FREQUENTLY ASKED QUESTIONS (FAQS) ABOUT BUY-SELL AGREEMENTS

Business owners use buy-sell agreements to record what should happen if one of them walks away from the business, becomes too disabled to work or dies. A buy-sell agreement can address other issues, such as what happens if an ex-spouse ends up with a piece of the business after a divorce or whether the owners can compete with the business if they walk away from it. These agreements can also protect the valuable S corporation status or, for a C corporation, increase the likelihood that a valuable gain exclusion will apply when the shares are sold.

Q1 – Why do you talk about "**business owners**" and "**business entities**"?

A1 – A buy-sell agreement can apply to shares of a corporation, to membership interests in a limited liability company, or to partnership interests in a partnership. So in this Bulletin, "business owners" includes shareholders, members and partners. "Business entities" include corporations, limited liability companies, general and limited partnerships, and LLPs

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We don't have a buy-sell agreement:

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Q2 – Can any business owner **sell** his or her ownership interests **to anyone**, including our competitor?

A2 – Yes, unless there are restrictions on transfer in a shareholders agreement or the bylaws, the articles of incorporation or in another agreement such as a subscription agreement.

Q3 – All the shareholders are employees. Does their **duty of loyalty** as employees prevent them from selling their shares to a competitor?

A3 – Probably not. They cannot divulge trade secrets in the process of selling the shares. How to make the secret sauce might be a trade secret. The last fiscal year's financial statements are probably not trade secrets.

Q4 – Ok, so one of us could sell their shares of our company to a **competitor**. Is that a big deal?

A4 – Every shareholder, even a holder of non-voting shares, has a right to annual financial statements for the business, a right to inspect the accounting books and records of the corporation, and a list of the other shareholders, their addresses and the number and class of shares that they hold. In addition, shareholders can question whether transactions between management and the corporation (like a company car) are "just and reasonable " to the corporation. Finally, in come cases shareholders holding less than 1/3 of the outstanding shares can ask a court to dissolve the corporation for mismanagement or other bad acts; if the business is dissolved, the competitor might bid on the business at a low price and buy it. Owners of interests in other business entities have similar rights. Those are the main reasons why you want the shares of your corporation in friendly hands.

Q5 – We all founded the business together and we are all friends. If I die, I expect the other business owners to **buy my ownership interests from my surviving spouse** at a fair price. Is that a reasonable thing to expect.

A5 – It might happen. The other business owners will be worried about the negative effects of your loss on the business. They are not likely to offer a price to your spouse that would be a price that you would expect during your life. If they are concerned about their own financial health, they might offer a low price to your spouse, especially if they know your spouse needs the funds to survive. With that scenario in mind, why leave it to your spouse to negotiate then what you are unwilling to negotiate now? After your death, your spouse will certainly not have the leverage that you have when you are healthy. Also, if a buy-sell agreement is made while all of the business owners are healthy, they each will balance what they want for their own spouses if they are the decedent against what they think the business can afford if they are the survivor; so it is much more likely that the arrangement will be fair to a surviving spouse.

Q6 – We **just organized a business entity** for our new business. Do we need a buy-sell agreement now?

A6 – Maybe. If you don't yet know if the business concept is viable, it probably makes more sense to devote your scarce cash to getting the business off the ground. You usually can do a buy-sell agreement only when the founders are still on good terms with each other. So stay on good terms and, the first week that you can go to sleep at night every night without wondering if the business is going to survive, make an appointment with an attorney to discuss a buy-sell agreement.

Q7 – The **marriage** of one of the founders is **on the rocks**. Can we do a buy-sell agreement now?

A7 – Probably not. In the buy-sell agreement the business owners will give each other options to buy their interests in the business if certain events happen. If the business interests are community property (or might be community property), the spouse who is not an owner also needs to sign either the buy-sell agreement or a "consent" to the buy-sell agreement. It is unlikely that an unhappy spouse will sign this. The unhappy spouse is likely to view the buy-sell agreement as a trick to keep the spouse from getting the full value of his or her community property interest in the business. So it's usually best for a business owner in an unsettled marriage to resolve the marriage issues before all of the owners get serious about a buy-sell agreement.

