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TOPIC: Buy-Sell Basics – A Brief Introduction

MARKET TREND: For many business owners, their business interests represent their biggest asset, which necessitates advance planning to preserve, maximize, and access the value of those interests, particularly during periods of transition.

SYNOPSIS: Buy-sell arrangements ("BSAs") address how the business or other business owners can "buy-out" an owner's interests after a specified triggering event, such as death. To be effective, the terms and structure of a BSA must be tailored to the unique needs of each business and business owner; there is no "one size fits all" form. BSAs also should take a comprehensive approach to buy-outs, addressing not just an owner's death, but also disability, divorce, and bankruptcy, among other events. Business valuation and buy-out funding are also critical to a BSA's success. In that regard, life insurance can play a vital role by limiting the strain on the business or other business owners to come up with cash or another funding source to buy-out a deceased owner, particularly when death is unexpected.

TAKE AWAYS: BSAs create a ready market for the purchase of a deceased or departing owner's interests at a fair value, which makes them a key component of a business owner's financial and legacy plan. To obtain optimum results, business owners should coordinate with their insurance advisors, attorneys, accountants, and other financial advisors from inception to ensure the BSA is properly customized to their business and appropriately funded. Owners and their advisors also should conduct regular reviews of their BSAs and any funding sources, especially after any changes in the business's ownership, tax status, or value.

Many closely-held business owners spend much of their careers building their businesses, so their planning should focus on capitalizing and ensuring access to the value of their interests, particularly during periods of transition (e.g. death, retirement, or other departure). Buy-sell arrangements ("**BSAs**") can accomplish these goals by creating a ready market for the purchase of a deceased or departing owner's interests at a fair value. BSAs address how the business or other business owners can "buy-out" an owner's interests after a specified triggering event. They also can control or restrict an owner's ability to transfer business interests to outside third parties. When creating or reviewing a BSA, business owners and their advisors should start with the following core components:

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1. TAILOR THE BSA

The buy-sell rights and obligations of the business and owners, including the determination of the purchase price and payment terms, must be tailored, reviewed, and updated regularly to conform to the business's and owners' current circumstances and future objectives. There is no "one size fits all" approach. For example:

- **Ownership**. A majority owner may want fewer transfer restrictions or triggered buyouts to apply to his interests, while the BSA may permit or require minority owners to transfer their interests only to the company or the majority owner upon their departure or death. Majority owners also may want to ensure they control decisions regarding sales of the business (such as including drag-along rights). If the BSA fails to account for such disparate ownership, minority owners could have far more leverage over the business than intended. When a family-owned business if involved, the BSA may want to permit transfers to other identified family members or trusts to facilitate estate and succession planning.

- **Anticipated Successors.** If the owners contemplate a transition primarily to other owners, family members, and/or key employees, their BSA may prioritize internal transfers and buy-outs to preserve ownership within a specified group, possibly with certain individuals given buy-out preferences. In contrast, maximizing the ability to transfer interests or business assets may be the owners' main focus if their exit plan involves a sale to a third party.

- **Timing**. Owners anticipating a sale of their business in the near term may be more concerned with interim protections in the event of an owner's death or disability, while businesses expecting a longer period of private ownership may want to plan for buy-outs upon an owner's retirement.

2. SELECT THE APPRORPIATE STRUCTURE

BSAs typically fall into one of three categories based on the party designated to buy-out a departing or deceased owner:

1. **Redemptions.** The BSA provides for the business entity to purchase (redeem) the business interests of a deceased or departing owner.
2. **Cross Purchases**. The surviving or remaining owners personally buy the interests of a deceased or departing owner.
3. **Combination/Hybrid Arrangements.** These arrangements combine aspects of redemptions and cross purchases. As one example, an arrangement could provide the remaining owners with a first option to buy a deceased/departing owner's interest, followed by a redemption by the company.[1]

The structure chosen can have practical and tax implications for the purchaser and departing/deceased owner, based on the ease of facilitating the buy-out and the type of funding involved (redemptions involve a single purchaser, cross-purchases can involve multiple purchasers if there are more than two owners); how and when gain is recognized on the interests sold and the character of that gain; if there is a step-up in basis for the acquired interests, etc. Accordingly, the preferred buy-sell structure for a business must consider the type of entity (C corporation, S corporation, partnership, or LLC) and business (e.g., products and/or services), the number of owners, their age, health, ownership percentages, and voting rights, their tax basis in the ownership interests, and the planned exit strategy.

