THE BUY SELL AGREEMENT

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THE BUY SELL AGREEMENT

I. BACKGROUND:

When the major asset of an owner's estate consist of a closely held business, estate planning problems may arise. Some of those problems are:

1. Estate taxes often can not be estimated with any degree of certainty because of the difficulty in valuing the closely held business.

2. The business is rarely liquid which causes a greater need for liquidity in such estates. The owner has a great need for liquidity, either for living expenses for the owner or the owner's family or for the payment of estate taxes.

3. Unlike public companies, interests in closely held businesses are not readily marketable.

4. It is very difficult for the estate of a deceased or disabled owner to receive a fair value after the owner is either deceased or disabled. The bargaining positions are unequal.

5. The surviving or non disabled shareholders usually do not want third party "outsiders" as new owners.

6. The surviving or non disabled shareholders may want to preserve S Corporation status.

II. FORMS OF BUY SELL AGREEMENTS: The different types of Buy Sell Agreement are:

a) Stock Redemption Agreement - The Corporation agrees to purchase the stock of a deceased or selling shareholder upon the occurrence of certain events.

b) Cross Purchase Agreement - The continuing stockholders individually agree to purchase the stock of a deceased or selling shareholder upon the occurrence of certain events.

c) Hybrid Agreement - A partial stock redemption and a partial cross purchase agreement.

III. CONTENTS OF BUY SELL AGREEMENTS: Some of the provisions in a Buy Sell Agreement are:

1. Parties to the Agreement: All stockholders, their spouses and the corporation should be parties to the agreement.

2. Purpose of the Agreement: Tax avoidance motivation should not be a purpose listed in the agreement. Otherwise it the agreement may be void for purposes of establishing an estate tax value. It should be established that there is a bonafide business purpose.

3. Restrictions on Transfer: The buy sell agreement must restrict the transfer of stock during the shareholder's lifetime or it will not establish a value for estate tax purposes. Usually

the agreement will give either the company or the shareholder a prorata right of first refusal if a shareholder wants to sell their stock to an outside party.

The agreement may permit certain transfers to family members without having to offer it first to the company or the other shareholders. In some instances transfers are limited by law, i.e. professional corporations that require all of the shareholders to have a certain license, such as a law corporation or an engineering corporation.

4. Encumbrances: Many shareholder agreements prohibit a shareholder from encumbering the stock (i.e. using the stock as collateral for a loan) under many circumstances. However this eliminates a substantial source of credit for the shareholders. If the agreement allows the shareholders to encumber the stock, it should give the company and then other shareholders the right to purchase the stock in the event of default in repayment.

5. Sale upon Termination of the Marital Relationship: In the event of the termination of the marital relationship by death or divorce, the shareholder should be given the right to acquire his or her spouse's community interest in the shares upon the terms and for the price stated in the agreement. If the shareholder does not do so then the company, followed by the other shareholders, should have the right to acquire the community interest. The non shareholder spouse should join in the agreement and should have the opportunity to have separate counsel review the agreement before signing.

6. Sale Upon Disability: If the active participation of all of the shareholders is important to a closely held business' success, then the company usually can not afford to continue compensation to a disabled shareholder.

a) Waiting Period - The waiting period before the disabled shareholder sells his stock to the company usually is between 6 and 24 months, depending on the actual physical services of the disabled shareholder. The waiting period also may be a designated period of time within a longer period of time, i.e. 9 months within a 12 month period.

b) Determining Disability - Can be one of a variety of methods. The disabled shareholder can't perform (a) their usual duties; (b) any meaningful duties; (c) the definition found in the disability insurance policy; (d) determination made by a physician of the corporation's choosing; (e) company and shareholder each choose a medical doctor and if they can't agree then those doctors choose a third doctor; (f) Company (i.e. Board of Directors) determines if there is disability by examining whatever medical evidence they deem appropriate; and (g) a disability insurance policy actually pays benefits.

7. Sale Upon Death: The buy sell agreement may fix the value for estate tax purposes.

The agreement may avoid a controversy with the shareholder's estate, spouse and children at a time of great emotional distress.

It may provide for planned secure funding such as life insurance or a sinking fund if shareholders are uninsurable.

It will provide the estate with liquidity if life insurance is used to fund the agreement and the shareholders are insurable.

The agreement will enhance third party relationships with employees, banks, suppliers, and customers because business interruption will be avoided.