Q8 – We really want to a buy-sell agreement and **we don't want to wait** until one of the business owners resolves things with his spouse. That might never happen. Do we really need to wait?

A8 – No, there are second-best steps that can be taken to get a buy-sell agreement done when one or more spouses refuse to sign it. Note that these additional steps add to the expense and addressing the situation adds to the complexity of the agreement.

Q9 – We have an LLC that holds real estate that has been in our family for generations. It's important to us to **keep the LLC interests in the family**. Can this be done in the operating agreement (or the limited liability company agreement), or do we need a separate buy-sell agreement?

A9 – It can be handled in the operating agreement, but it is probably better to have a separate buy-sell agreement. The operating agreement and the buy-sell agreement would need to be tightly integrated. It is also worth exploring with an estate planning attorney whether future generations would be best served if the LLC interests were held in one or more "dynasty" trusts that would protect the interests from creditors of future generations and from awards of LLC interests to divorced spouses.

Q10 – Our business is in a C corporation because we hope to use **the gain exclusion in Section 1202** of the Internal Revenue Code when we sell the business. We expect that to be a huge tax benefit. Can a buy-sell agreement increase the likelihood that the Section 1202 gain exclusion will apply?

A10 – Yes. The buy-sell agreement can defer redemptions until the required period after the shares have been issued. It can require the corporation to issue the reports that the corporation must provide to the IRS, if requested. It can require the corporation to provide to the shareholders the info about the corporation that they will need to prove that they are eligible for the exclusion. It can require shareholder approval before the corporation engages in a business that is not a "qualified trade or business" under Section 1202. It can require an annual report to the shareholders on whether the shares would still qualify for the exclusion if the shares were sold.

Q11 – Our business is held in an S corporation. We want to have one level of tax (not two) when we sell the business, and we want as much of the gain on the sale to qualify for the low federal tax rates on long-term capital gain, even if the corporation sells its assets. We are concerned that C corporation status is the default status, and a transfer of shares to **a person or entity that is not eligible to hold S corporation shares** will cause the corporation to become a C corporation, subject to a double tax (at the corporate and shareholders levels) if the corporation sells its assets. Can a buy-sell agreement help protect the fragile but valuable S corporation status?

A11 – Yes. The agreement needs a lot more than a clause that "no shares shall be issued or transferred to anyone who is not eligible to hold shares of an S corporation." The agreement should address how shares are allocated among trusts after a business owner dies. The agreement should also address the possibility that shares (or a community property interest in shares) would be acquired by a "resident alien" (that is, someone who is not a U.S. citizen but has a "green card" and pays U.S. taxes) who ceases to be a resident of the U.S. and becomes a "nonresident alien" and so ineligible to hold shares of an S corporation. If the agreement allows shares to be held by qualified retirement plans or charitable organizations, the agreement could address the possibility of a change in the tax status of those entities that would cause them to be ineligible to hold shares of an S corporation.

Finally, the agreement should provide that if a shareholder terminates the S corporation status without the consent of a majority of the shareholders, that shareholder will reimburse the corporation for the second level of tax on corporate profits that are earned by a C corporation, taxed to the C corporation, then taxed again when they are distributed to the shareholders.

Q12 – We own an interest in an LLC that owns **commercial real estate** that is rented to operating businesses. We are not related to the other members of the LLC. Do we need a buy-sell agreement?

A12 – Probably not. It would be good to have in the operating agreement for the LLC a "right of first refusal" clause, so that if any member wants to sell an interest, he or she must first offer it to the other members before selling it to a stranger.

Q13 – OK, we know we need a buy-sell agreement. But we doubt that we will be able to think of every possible scenario that could possibly happen. So at some point the buy-sell agreement might feel like a too-tight coat. Is there a way to **keep it flexible**?

