VII. DRAFTING CONSIDERATIONS

In the real estate context, many buy-sell agreements are similar because of the common issues of valuation and issues of liquidity. There are also issues of intent to continue the business, the basis of the company in its assets, the relationship of the owners and their respective families, the existence of “problem” heirs and potential creditors of the owners, the health of the owners and the issue of immediate payment of taxes or expenses. Below are examples of provisions that a drafter should consider.

A. RESTRICTIONS ON TRANSFERABILITY.

1. With no such restrictions, a surviving owner is forced to share control with persons not of their choosing. Crucial in situations where the input and expertise of the partners is important to the administration of the business (because the new owner may not be qualified or competent).


   a. Requirement of unanimous consent (or high percentage) of a vote of the non-selling owners to approve the assignment.

   (1) Most corporate acts do not contain provisions restricting the transfer of corporate stock, but will allow owner restrictions by voluntary agreement in certain circumstances [See Revised Model Business Corporation Act § 6.27 (2006)].

   (2) Assignee cannot become a member of a limited liability company except by unanimous consent of all of the remaining members, however [See Model Limited Liability Company Act § 502 (2006)]. This can be modified by agreement of the owners, however [See § 401].

   b. Agreement may contain provision to allow transfers to “permitted transferees” such as lineal descendants or spouses without the need for unanimous consent.

   c. S-Corporations
(1) S-Corporation can lose its S-Election for transfer to non-qualified shareholder.

(2) Restriction should be listed in the Bylaws and placed on the stock certificate (Show lack of company authorization).

(3) Issue of one class of stock requirement [See IRC § 1361(b)(1)(D); Treasury Regulation § 1.1361-1(l)(2)(iii)(A)].

B. RESTRICTIONS ON TRANSFERABILITY - ESTATE TAX ISSUES

1. IRC § 2056(b)(1): Marital deduction denied for transfer subject to a terminable interest.
   a. Transfer will terminate or lapse on a particular event or condition.
   b. Someone other than surviving spouse receives the property upon the event.
   c. Example: Stock transferred to surviving spouse subject to an obligation that the stock be sold at a price less than fair market value to another party. See PLR 9147065 (Marital deduction denied for stock devised to surviving spouse subject to the right of the sons to purchase the stock at less than FMV. IRS held right converted spouse’s interest in stock to “terminable interest.” And denied marital deduction for the trust).
   d. See Also Renaldi v. United States, 38 Fed. Cl. 341 (1997), aff’d, 178 F. 3d 1308 (Fed. Cir. 1997).

2. IRC § 2056(b): Annual Exclusion for Gifts ($15,000 per individual/$30,000 per couple) to another done free of gift tax.
   a. Gift must constitute a “present interest.” Treasury Regulation § 25.2503-3(b).
   b. See Hackl v. Commissioner, 335 F. 3d 664 (7th Cir. 2003).
      (1) Family-owned LLC where interest transferred was subject to numerous restrictions, including a requirement to offer to the interest to the LLC and a requirement of manager consent for any third party sales.
      (2) Donor essentially kept total control over the interests he had gifted to his children
      (3) Court held that the gift was not one of a “present interest” and the annual exclusion did not apply.
(4)  Application of Substantial Present Economic Benefit Rule to determine whether the transfers constituted a “present interest.” The Court found that all potential economic benefits were clearly in the future, rather than in the present.

C. TRIGGERS FOR BUY-SELL PROVISIONS.

Every BS Agreement should contain specific provisions outlining when the obligation to buy or sell has become effective (i.e., a “trigger”). These can include the following:

1. Death

2. Voluntary transfer of the interest (Sale to third party in violation of Buy-Sell Agreement)

3. Disability (especially prevalent in situations where participation of management of the business is critical.

4. Involuntary Transfers (Divorce)

5. Termination of Employment

6. Disability of the owner

7. Retirement of the owner (Avoid application of IRC § 409A, however)
   a. **IRC § 409A** applies to payments received under agreements that are considered to be non-qualified deferred compensation (includes severance agreements of employees and retirement agreements with owners) rather than buyout of equity interest.
   b. Danger of immediate recognition of all deferred income in the immediate year. There is also a 20% penalty on the full amount of compensation. *See Summit Inv. & Dev. Corp. v. Leroux*, 69 F. 3d 608, 614 (1st Cir. 1995).

