise exist.
3. Estate and Succession Planning. Buy-sell agreements can ease the estate administration process by pre-determining certain persons to be a deceased business owner's successor. Buy-sell agreements, to a certain extent, also can help reduce and/or set the value of a business interest.
4. Maintain S Corporation or Other Status Related to Makeup of Owners. Buy-sell agreements can help ensure that the ownership makeup does not violate any applicable legal restrictions on who can be an owner, such as S corporation ownership requirements or restrictions on professional corporation or professional limited liability company ownership.
5. Prevent or Deal with Deadlock. Buy-sell agreements can help prevent or deal with deadlock among owners by providing both an incentive to avoid deadlock and/or a mechanism for an owner(s) to buy out another owner(s) with whom he is deadlocked.
6. Restrain Competition. Buy-sell agreements can protect a business by restricting or severely limiting a current or former owner's ability to compete against the business.

The various purposes to which a buy-sell agreement is put will determine what the trigger events will be in the agreement itself.

### **Pool of Buyers Affects Agreement Type**

There are three typical types of buy-sell agreements: cross-purchase agreements between owners, redemption agreements where the entity is the purchaser and hybrid agreements that provide both cross-purchase and redemption features.

1. Cross-Purchase Agreement. In a cross-purchase agreement, if a trigger event occurs with respect to one owner, the remaining owners have the option or obligation to purchase that owner's interest.
2. Redemption Agreement. In a redemption agreement, if a trigger event occurs with respect to an owner, the entity itself has the option or obligation to purchase that owner's interest.
3. Hybrid Agreement. A hybrid agreement combines the cross-purchase and redemption features explained above. This type of agreement will provide for a primary cross-purchase or redemption option (but not an obligation), with the remaining owners or the entity, as the case may be, having a secondary option or obligation to purchase that portion of the departing owner's interest not acquired through the primary option. For example, a corporation may

have the initial redemption option. If or to the extent it does not acquire the stockholder's interest, the remaining stockholders have the option or obligation to do so.

Because of its flexibility, the hybrid agreement is perhaps the best planning tool where the buyer will be the remaining owner(s) or the entity.

Sometimes it may be appropriate for an owner to be required to sell the owner's interest to a third party that does not yet have an ownership interest in the entity. This might happen where a business succession plan calls for a key employee to buy into the entity at an owner's retirement or death or where an entire employee base will take ownership of an entity at an owner's retirement or death through an employee stock ownership plan (ESOP).

### **Price Mechanism Depends on Purpose, Type of Business and Other Factors**

Often, the price under a buy-sell agreement will be the price agreed upon by the buyer and seller upon the trigger event. In many other instances, the price and other will be set by a bona fide offer from a third party or, in the case of a two-owner entity, one of the owners. Where there is not an agreement or a bona-fide offer, there are three general approaches to setting the purchase price in a buy-sell agreement, with each general approach subject to any number of individual factors that will affect the final price. The three general approaches are:

1. **Fixed Price.** This approach requires that the owners set a price, typically at the outset of the venture that will be used to determine the purchase price of a departing member's interest. This price would then need to be adjusted over time by future agreement or, absent a later agreement, possibly subject to adjustment by some indexed rate (e.g., an industry-specific growth rate).
2. **Formula.** This approach determines a purchase price by providing a formula by which the price is set. Typically, the basis of the formula approach will be establishing a value for the business entity based on known figures, such as book value or a multiple of earnings.
3. **Appraisal.** This approach establishes a purchase price through the use of one or more appraisers, whose selection and payment are governed by the buy-sell agreement and who will determine a price for the subject business interest based on those parameters set forth in the buy-sell agreement.

These general approaches vary greatly in terms of complexity and, therefore, implementation cost and accuracy. In choosing a method, business owners will need to determine the extent to which they require more accuracy and are willing to pay for it.

### **Financing Source Affects Buy-Sell Agreement Payment Plans**

Buyers under a buy-sell agreement rarely have the disposable personal finances to purchase a subject interest for an all-cash purchase price. Therefore, financing often will have to come in whole or part from other sources. Three typical sources are:

1. **Seller-Financing.** Often, the purchase price will be paid with some portion due up front in cash and the balance payable over time pursuant to the terms set forth in the buy-sell agreement (often secured by a collateral pledge of the purchased interest).
2. **Third-Party Financing.** In some instances, the purchase price will be paid in full at closing in whole or part from proceeds obtained from some third-party, possibly a bank or private equity firm.
3. **Insurance.** Frequently, all or part of the purchase price will be funded from the proceeds of an insurance policy that pays out upon a trigger event. The most obvious example of this type of financing is when a deceased owner's interest is being purchased with life insurance proceeds, but insurance may also cover lifetime triggers like disability.