A13 – Yes, but generally only with the consent of all of the business owners. The flexibility is provided by waivers and amendments. The whole point of a buy-sell agreement is to place restrictions on the ability to transfer interests in the business. While the business owners get along with each other, a sale or transfer of shares that "makes sense" to all of them can be accomplished by all of them waiving the provisions in the buy-sell agreement that would otherwise complicate the transaction. Or the parties can agree to amend the agreement to change the approach to a particular situation. An amendment or waiver generally requires the consent of all of the shareholders. Otherwise, when one gets bad lab results, the others could change the agreement to lower the purchase price or lengthen the payment period. Without a buy-sell agreement, the rule is "anything goes." A buy-sell agreement changes the default rules, but the new default rules can still be changed if all of the business owners agree. Generally, the consent of the spouses is not required for a waiver or amendment, unless the rights of the spouses are affected directly.

Q14 – I can't stand the thought of turning the pages of a dense, 60-page agreement. **Can't it be shorter**?

A14 – Yes, it can be shorter. However, the business owners might someday reach a point at which they will do only what the buy-sell agreement specifically requires them to do -- the "no more Mr. Nice Guy" scenario. The degree of detail necessary to be effective in that situation makes for a long agreement. In that scenario, a shorter agreement would leave a lot to be determined by a judge or arbitrator, which could slow down the sale and distract everyone from the conduct of the business. There is a risk with a short agreement of "killing the goose that lays the golden eggs" – that is, hurting the business by diverting the owners' energies from the business to the litigation.

What *can* be short and helpful is a separate summary of the key terms of the agreement. This can help the shareholders and spouses get a "big picture" view of how the agreement works, while the big agreement still provides the details that might ultimately be helpful.

Q15 – Ok, so we need a buy-sell agreement. Must we to sit in a conference room for hours and go over **every possible provision of every possible buy-sell agreement** to pick the ones that make sense for us?

A15 – Not at all. An attorney who has a lot of experience with buy-sell agreements can ask a few questions, then make a proposal on the spot, and work with you to quickly tune up the proposal. I have between 12 and 21 questions that I need answered to before I can offer a proposal. After less than an hour, the attorney will be able to proceed. Some shareholders might want to see a written proposal in bullet point format to discuss among themselves, and with their spouses, CPA, financial advisors and insurance providers. Other at that point might be ready to see a draft agreement and summary, which will probably be delivered to them within a week.

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We're ready to work on a new buy-sell agreement

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Q16 – What if the entity does not want to exercise its option to buy the offered interests, and the other business owners don't buy them, but the owner of those shares really wants to sell them?

A16 – If the entity and the other owners will not exercise their "**call options**," a buy-sell agreement sometimes gives the owner a "**put option**" to require the entity to buy the interests. A put option is usually only given if the owner died, became too disabled to work, or was fired without cause.

Q17 – We've talked about a buy-sell agreement, but we can't come up with a formula value for the shares, and we're concerned about the expense of an appraisal. Can we just **agree on the value** of the shares each year when we get the year-end financial statements?

A17 – You *can*. But … you *won't*. People update the values for a year or two, then they just don't. But in a buy-sell agreement it is possible to provide for this "agreed value" and a back-up way to value the shares. The back-up would kick in if there had been no new agreed value for a period of time (15, 18 or 24 months). For example, when shareholder D gets bad lab results, shareholders E and F are not going to be very motivated to increase the agreed value, and shareholder A will not be willing to reduce the agreed value. Typically, an appraisal provision kicks in to assure that there is a fair price paid for the shares when shareholders D eventually becomes disabled or dies on the job.

Q18 – How will we know what a **fair price** for a business interest will be in the future?

A18 – The best way is to have the business interests appraised at that time. An appraiser can take into account the finances of the business and the non-financial developments (a big new contract, the recent fire, the purchase of a competitor at a high price, etc.) A formula takes into account only the financial information, so it always looks at the past.

Q19 – **Our business is unique**. There are no close comparable businesses. How will an appraiser know how to value it?

A19 – The buy-sell agreement can specify an appraiser who is a member of the American Society of Appraisers and who has at least five years of experience valuing closely-held businesses in the area in which your business is located. The appraiser will consider different methods of valuing the business, and will specify why the appraiser chooses one or more methods.

Q20 – What if the **seller does not agree** with the appraised value?

