Choosing The Right Type Of Buy-Sell Agreement For Your Business

By: John L. Egloff - RBE Partner

Consider the following scenarios –

<u>Scenario 1</u>: Mary, Mark, and Melinda are the sole owners of Acme Widget Company, Inc., an S-Corporation, with each of them owning 1,000 shares of stock. Unfortunately, Mark decides to file for divorce from his wife, Marjorie, with whom he's always had a very difficult relationship. At the conclusion of their bitterly contested divorce proceedings, the court awards Marjorie one-half of Mark's shares in Acme.

<u>Scenario 2</u>: Once again, Mary, Mark, and Melinda are the sole owners of Acme Widget Company, Inc., with each of them owning 1,000 shares of stock. One morning, Mary and Melinda are saddened to learn that Mark had died of a heart attack during the night. A few weeks later, Mary and Melinda are even more distressed to learn that, in his will, Mark had left his shares of stock in Acme to scores of family members, friends, and charities.

In Scenario 1, the original owners have suddenly found themselves saddled with a new and potentially very hostile "partner." In Scenario 2, the multitude of new Acme shareholders will not only create a management nightmare, but may also result in the loss of Acme's S-Corporation status and trigger certain securities law obligations.

Of course, many other such scenarios are also possible. For example, an owner's shares could be seized by the IRS or some other creditor in a judicial proceeding, or an owner could simply decide to sell or give away some or all of his shares during his lifetime.

The examples above illustrate the reasons why closely-held businesses should take steps to restrict the ability of their owners to transfer their shares to persons outside of the existing ownership group, whether voluntarily or involuntarily. Our December 2020 article ["Does My Business Need (Or Need to Update) A Buy-Sell Agreement?"] provided an overview of the basic elements of buy-sell agreements. Now let's take a closer look at the three most common varieties of these agreements and their respective advantages and disadvantages.

For simplicity, this article uses the terms "shares" and "shareholders," which would apply in the case of a corporation. However, this discussion is equally applicable to "membership units" and "members" in a limited liability company.

I. Redemption Agreement

When a buy-sell agreement is structured as a "redemption agreement," the company itself will have either the option or the obligation (depending upon the agreement's design) to purchase the shares in the event of any proposed or impending transfer. A company will often obtain insurance to assist with the funding of a repurchase arising out of the death or disability of a shareholder, although the premiums paid are not tax-deductible.

The advantage of a redemption agreement is that the company, rather than the individual shareholders, will be responsible for funding the purchase of the shares. In contrast to a cross-purchase agreement (discussed below), only one policy per shareholder is necessary. In the case of a repurchase obligation not funded (or not fully funded) by insurance, the company may have greater resources to make the required payment than would the individual shareholders, including the ability to borrow the required funds, if necessary. Moreover, if for any reason the corporation were unable to fulfill its obligation to pay for the shares, the remaining shareholders would have no personal liability for that payment.

The disadvantages of a redemption agreement include the fact that, like any other company asset, insurance policies owned by a company are subject to the claims of the company's creditors. In addition, there are a number of potential tax disadvantages. To the extent that a company wanted to reserve funds to assist with any repurchase not covered (or not fully covered) by insurance proceeds, the owners would nonetheless be taxed on the reserved funds if the company is a pass-through entity (such as an S-Corporation or an LLC that is taxed as a partnership), and the set-aside funds could be subject to the accumulated earnings tax liability in the case of a C-Corporation. Additionally, the redemption of a shareholder's shares by the company will not have the same favorable effect on the tax basis of the other shareholders as would be the case with a cross-purchase agreement (see below). Lastly, in the case of a family-owned business, certain attribution rules may apply, as a result of which the redemption price could be treated as a dividend for tax purposes.