When choosing a payment method, owners will need to review carefully the type of purchase method that will work for them. It is likely that no other component of a buy-sell agreement will highlight more the differences in owners' personal situations, from financial resources to health. If an owner would not have the financial means to exercise a purchase option, then the option is essentially

worthless and the owner would be put in a difficult spot vis-à-vis the other owners who could exercise their options.

### **Buy-Sell Agreement Drafting is a Balancing Act**

While the basic premise behind buy-sell agreements is simple—one or more owners (or the owned entity) are given the right or obligation to buy another owner's interest upon the occurrence of a certain event and upon pre-determined terms—drafting these agreements requires a careful balancing act in order to provide the desired result and avoid unintended, negative consequences. Buy-sell agreements are not all the same, and no pre-drafted form agreement can accomplish the variety of possible goals sought to be achieved. Some of the potential "traps" in drafting buy-sell agreements include:

- Destroying the marital deduction available in determining the federal estate tax where a deceased owner's surviving spouse is obligated to sell the interest under a buy-sell agreement.
- Triggering the acceleration of estate taxes attributable to an ownership in a closely-held business that otherwise would be deferred under the Internal Revenue Code even though payments for the interest are payable pursuant to a note and cash is not currently available.
- Foreclosing the ability to use third-party financing to pay the purchase price because of restrictions on encumbrances.
- Creating bias against certain owners who cannot realistically exercise a purchase option (e.g., where an all-cash purchase price is required and an owner has no prospect of being able to pay it).
- Creating bias against certain owners who must incur greater costs under the buy-sell agreement (e.g., a younger, healthier owner who is required to carry insurance on the life of his older, less healthy owner).
- Failing to properly account for the fact that owner/employees and owner/non-employees will have different objectives.
- Failing to qualify for redemption treatment under federal corporate tax laws.
- Creating a taxable dividend where a corporation redeems one owner's stock when the taxpayer/owner had the primary obligation to purchase the stock.
- Using a purchase price formula that is inappropriate for the type of business being valued.

### **The Importance of Professional Advisors (and Communication between Them)**

Proper implementation of a buy-sell agreement requires that competent professional advisors be engaged and act as a team. Attorneys, accountants, insurance advisors and business valuation professionals each can have an important role to play to ensure that the buy-sell agreement is based on a full and complete understanding of the business and its future prospects, effects the desired purposes for the document (including the intended economic effect), and does so in the most efficient way possible.

Failing to engage competent advisors or relying on one or two to advise the business owners on issues that the advisor may not be qualified to handle can not only be a waste of time and money, it can exacerbate the problems that buy-sell agreements are intended to resolve.

### **Worth the Time, Effort and Money**

Properly drafting and implementing a buy-sell agreement requires that business owners and their advisors devote the necessary time and effort to identify what it is that the business owners want to achieve, reduce those goals to writing in a clearly understandable and functional document, and then carry out the terms of the agreement as trigger events occur. Depending on the scope of the undertaking, the initial drafting and execution of a buy-sell agreement could cost several thousand dollars, when taking into account the fees charged by attorneys, accountants and other advisors. Likewise, future expenses may be incurred, such as insurance premiums where there is insurance funding for the agreement and attorney, accountant and appraisal fees to effect the purchase and sale requirement of the agreement or to update the agreement itself. In short, the exercise is not inexpensive.

However, while there can be a significant cost associated with preparing a buy-sell agreement, proceeding without one may be “penny wise and pound foolish,” resulting in substantial costs, both measurable and immeasurable, that far outweigh the cost of executing and implementing such an agreement. The monetary and psychological cost of doing business with people you disagree with about major business issues, no longer like or with whom you otherwise do not desire to do business, while difficult to quantify, may be substantial. What is more measurable and at least as taxing is the cost to litigate disputes between business owners—which can easily result in legal fees in the tens of thousands of dollars or more if the case ultimately goes to trial.

### **About the Author**

A Rock Hill native, Freddy graduated Cum Laude from Clemson University in 2000 with a Bachelor of Science degree in Accounting. He graduated Cum Laude from the University of South Carolina School of Law in 2003, where he was a member of The South Carolina Law Review and a recipient of the Arthur B. Custy Tax Award. Freddy received his Masters of Law (LL.M) in Taxation from the Graduate Tax Program at the University of Florida in 2004.

Prior to joining the firm, Freddy was an associate with Kennedy Covington Lobdell & Hickman, L.L.P. in Charlotte, North Carolina (now part of K&L Gates, LLP), where he advised clients on a variety of tax and general business matters.

Freddy is a member of the American Bar Association, the South Carolina and North Carolina Bars and the York County Bar Association. His practice focuses on taxation, business law, closely-held business law, business succession planning, estate planning and administration.

### **About the Firm**

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