A20 – The buy-sell agreement can specify a procedure that is likely to give the sellers and buyers input into the appraisal process. For example, the entity can pick an appraiser and notify the seller. The seller can decide whether to go with that appraiser or hire a second appraiser. If there is one appraiser, all parties abide by the value determined by that appraiser. If there are two appraisers, and the lower value is at least 85% of the higher value, the results can be averaged to get the purchase price. If the values are father apart, a third appraiser is selected by the first two appraisers. Then the two appraisals that are closest to each other are averaged and the outlier is ignored. This is intended drive the values to a reasonable value, and away from the extremes.

Many buy-sell agreements provide that if there is one appraiser, the entity pays for it. If there is more than one appraiser, the entity and the seller split the appraisal costs.

At the end of a process like this, with the opportunity for input from both parties, the parties generally feel that the process has been fair.

Q21 – Appraisers want to apply **discounts for minority interests**. Can we prevent them from reducing the purchase price with these discounts?

A21 – Yes, but it has consequences beyond your buy-sell agreement.

The appraisers will refer to studies that show that interests of less than a majority interest are worth less per percentage interest that interests that can control the decisions about the entity. The minority discounts reflect this lack of control and also that there is no ready market for the shares of a closely-held business.

The founders of the business might have minority interests, but they often feel strongly that the minority discounts should not apply when they sell their shares. It is possible in the buy-sell agreement to instruct the appraiser not to apply these discounts.

However, the owners might want to use the discounts to minimize the tax consequences when key employees acquire interests and when they buy the interests back from those employees at the termination of their employment. A judge who sees that the minority discounts apply to the employee but not to the founders might decide not to apply the discount to the employees.

Also, the minority discounts are very helpful in estate planning. Before you tell the appraiser in the buy-sell agreement to ignore minority discounts, you should have a conversation about this with your estate planner. This is a particular concern if your net assets exceed in value $5 million if you are single or $10 million (as a couple) if you are married.

Q22 – How much does an appraisal **cost**?

A22 – An appraisal of a business with one location and one line of products might cost $15,000 to $25,000.

Some business owners would want to have the business appraised before they sign their buy-sell agreement, so that they can see how the appraiser views their business. This can give the owners valuable insights into the aspects of their business that drive its value to others.

Appraisals have consequences for estate planning, in a later divorce and for enforcing later judgments against the owners. To some extent, these issues can be addressed by having the attorney commission the appraisal as the attorney's "work product."

Q23 – We have three founders with 30% each and then a group of key employees, each with less than 5% of the outstanding shares. We can agree on the terms of a buy-sell agreement for the founders, but none of the **key employees** should participate in that. For example, if a key employee terminates employment, we just want to buy back his or her shares. No one else should have options to buy those shares. But if one of the founders dies, the other founders – but not the key employees -- should have options to buy the decedent's shares. How do we accomplish this?

A23 – This is typically handled by having a "buy-*sell* agreement" among the founders and a separate "buy-*back* agreement" for each key employee. So all of the founders would have a buy-*sell* agreement that allowed them to buy the shares of another founder in certain circumstances. The key employees would not be parties to the buy-*sell* agreement, so they would not have any right to buy any of the founders' interest in the business. Each key employee who has shares would also have a buy-*back* agreement with the entity (not with the founders). The buy-*back* agreement would give the entity the right to buy the employee's business interests when the employee's employment in the business terminated.

Q24 – Can our buy-sell agreement **just flat out prohibit sales** of ownership interests to anyone except the current owners? Or how about prohibiting sales to anyone outside of our family?

A24 – No. There is a concept in the real property laws of the U.K. and the U.S.A. that does not allow a contract to prohibit the sale of property. This was a reform from the laws of primogeniture (all of my property goes to my first-born son and to no one else). To make this rule effective, there is another rule that unreasonable restraints on the transfer of property will not be enforced. These rules also apply to sales of business interests. Limiting sales to the few other owners or to one family is dangerously close to an "unreasonable restraint" on selling property. If a court finds the restrictions to be "unreasonable," the court will not enforce the restriction. Rather than risk having an unenforceable restriction, it is usually better to provide the business entity with a right of first refusal at the offer price (or its equivalent in cash).

Q25 – Is there any reason why the **business entity would not buy** the ownership interest in a right of first refusal situation?