3. CONSIDER THE TRIGGERS

Events. Many BSAs focus on buy-outs upon death but fail to cover other common events impacting business owners. As conflict and litigation is far more likely to result from what the BSA does <u>not</u> say, owners also should address the following situations:

- <u>Disability</u>**.** BSAs should address buy-outs in the event of an owner's disability, clearly specifying the definition, criteria, and procedure for determining such disability.
- <u>Voluntary Transfers</u>. Owners may receive offers to buy their interests or want to sell their interests to other parties. BSAs can include a right of first offer/refusal ("**ROFO**") requiring the selling owner to first offer those interests to the business and/or the other owners at the same (or more favorable) terms as offered to/by the proposed purchaser.[2]
- <u>Divorce</u>**.** Business interests could end up held by a non-owner spouse upon an owner's divorce. BSAs can mitigate this risk by making divorce a buy-out trigger, potentially giving the divorcing owner the first option to buy the affected interest so he or she maintains the same ownership percentage in the company.[3]
- <u>Involuntary Transfers/Bankruptcy</u>**.** An owner's bankruptcy or insolvency can trigger a buy-out to keep those interests from ending up in the hands of an owner's creditors.

- Retirement**.** The BSA can permit or mandate retirement at a specified age or require a certain amount of notice before an owner plans to retire to allow planning for the buy-out.
- Termination of Employment**.** BSAs can trigger buy-outs upon an owner's termination of employment, with or without cause, to prevent a former employee-owner from having continued rights in the business.[4]
- Criminal Conduct**.** An owner's conviction for a felony or other specified illegal activities (e.g., fraud, embezzlement) also can trigger a buy-out to terminate the convicted owner interest in the business.
- Loss of License**.** If owners must hold special licenses or certifications in connection with their business (as in professional practices), the BSA should address the loss of such licensing, such as triggering a buy-out if the license is not reinstated within a specified time.

Mandatory or Optional. BSAs can make buy-outs mandatory or optional, based on the triggering event and the owners' circumstances and goals. For example, many agreements mandate buy-outs upon an owner's death but provide for optional buy-outs if the owner wants to voluntarily transfer his or her interests. Optional buy-outs provide more planning flexibility and lessen funding pressures if the business and/or other owners do not have readily-available resources to pay for the interests. Mandatory buy-outs ensure the deceased/departing owner receives value for the interests and also prevent those interests from passing to or remaining with undesirable owners, such as creditors or former spouses. As discussed below, BSAs often mandate buy-outs to the extent insurance proceeds are available to help fund the purchase.

4. SET THE VALUE

A BSA's failure to specify a valuation method for determination of the buy-out price will likely lead to disputes and delay in closing on the transfer of the interests. Owners can adopt numerous approaches to business valuations in the BSA including the use of fixed values, book values, values set by owner agreement, formulas (e.g., annual revenues), or independent appraisals.

When selecting a method, however, owners should note that companies often outgrow fixed values or formulas that were set when the BSA was originally drafted. Further, many owners look to outside guidance to reach agreed-upon values to help ensure the buy-out price is close to fair value. Family-owned business also must proceed carefully in this regard, as buy-outs for more or less than fair market value can trigger estate, gift, and/or generation-skipping transfer tax issues for related owners. To minimize these issues, owners may want the BSA to require independent qualified appraisals to value an owner's interests upon a buy-out.

5. SPECIFY FUNDING & PAYMENT

Triggering a buy-out under a BSA will accomplish little without funding to support the purchase. While lump-sum payments are easy to implement and likely desired by deceased/departing owners, generating sufficient liquidity can be difficult for the purchaser, particularly if the buy-out is unexpected. Accordingly, most BSAs combine one or more of the following approaches:

Life Insurance. Acquiring life insurance is one of the simplest ways to fund a BSA. Its unique features (e.g., a cash payout of death benefits generally without income tax) provide the purchaser with readily-available cash, facilitating a lump-sum payment for a deceased owner's interests. The ownership and beneficiary of the insurance typically tracks the BSA's structure. For example, in a classic redemption, the business owns a single policy on each owner and pays the premiums, while in a cross-purchase structure, each owner owns, pays for, and benefits from a separate policy on every other owner.[5] To ensure insurance-funded BSAs work as intended, owners should consider the following:

- Match Coverage to Structure. Mismatches in life insurance funding and buy-sell obligations may lead to unintended outcomes if the party who receives the insurance benefits does not buy the deceased owner's interests. For example, if the BSA is structured as an optional cross-purchase, with the surviving owner receiving the life insurance benefits on the deceased owner, the surviving owner may forgo the purchase option in favor of retaining the insurance proceeds. As noted, BSAs may avoid this result by mandating a buy-out of a deceased owner's interests by the recipient of the insurance proceeds, at least to the extent of those proceeds.

- Regularly Review Coverage. Owners should have their insurance coverage evaluated along with a regular review of their BSA (see below), as changes in the value or ownership of the business may necessitate adjustments to the coverage (such as a coverage increase to track the growth of the business's value). Insurance advisors can provide a significant value-add by reviewing the life insurance and maintenance needs of the business owners, helping to craft annual review plans and provide regular reminders for BSA and policy reviews.