8. Retirement: Especially if there are older shareholders. Usually this will be provided for in a separate agreement.

9. Bankruptcy or Insolvency: The bankruptcy or insolvency of a shareholder or specified acts indicating credit problems, such as a deed in lieu of foreclosure or an assignment for the benefit of creditors, may give the corporation or the other shareholders the right to purchase the stock.

10. Termination of Employment: Usually not included when two shareholders each own fifty percent. There can be a mandatory buy out, where the company is required to buy the shares upon termination of employment, or the company may have the option to buy the shares.

11. Tag Along Provisions: This is a provision where the minority shareholders must join in any sale approved by the majority as long as the sale is upon the same or similar terms. This may also protect the minority.

12. Other Terms: It may establish the terms for purchase including the price, or a method of determining the price, the form of the promissory note, the number of payments, the interest rate, the form of the security agreement and the collateral.

IV. SOME VALUATION METHODS:

Choosing the appropriate method of valuing the company has always been one of the most difficult issues in buy sell planning. The additional complexities of Chapter 14 have only made the task of valuing the company more difficult.

1. Agreed Value Method: The shareholders agree on a value for the shares and periodically reevaluate the price, i.e. at the annual shareholders meeting. It is easy to draft, understand and apply. It will be periodically reviewed, inexpensive to implement, and it permits all factors to be weighed by the business owners themselves.

However, unless unrelated parties own more than 50% of the business, this method will probably not withstand IRS scrutiny.

If this method is used, there should be a backup formula, if the parties fail to make the required reevaluation.

This method usually satisfies the surviving spouse of the deceased shareholder because the surviving spouse knows that the deceased spouse approved of the formula.

2. Book Value: If the book value is used to value the shares, the formula used to determine the book value should be stated in the agreement.

Book value may not show the fair market value of some assets. Cash, accounts receivable and often inventories may be accepted at their book value. Assets such as machinery and equipment, patents, and real estate, unless purchased recently, will usually have values different than their book value. i.e. in an inflationary economy, real estate is often worth substantially more than its book value.

The book value does not take into account future growth potential, the value of personnel and labor relations. Book value is often adjusted to include goodwill, litigation and claims.

3. Multiple of Earnings: The purchase price could be set at a multiple of earnings over a period of time.

The accounting method used to determine earnings will effect earnings and therefore the value.

An appropriate multiplier must be found. Salary adjustments and personal expense adjustments often have to be made because the shareholder employees often are paid based upon personal needs rather than bonafide employer-employee negotiations.

4. Bonafide Offer: The purchase price could be set at the amount of a bonafide offer that the estate receives for the stock. This method creates uncertainty about value and such arrangements are rare.

5. Appraisal Method: An independent business appraiser determines the value. This method may be expensive and time consuming. Federal estate tax values will not be established. However, in family owned businesses this may be the only viable approach. Questions become who will be the appraiser, special instructions, i.e. book value, fair market value, etc.

V. NON CHAPTER 14 FACTORS SET FORTH BY THE IRS IN VALUING A BUSINESS:

The Internal Revenue Service has set forth factors to be taken into account in valuing a closely held business.

a) The nature of the business and its history.

b) The general outlook for the entire economy, this particular industry and this particular company.

c) The book value of the company.

d) The earning capacity of the company.

e) The dividend capacity (rather than the dividend history) of the company.

f) The existence of goodwill.

g) Recent sales of shares of stock in the company.

h) The market price of publicly traded stock in similar industries.

VI. CHAPTER 14 FACTORS SET FORTH BY THE IRS IN VALUING A BUSINESS:

1. CHAPTER 14 section 2703

a. Scope; Effective Date

Section 2703 applies to all agreements, options, rights or restrictions entered into or granted after October 8, 1990, and it also applies to those that are " substantially modified" after that date.

b. General Rule

The general rule of Section 2703 provides that "the value of any property shall be determined without reference to (i) any option, agreement, or other right to acquire or use the property at a price less than fair market value of the property (determined without regard to such option, agreement or right), or (ii) any restriction on the right to sell or use such property.

c. Safe Harbor

There is a statutory safe harbor that provides that the general rule will not apply to any option, agreements, right or restriction (collectively, for purposes of this section referred to as "Buy-Sell Agreement") which meets each of three specific requirements":

(1) The Buy-Sell Agreement is a bona fide business arrangement;

(2) The Buy-Sell Agreement is not a device to transfer the covered property to members of the decedent's family for less than full and adequate consideration in money or money's worth; and

(3) The terms of the Buy-Sell Agreement are comparable to similar arrangements entered into by persons at an arm's length transaction.