A25 – Yes, there are several. The entity might not have the cash to make the purchase, and it might not want to use its borrowing capacity for this purpose. This might occur if the business was growing rapidly, and management could barely find enough cash to meet the demand for the product or to execute the business plan.

It is also possible that using the cash of the business for this purpose would disadvantage the creditors of the business in a way that would make the purchase illegal. If the business would not be able to pay its debts as they become due in the ordinary course of the business, the creditors could reclaim the payments to the exiting business owner – and otherwise from the managers who approved the purchase. Another test is whether the entity's liabilities would exceed the value of its assets. Finally, for corporations, if the purchase pushed the corporation into negative retained earnings, the purchase is prohibited unless the market value of the total assets exceeds the total liabilities after the purchase.

Q26 – What if the other business owners want to buy back the business interests, but **the entity can't or won't buy** them?

A26 – If the entity does not buy, generally the buy-sell agreement would allow the other business owners to buy, in proportion to their ownership in the entity. If some of them buy none or less than they could buy, there is often an opportunity for the ones who bought all they could to buy what's left.

Q27 – Does a buy-sell agreement allow the entity or the other business owners to **buy just part of the selling owner's interest** in the business?

A27 – Some do. For 50-50 owners, having one owner buy a 1% interest from the other and changing the ownership to 51-49 would be a big change. Also, for a business owner who has an offer to sell a 25% interest to a buyer, it is unlikely that the buyer will want to buy the 5% left after the entity and the other business owners bought a total of 20%. To address this, many buy-sell agreements have an "all or none" provision that says that unless the entity and the other business owners buy all of the offered interest, they can't buy any.

Q28 – We see the purpose of a buy-sell agreement if one of the founders dies or becomes too disabled to work. Can we throw in a right of first refusal and call it a day?

A28 – That is possible, but you will probably want to address other common situations. For example, a founder who works in the business "**walking away**" from it. What if a business owner (let's call him "Bob") who's married to an attorney says "I'm tired of working every day. I quit. Since the entity makes regular distributions to the owners, I'll just collect my share of the distributions. You guys can run the business. It's fine if you take salaries and the business provides your cars. Just so you know, I will be keeping an eye on all of the business expenses to be sure that you are not taking too much salary or otherwise being unfair to the 'outside' shareholder – me." In some mature businesses, the "founders" would have transitioned to "investors" and this would be fine. In less mature businesses, the other owners would resent Bob and would rather buy his ownership interest than feel like they were working so he could kick back and collect distributions. If they would resent Bob, they should have an option to buy his shares when he terminates of his employment in the business.

Q29 – Can we say that if a business owner gets **divorced**, the business owner and not the ex must end up with the business interest?

A29 – We can't control how the family law judge will allocate the couple's property. It is likely to be allocated to the business owner, if that is possible. What we *can* do in the Buy-Sell Agreement is give the business owner the right to buy the shares from the ex if the judge awards any shares to the ex. But the business owner might not have any cash left at the end of the divorce process. So it is also good to give the entity and the other owners options to buy shares from the ex if the business owner can't or won't buy.

It is also possible that a spouse will die and, whether on purpose or not, leave an interest in the business to someone other than the business owner. The above procedure works well in that situation. First the business has an option to buy that interest, then the business entity, then the other business owners.

Q30 – If an owner gets married after the buy-sell agreement is signed, will the **new spouse** be bound by the buy-sell agreement if they eventually divorce?

A30 – Probably. If the new spouse acquires a community property interest in the business, the new spouse cannot acquire rights that are superior to the rights that the owner spouse has. But the buy-sell agreement is most likely to be enforced against the new spouse if early in the marriage the new spouse signs a document stating that the new spouse is aware of the buy-sell agreement and agrees to be bound by it.

Many buy-sell agreements provide that the new spouse must "adopt" the buy-sell agreement soon after the marriage. This is not very romantic, and it feels like a prenuptial agreement, which the couple might have already fought about. How can the buy-sell agreement encourage the new spouse to adopt the buy-sell agreement in this situation? One way is to give the entity and the other owners options to buy the interest of the newly married owner if the new spouse does not adopt the buy-sell agreement.