II. Cross-Purchase Agreement

When a buy-sell agreement is structured as a "cross-purchase agreement," each of the other shareholders will have either the option or the obligation (depending upon the design of the agreement) to purchase his/her pro-rata portion of the shares involved in any proposed or impending transfer. For example, if A owns 100 shares, B owns 50 shares, C owns 50 shares, and C dies, A would repurchase 2/3's of C's shares (since A owns 2/3's of the combined total of A and B's shares) and B would purchase the remaining 1/3 of C's shares. A typical cross-purchase agreement will require each shareholder to purchase life insurance on each of the other shareholders to provide the purchasing shareholder with the money to fund the repurchase obligation. Once again, however, the premiums paid for this insurance coverage are not tax-deductible.

One advantage of a cross-purchase agreement exists in the case of the death of a shareholder, where life insurance proceeds are payable to the purchasing shareholders. To the extent that a shareholder then uses his/her share of these tax-free proceeds to purchase shares of the selling shareholder, the purchasing shareholder will have a corresponding increase in the tax basis of his/her shares. So, for example, if a shareholder had originally purchased 100 shares of stock in the company for a total $1,000 when it was first formed many years ago, and he now purchases 50 additional shares upon the death of one of the other shareholders using $50,000 of life insurance proceeds, the purchasing shareholder will now own 150 shares of stock with a tax basis of $51,000. As a result, A has used his $50,000 in tax-free life insurance proceeds to increase his basis by $50,000, which will ultimately reduce his tax liability by $50,000 when he sells his shares. Note also that, while company-owned life insurance policies are subject to the claims of the company's creditors, individually owned policies are not subject to the claims of the individual's creditors under Indiana law.

There are, however, several disadvantages to a cross-purchase agreement. First, each shareholder will need to rely on his/her fellow shareholders to maintain the necessary insurance in force, and to have sufficient solvency to fulfill his/her purchase obligation in the case of an uninsured event that triggers a purchase obligation. Second, maintaining the required insurance policies becomes administratively cumbersome if there are more than two shareholders. For example, if there are three shareholders (A, B, and C), six insurance policies will need to be in place: A would have policies on B and C, B would have policies on A and C, and C would have policies on A and B. If there are four shareholders, twelve policies would need to be put in place. Third, there could be significant differences in the premiums that each shareholder would be required to pay as a result of age differences and medical issues affecting the individuals insured by those policies. Although it is possible to address some or all of these disadvantages by having the required policies owned by a trust of which the shareholders are the beneficiaries, that creates certain additional expenses and complexities.

III. Hybrid Agreements.

Hybrid buy-sell agreements can create certain rights and obligations for both the company and the shareholders. For example, a hybrid agreement could create a cross-purchase obligation among the shareholders in the case of death, where the obligation can be fully insured, but provide for a redemption by the company in instances where the repurchase obligation is not insurable (such as upon a shareholder's retirement). Alternatively, a hybrid agreement could provide the shareholders with an option to purchase the offered shares on a pro-rata basis, with the corporation then having the option or obligation (depending upon how the agreement is structured) to purchase any shares not purchased by the shareholder. Thus, a hybrid buy-sell agreement can help avoid some of the disadvantages of both redemption agreements and cross-purchase agreements.

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Not surprisingly, there is no "one-size fits all" buy-sell agreement. Prudent business owners will want to evaluate their own unique circumstances and confer with experienced legal counsel to create the buy-sell agreement that best suits their needs and addresses their concerns.

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ABOUT THE AUTHOR

John Egloff serves as trusted legal counsel for scores of local, regional and national businesses, providing a full range of legal services with respect to their operational and transactional needs. John's more than 40 years of experience as a business attorney includes the formation, acquisition, sale and merger of business entities large and small, and the negotiation, drafting and/or review of virtually every type of business agreement and business-related documentation, including real estate and equipment leases and purchase agreements; financing documents (loan agreements, notes and mortgages); private placement memoranda; employment agreements (including non-competition agreements); licensing and franchise agreements; dealership and distributorship agreements; and routine customer and vendor documents (such as purchase order forms and warranty documentation).

John has served as the Firm's managing partner and has continued to serve on the Firm's Management Committee.