VII. CORPORATION'S ABILITY TO PURCHASE SHARES:

A Texas corporation may purchase its shares unless a) prohibited by its articles of incorporation; or b) the corporation will be insolvent after the distribution; or c) the distribution exceeds the surplus of the corporation. Insolvency means the inability to pay its debt as they become due in the usual course of business. Surplus means the net assets over stated capital.

VIII. "COMPARISON OF STOCK REDEMPTION AGREEMENT AND CROSS PURCHASE AGREEMENT:

1. COMPARATIVE TAX RATES:

Redemption Agreement- Corporation pays for insurance policies and for stock with after-tax corporate dollars. Premium payments are not considered constructive dividends to shareholders unless shareholder obligations.

Cross Purchase Agreement- The stockholders pay for insurance policies and for stock at after-tax individual rate.

2. CREDITORS:

Redemption Agreement- Proceeds on insurance or sinking fund which are used to fund the agreement are subject to claims of creditors.

Cross Purchase Agreement- The proceeds of any insurance received by the stockholders are removed from claims of the corporation's creditors unless the stockholders are individually liable for corporate obligations.

3. TAX BASIS:

Redemption Agreement- Remaining stockholders will continue to have the same basis in their stock.

Cross Purchase- Remaining stockholders receive an increased basis for the shares purchased.

4. RELATED PARTIES:

Redemption Agreement- IRS Section 318 attribution problems arise if remaining stockholders are related to the selling stockholder or are beneficiaries of his estate.

Cross Purchase- There are no attribution problems with corresponding potential dividend problems.

5. FUNDING WITH INSURANCE:

Redemption Agreement- As a rule the corporation owns a policy on each stockholder. Insurance proceeds therefrom are received tax-free by corporation (subject to possible alternative minimum tax).

Cross Purchase- Each stockholder owns a policy on the life of other stockholders. This cumbersome arrangement (ten stockholders would require 90 policies) results in transfer and administrative problems. Partnerships are being considered as alternative owners. Shareholder-beneficiaries receive insurance proceeds tax free.

6. TRANSFER OF INSURANCE POLICY:

Redemption Agreement- No transfer required.

Cross Purchase- Transfer for value problems may arise where there are three or more stockholders should a stockholder purchase a policy on the life of another stockholder from the estate of a deceased stockholder.

7. FUNDS TO PAY INSURANCE PREMIUMS:

Redemption Agreement- Corporate earnings are used to pay the premiums on corporately owned policies.

Cross Purchase- Additional compensation or dividends may be paid to stockholders to provide funds to pay for premiums on individually owned policies.

8. INCREASE IN STOCK INTEREST:

Redemption Agreement- The purchase of withdrawing stockholder's stock results in a strict proportionate increase in the stock interest of the remaining stockholders.

Cross Purchase- Proportionate increase can be altered if desired.

9. CAPITAL REQUIREMENTS EARNED SURPLUS:

Redemption Agreement- The agreement must comply with state law regarding legality of the corporation's right to redeemed its shares, i.e. Texas-- "surplus" (and "no insolvency" requirements).

Cross Purchase- No State law restriction.

10. LIABILITY FOR PURCHASE PRICE:

Redemption Agreement- The corporation is liable unless the other stockholders agree to guarantee the note.

Cross Purchase- Unless otherwise agreed, the remaining stockholders will be individually liable for the purchase price of the withdrawing stockholder's stock.

11. BURDEN OF FUNDING:

Redemption Agreement- The stockholders bear the burden of the cost of funding the agreement in proportion to their stock ownership.

Cross Purchase- If the agreement is funded with insurance, the amount of insurance each stockholder must carry is inversely proportionate to his percentage of ownership. For example, if A owns 70% of corporate shares and B owns 30% of corporate shares, B must carry insurance in an amount at least equal to 70% of the net worth of the corporation if the agreement is fully funded. The proportionate burden on B is even higher if A is substantially older than B." (From Mincey and Kroney- See Below).

Sources: Planning an Estate, by Harold Weinstock, Mcgraw-Hill (1988); Estate Planning and Taxation Coordinator, Research Institute of America (1993); Buy/Sell Agreements, by James M. Mincey, Jr. and Robert H. Kroney, State Bar of Texas, Advanced Drafting: Estate Planning and Probate Course (November 1992); Drafting Buy Sell Agreements, by Michele A. Mobley, State Bar of Texas, 10th ANNUAL ADVANCED DRAFTING: Estate Planning and Probate Course (October, 1999).

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