Q31 – Do we have to pay cash for the shares?

A31 – No. Most buy-sell agreements provide for a **cash down payment** for the business interests and then a **promissory note** for the balance. The note can be payable over three to seven years. You will want to pay it off as soon as possible without hurting the business. The payments for the shares are not deductible for tax purposes. The note should bear a fair rate of interest, usually the rate that the business pays to borrow.

Q32 – Should the promissory note given in payment for the business interest be **secured**? If so, by what?

A32 – For a buy-*sell* agreement, the note should be secured, usually by the purchased shares. For a buy-*back* agreement for key employees, the note is generally *not* secured and the payment terms are often shorter, because a smaller interest in the entity is being purchased.

For two shareholders with large interests in the business (40% to 50% each), consider having all of the buyer's interest in the business secure the note. If the buyer defaults, it will be because the buyer could not successfully run the business. If the seller has to step back in at that point, the seller should have complete control over the business, not control shared with a failed operator.

It will rarely make sense to have the assets of the entity secure the note. Doing so means the entity cannot get bank financing and give the bank a first position in its assets as a secured party.

If the entity buys the seller's interest, the interest no longer exists, so it cannot be used for security. In that situation the other owners must guarantee the entity's debt (it can be a nonrecourse guarantee) and then pledge their interests in the entity to secure their guarantees. It sounds complicated, but it's routine.

Q33 – What if the buyers are paying on the promissory notes, and they sell the business?

A33 – The promissory notes would typically **accelerate** and become due if the remaining business owners cashed out, issued cheap stock to water down the seller's security, or pumped all the value out of the entity as distributions or compensation.

Q34 – We are planning to purchase **life insurance** to fund the purchase of the business interests. How does that fit with the promissory note and the security arrangements?

A34 – If the life insurance is collected before the decedent's business interests are purchased, the buy-sell agreement would provide that the life insurance proceeds would be paid as a down payment. Any excess of the purchase price over the life insurance proceeds would be paid with the secured promissory note.

If the life insurance proceeds are collected after the decedent's business interests are purchased, the buy-sell agreement would provide that the life insurance proceeds would be paid to the seller as a pre-payment on the promissory note. The prepayment would reduce the last payments on the note first, and then reduce other payments, in from the last to the first. This way the payments are due every month until the note is paid in full. The effect of the pre-payment is to cause the note to be paid off sooner.

Generally the security arrangements would not be affected by the receipt of life insurance proceeds, even though the payment of those proceeds would cause the note to be over-secured.

Remember that there will probably be events other than death that trigger a sale of the business interest under the buy-sell agreement.

Q35 – If we are going to fund the purchase of life insurance with the funds of the business, we don't want the business entity and the other owners to have *options* to acquire the interests of the decedent. Can we *require* the entity to purchase the business interests of an owner whose life is insured with funds of the business?

A35 – Yes, there is typically a **mandatory purchase** of the decedent's business interest in this situation.

With a mandatory purchase by the business entity, it is necessary to have the sale conditioned on passing the tests for the protection of creditors. Otherwise, a buy-sell agreement that requires the entity to buy interests might be unenforceable as a contract to do an illegal act.

The buy-sell agreement should identify the policies that are purchased to fund a sale under the buy-sell agreement. For one thing, the owners of the policies should not be allowed to borrow against them and should be required to keep them in force. Also, California corporate law exempts purchases of shares with life insurance bought for that purpose from the creditor protection tests; so it is good to say "These are the policies that we bought for this purpose."

Note that if the business owners are obligated to buy the interest, but the entity buys it instead, the purchase price will be treated for income tax purposes as if the entity distributed the funds to the other owners to pay for the interest.

Q36 – If we buy life insurance to fund the purchase of the interests of a business owner who dies, we need to decide now whether the business entity or the business owners will buy the life insurance and purchase the decedent's interest. Which is best?

A36 – To answer this, you need to understand that a buy-sell agreement is more like a car that you drive for a few years and then get a new one, and less like a house that you buy and might live in for the rest of your life. You start out with a basic car and get more bells and whistles in later cars, when you can appreciate them.

