

# Buy/Sell Agreements

## Tax Info Sheet (2005)

### WHAT ARE THEY?

A *buy/sell agreement* is a contract that restricts the ability of corporate shareholders, partners or limited liability company (LLC) members to freely transfer their ownership interests. It provides that an owner's interest in the business will be sold (or at least offered for sale) at a specified price to the other owners and/or to the business entity itself upon the occurrence of specified events. This prevents unwanted individuals from becoming members of the owner group and ensures a ready market for closely held ownership interests.

#### Who Needs One?

<b>Liquidity of Ownership Interests Is Desired</b>	<ul style="list-style-type: none"> <li>• Owners want to ensure a ready market for their ownership interests (in the event of death, disability, retirement, etc.).</li> <li>• Can be particularly important for heirs or retiring owners with noncontrolling interests.</li> </ul>
<b>Owners Want to Eliminate Uncertainty About Ownership Transfers</b>	<ul style="list-style-type: none"> <li>• Co-owners are comfortable with an owner's plans to transfer ownership to a child in the event of death or disability.</li> <li>• An agreement between the parent and child (with an option on the part of the remaining owners to buy the interest if the child doesn't) removes the uncertainty that exists if a will or other document is being relied upon to effectuate the transfer.</li> <li>• Wills can be changed at the last minute or challenged by heirs or potential heirs. A binding buy/sell agreement can nail down the rights and obligations of the parties.</li> </ul>
<b>Future Ownership Conflicts Can Be Foreseen</b>	<ul style="list-style-type: none"> <li>• It is anticipated that the remaining owner(s) would have difficulties coexisting with the family of a deceased or withdrawing co-owner who would inherit an interest.</li> <li>• A former spouse could wind up with an ownership interest in a divorce settlement.</li> <li>• A buy/sell agreement can ensure that the remaining owners control the interest.</li> </ul>
<b>Ownership By Outsiders Is Undesirable</b>	<ul style="list-style-type: none"> <li>• Applies when owners are a tight knit group.</li> <li>• A creditor could become a member of the owner group if an owner goes bankrupt.</li> <li>• A buy/sell agreement ensures that interests can't leave the existing ownership group without its approval.</li> </ul>
<b>Owners' Heirs Not Interested</b>	<ul style="list-style-type: none"> <li>• The heirs feel the business is too risky for their tastes or they simply have no desire to participate.</li> </ul>
<b>Estate Tax Valuation is Desired</b>	<ul style="list-style-type: none"> <li>• Owners are interested in establishing the estate tax value of their ownership interests.</li> <li>• A buy/sell agreement can be used if certain requirements are met.</li> </ul>

### HOW ARE THEY FUNDED?

A buy/sell agreement is of little benefit without a funding mechanism to provide the cash needed to fund the purchase upon the occurrence of a triggering event. Life insurance is the most common method of funding buy/sell agreements because it assures that a large lump sum will be available upon the death of the insured while requiring only modest annual premiums. Some prospective purchasers may choose to accumulate earnings over time to fund a buyout obligation (a sinking fund). Disability buyout insurance is commonly used to fund the purchase of a disabled owner's business interest. An installment sale can enable funding in the absence of adequate cash reserves or insurance.

### HOW DO THEY WORK?

#### Redemption Agreement:

- The owner of a business entity and the entity itself (whether a corporation, partnership or LLC) enter into a contract. The owner agrees to sell his ownership interest to the entity according to the specified price, terms and circumstances.
- Typically amounts to giving entity the right of first refusal when an owner wishes to sell the interest to a party outside the current ownership group. If entity chooses not to exercise its right, the owner is typically free to sell to the third party. May obligate entity to purchase if no outside buyer.
- If there is no third party buyer, entity must buy owner's interest upon certain circumstances (e.g., death, disability or retirement). Agreement can require deceased owner's estate to offer the interest to entity at specified price and terms.
- Sometimes referred to as *entity plans*. For partnerships, often called a *liquidation agreement*.

#### Cross-Purchase Agreement:

- A contract between the owners of a corporation, partnership or LLC (sometimes referred to as a "criss-cross" agreement) under which the owners agree to offer their ownership interests for sale to each other at the specified price and terms.
- Upon an owner's death, the estate normally must offer ownership interest for sale to other owners at specified price and terms. If there is no third party buyer, other owners are generally obligated to buy interest in the event of certain circumstances (e.g., death, disability or retirement). A cross-purchase agreement is essentially a right of first refusal combined with a purchase obligation (or option).
- Works best when business only has two or three owners. As number of owners increases, the mechanics of a cross-purchase become complex.

#### Hybrid Agreement:

- The business owners contract both with the entity and the other owners. Upon certain events, the owners agree to offer their ownership interests for sale to the entity and/or other owners at a price and terms specified in the contract. The same is true for the estate of a deceased owner.
- Sometimes provide that ownership interest will be offered first to entity and then to other owners if entity doesn't buy interest. In other agreements, owners may have option to purchase interest with entity required to buy if other owners decline.
- May provide that part of ownership interest first be offered to entity and remainder to other owners.
- A right of first refusal if there is a third-party buyer or a purchase obligation (or option) if not.
- Hybrid agreements generally aren't used when insurance is necessary for the buyout, because of the uncertainty as to who might actually be the buyer (the entity or the remaining owners). Thus, hybrid agreements typically tend to be used when the buyout will be seller financed.

#### Third-Party Agreement:

- Involves a contract between the owners and one or more parties outside the current owner group.
- For example, there may be two existing owners of a corporation and a key employee who is well-regarded by both owners. A buy/sell agreement could provide the employee with the right of first refusal to acquire the shares of either owner, with the other owner and/or the entity obligated to purchase the shares if the employee doesn't.