- Comply with EOLI. Life insurance policy beneficiaries typically receive the death benefits without income tax. However, for "employer-owned life insurance" ("**EOLI**") contracts insuring employees, Internal Revenue Code ("**Code**") §101(j) limits the amount of death benefits that the insuring employer can receive without tax to the premiums and consideration paid by the employer for the contract. Broad exceptions apply to this rule, but only if the employer complies with specific employee notice and consent requirements ***before* issuance of the policy**. Any life insurance intended to fund a BSA should be reviewed for EOLI issues, especially if the business is or will be the policy owner and beneficiary.[6]

- Implement Monitoring and Maintenance Procedures**.** Insurance-funded BSAs should identify and address maintenance of the insurance policies, assign responsibility for premium payments, and include methods for tracking late or missed payments (such as notifying the insured, who can pay the missed premium and seek reimbursement).

- Involve the Advisory Team. When implementing insurance-supported BSAs, owners should include their attorneys and accountants in the insurance discussions to assist with the above issues and avoid other pitfalls that can arise when incorporating life insurance into the plan, based on the BSA's structure, the business entity involved, and the designated owner and beneficiary of the policy. For example, owners will want to make sure they do not inadvertently retain "incidents of ownership" over a policy insuring their lives, which could result in inclusion of policy death benefits in the insured's estate for estate tax purposes (in addition to the value of his or her business interests), even if the proceeds are paid to the company or another owner.[7]

As discussed in *WRMarkeplace No. 16-50*, business owners also may consider other uses for insurance, including for disability, personal, and/or retirement planning, to provide the business with protection from the loss of a key owner or employee, or to serve as a part of deferred compensation funding or as an employee retention tool (e.g., 162 bonus plans).

Promissory Notes (Deferred Payments). Promissory notes are a common funding mechanism for BSAs and effectively provide internal financing between the deceased/departing owner and the purchaser. To limit extended negotiations and conflicts at the time of the buy-out, the BSA should clearly state when notes may be used (e.g., at the option of the purchaser and/or when insurance proceeds are insufficient or unavailable) and the required note terms, including duration, payment schedule, applicable interest rate, and the ability to prepay without penalty. Owners also may want the buy-out notes to provide default remedies or require security/collateralization. When deciding on terms, owners will need to navigate between the competing goals of the deceased/departing owner, who will want the money as soon as possible, and the purchaser, who likely will want the flexibility to extend payments as needed to adjust to cash flow or other financial considerations. Providing for down payments, interest rate adjustments, and/or payment acceleration triggers can help manage these disparate interests.

Non-Voting Interests. The provision of non-voting interests as part of a buy-out can provide economic benefits to a deceased/departing owner or his or her successors while preventing their participation in the governance and management of the business.[8]

6. REVIEW & UPDATE

BSAs are not "set it and forget it" arrangements. Owners should conduct periodic (e.g., annual) reviews of BSAs with their advisors, as failure to update agreements to reflect the addition or departure of owners, changes in the entity's tax status (such as partnership to S corporation), or adjustments in the business's value may result in confusion and dispute about buy-sell obligations or leave the arrangement insufficiently funded.

TAKE AWAYS

BSAs create a ready market for the purchase of a deceased or departing owner's interests at a fair value, which makes them a key component of a business owner's financial and legacy plan. To obtain optimum results, business owners should coordinate with their insurance advisors, attorneys, accountants, and other financial advisors from inception to ensure the BSA is properly customized to their business and appropriately funded. Owners and their advisors also should conduct regular reviews of their BSAs and any funding sources, and especially after any changes in the business's ownership, tax status, or value.

NOTES

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[1] *Insurance LLCs or trusteed buy-sell arrangements would fall into this category.*

[2] *ROFOs can be customized, including to eliminate offers from competitors or to still require the consent of the other owners to transfer interests, even after compliance with the ROFO procedures.*

[3] *When addressing divorce in the BSA, owners should confer with local counsel regarding the binding application of such provisions on spousal rights under applicable state law and whether spousal consents are recommended.*

[4] *To provide additional clarity, the BSA can define termination of employment "with cause"*

[5] *Note that each structure has its own benefits and considerations, including, for example, with regard to redemptions, the ability of all owners to monitor the policies to ensure that they remain in-force, since the business owns and pays for the policies. Further, if the owners differ in age and/or health condition, the disparate premium costs for insurance on each owner can be borne by the company. However, business creditors could attach the redemption insurance proceeds paid to the business, and, for partnerships or S corporations, the remaining owners may not receive a desired adjustment in the income tax basis of the redeemed shares (at least not without additional planning). While cross-purchases eliminate many of the redemption issues, they involve increased complexity. Since each owner owns a separate policy on every other owner, the required number of policies can increase exponentially with more owners. Further, since owners cannot directly monitor premium payments by other owners, they may not realize a policy lapsed until the time of buy-out. Proceeds paid to an owner also may be subject to the claims of that owner's personal creditors.*

[6] *See WRMarketplace No. 12-24 for a more detailed discussion of EOLI.*

[7] *See WRMarketplace No. 13-44 for a discussion of avoiding inadvertent incidents of ownership in a life insurance policy.*

[8] *The provision of voting and non-voting interests or stock should not run afoul of the one class of stock rule for S corporations, so long as all interest/stock are entitled to the same distribution and liquidation rights.*