If this is your first buy-sell agreement with this group of business owners, it is probably best to have the entity buy the policies. This is because this is the most simple way to proceed, and having an 80% perfect buy-sell agreement is a lot better than having no buy-sell agreement.

When the business increases in value and the owners can explain to their spouses how the buy-sell agreement works and why it is needed, then it will be time to reconsider the buy-sell agreement and, perhaps, increase the amount of life insurance that funds the buy-sell agreement. At that time also, the business owners can reconsider whether the entity should own the life insurance and buy the business interests (called an "**entity purchase**" arrangement), or whether the business owners should own the life insurance and buy the business interests (called a "**cross purchase**" arrangement.

The entity purchase has two problems for a C corporation. First, the receipt of the life insurance proceeds by the corporation will be subject to alternative minimum tax (or "AMT"). Second, the purchase by the corporation will not give the remaining shareholders tax basis in their shares, even though they suffer the economic benefit of not getting the corporate profits used to buy the shares; this is the "disappearing basis problem." Neither of these problems occur with S corporations or other business entities. However, tax basis is wasted when the life insurance proceeds are paid to a non-C-corporation entity while the decedent's family still holds an interest in the business. So for every business entity, an entity purchase is worse tax-wise. Finally, for an entity purchase the entity must deal with the "corporate owned life insurance" ("COLI") rules to avoid tax penalties; these rules are manageable, but they are an added hassle.

In a cross purchase, each business owner needs to own a policy on each other business owner (ignoring the employees with buy-back agreements). Also, the business entity needs to get funds to the business owners to pay the premiums. Because the premiums will be a function of the age and health of each owner, the premiums will not correlate with the percentage interest in the business. There are ways to deal with these concerns, but they add complexity to an already complex buy-sell agreement. Nevertheless, often business owners will choose a cross purchase arrangement after their first buy-sell agreement.

Q37 – In an entity purchase, if an owner is bought out for a reason other than the owner's death, what does the entity do with the life insurance after the owner is bought out? In a cross purchase, even if a decedent dies, the family will own **policies on the other owners** and the family will no longer need them. What does the decedent's family do with those policies?

A37 – The buy-sell agreement will often give the insured the right to buy the bought-out business owner's life insurance on the lives of the remaining business owner. If the buy-out is not triggered by death, the bought-out business owner will also have an option to buy the life insurance policies on his or her life that are owned by the entity or the other business owners.

Q38 – Should we buy **term or permanent life insurance** to fund the buy-sell agreement?

A38 – It's a question best discussed with your life insurance professional. One consideration is how long you plan to hold your interest in the business and whether the business will issue shares to the public or sell to a publicly traded company for stock.

Q39 – If we get life insurance to fund the purchase of a business interest when an owner dies, should be also get **disability buy-out insurance** to fund the purchase if an owner becomes unable to work?

A39 – That is certainly logical. And it is statistically much more likely that a disability will trigger a purchase under the buy-sell agreement as compared with death. The policies are readily available. The problem is that the policies are expensive. Some owners that buy life insurance to fund a buy-out also buy disability buy-out insurance, and some don't.

If you decide to buy this insurance, the terms of the buy-sell agreement need to fit this policy, unlike a life insurance policy that is merely listed as a exhibit to the buy-sell agreement. So the definition of a "disability" in the buy-sell agreement should be the definition in the policy. Also, the purchase date in the buy-sell agreement should reflect the waiting period in the policy (usually 12, 18 or 24 months). Keep in mind that the entity will probably pay the disabled owner's salary until the policy benefits become payable. So the low premiums for a 24-month waiting period have an expense associated with them.

Using the definition in the policy will keep you from saying that a doctor will decide when an owner is disabled. This is not easy to do in our era of patient privacy protections.

Q40 – If a business owner dies, becomes too disabled to work or is fired without cause, we are OK with paying the full appraised value for the shares. But if the owner walks away from the business or messes with the S corporation status, or we buy out an ex or an owner whose new spouse won't sign the agreement, can we **pay just a percentage of the appraised value**?

A40 – It's best to use one value for all purposes of the buy-sell agreement. Using different values invites a judge to throw out the valuation mechanisms in the buy-sell agreement and do whatever the judge things is fair. However, for situations that demand quick action, like threatening the S corporation status, it would be possible to use a rough formula to value the shares; if so, it is a good idea to explain in the buy-sell agreement why a quick valuation and buy-out are needed.

A better way to deal with the fact that some buy-outs are for sympathetic reasons and others less so is to vary the payment terms. If the deal for sympathetic situations is a 20% cash down payment and payment over 60 months at the prime rate of interest, the terms for a less sympathetic situation could be 5% down and the balance over 84 months, using the minimum tax rate to avoid imputed interest. However, having different payment terms adds complexity to an inherently complex buy-sell agreement

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Q41 – No matter what we put in the buy-sell agreement, there will be a risk that we end up in a **legal dispute** about it. Is there a way to minimize the risk that such a dispute will drag on forever, distract our attention from the business and "kill the goose that lays the golden eggs"?

A41 – Most buy-sell agreements have say something about how disputes will be resolved. You probably do not want a jury trial for your business dispute. You can require the parties to put the grievance and response in writing and to meet without lawyers to see if they can settle it. If that fails, they can be required to sit with a professional mediator and their attorneys to try to settle the dispute. Failing that, some agreements provide for arbitration, which is private and can be quick, but generally is not appealable. If a quick solution is better than any drawn out solution, arbitration might fit the bill. However, if the arbitrator does not want to move the proceeding along quickly, there is not much that the business owners or their attorneys can do about it.

Business litigators tell me horror stories about arbitrations, and they recommend using a "rent-a-judge" also called a "judicial reference." A real judge appoints a retired judge (a "referee") to try the case. The retired judge hears the case and makes decisions on the facts and the law and writes a reasoned opinion. Problems with the retired judge can be resolved by the real judge. The decision of the retired judge can be appealed, just like a court case. It is not private like an arbitration.

To encourage the parties to use the first two steps (consultation and mediation) to try to settle, the buy-sell agreement can award attorneys fees and costs to the prevailing party, but not if the prevailing party skipped either of the first two steps.

Q42 – The appraisal procedure above would be a nice way to **value the business interests in a divorce** proceeding. Also, the dispute resolution procedure above would be a nice way to **determine what was community or separate property in a divorce**. Can the buy-sell agreement require these procedures to be used if a business owner gets divorced?

A42 – Family law attorneys tell me that this is possible and that the buy-sell agreement should have these provisions.

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We have a buy-sell agreement and have questions about it.

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Note that questions about a specific buy-sell agreement should be referred to counsel. This part of the FAQs is based on typical buy-sell agreements, and your might not be typical.

Q43 – One business owner wants to transfer some of his interest to his children. We don't have a particular problem with that. Will we still be able to buy the shares from the children if the business owner terminates employment?

A43 – Not unless the buy-sell agreement provides for this. The buy-sell agreement will probably say that it also applies to any transferee of interests in the business. However, that means the right to buy the shares applies when the donee child dies, not when the donor parent dies. It will probably require an amendment to the buy-sell agreement to trigger a buy-out of the child's shares when the parent terminates employment.

Q44 – One of the business owners sold his business interest to someone without going through the right of first refusal process required by our buy-sell agreement. The buyer says that she did not know about the buy-sell agreement and so it should not apply to her. Is that possible?

A44 – It is possible. For corporations and other business entities that issue certificates for the ownership interests, the buy-sell agreement would usually require the entity to place on each certificate a **legend** that would alert a prospective buyer to the existence of the buy-sell agreement. For entities without certificates evidencing ownership, the cover page of the operating agreement or partnership agreement would refer to the legend. The goal would be to defeat the possibility of a buyer convincing a judge that the buyer had no notice of the existence of the buy-sell agreement. But if the buyer can convince the judge of that, then the buyer might be able to avoid the restrictions of the buy-sell agreement.

When the buy-sell agreement is finally signed, it's a hassle to round up the stock certificates (or other ownership certificates), to place the legends on them and to redistribute them to the owners. However, it is an important step that should not be skipped.

I regularly prepare and review buy-sell agreements among business owners. Contact me if you would like to discuss your situation.

Bill Staley
818-936-3490
www.staleylaw.com

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