8. Bankruptcy (some controversy regarding this issue).
   a. A Bankruptcy trustee may avoid restrictions on alienability of interests.
   b. **11 U.S.C. § 365**: trustee has the power to avoid executory contracts.
      (1) Courts have interpreted this statute to include Buy-Sell Agreements that are conditioned on bankruptcy.
(2) 11 U.S.C. § 365(e)(1): Trustee may disregard provisions in an executory contract that trigger an action upon the filing of bankruptcy by a debtor. See Also Summit Inv. & Dev. Corp. v. Leroux, 69 F. 3d 608, 614 (1st Cir. 1995).

c. 11 U.S.C. § 541(c)(1): Trustee may disregard terms that restrict assignability of the interest, where the Buy-Sell Agreement is considered non-executory. See Also In re Garrison-Ashburn, LLC, 253 B.R. 700, 708 (Bankr. E.D. VA 2000) (Holding operating agreement was non-executory and thus the restrictions on transfer of interests contained therein could be disregarded).

d. Issue of whether agreement is considered executory or non-executory (high probability of challenge by bankruptcy trustee).

D. DETERMINING THE TYPE OF BUY-SELL AGREEMENT.

1. Redemption Agreement (Company obligated to purchase).
   a. Should include buy-sell provisions in corporate operating documents (LLC – Operating Agreement; Partnership – Partnership Agreement; Corporation – Bylaws)

2. Cross-Purchase Agreement (Other owners are obligated to purchase).
   a. Parties enter into a separate agreement such as a shareholder’s agreement or a member’s/partner’s agreement.
   b. All owners are obligated to the terms of the buy-sell agreement.
   c. The Company is not a party to cross-purchase agreements unless it has a right of first refusal in the purchase of the interest.

3. Hybrid Agreements.
   a. Company has the right of first refusal for a repurchase of an owner’s interest and would therefore provide each owner with a right to purchase the departing owner’s interest.

E. VALUATION PROVISIONS.

1. Agreement on manner of valuation.
   a. Fixed Price.
   b. Adjustable Fixed Price.
c. Fair Market Value.

d. Other standards of valuation.

2. Compliance with IRC § 2703 regarding setting price of the interest in intra-family transfers.

F. OPTIONAL VS. MANDATORY PROVISIONS.

1. Mandatory Buy-Out Provision—this obligates the Company (or other Owner) to buy, and the Departing Owner to sell, the interest in the company.

   a. Owners may purchase at an agreed price if the Company does not exercise its option.
   b. If neither the company nor the owners exercise the option to purchase, the departing owner or the departing owner’s heirs can sell the interest to a third party.

3. Assignability of financial rights of the interests (not the actual interest itself).
   a. Actual interest cannot be assigned without consent of the remaining shareholders / owners.
   b. Issue with S-Corporation regarding qualified shareholders / loss of S-election.

G. FUNDING/PAYMENT PROVISIONS.

1. Agreement funded by insurance.
   a. If insurance is going to be utilized for the purchase of the interest, there should be a provision that requires the insurance to be maintained, either by the company or the respective owners in case of a cross-purchase agreement.
   b. There should be a stipulation as to the ownership and control of the life insurance policy that is made subject to the agreement, and as to the disposal of the policy should the agreement be terminated during the lifetime of the parties (sole proprietorship).
   c. There should be a commitment on the part of each partner (same with stockholders) that such partner shall not dispose of the
partnership interest during that partner’s lifetime without first offering it for sale to the other partners at the contract price (same for the deceased partner’s estate).

d. There should be a commitment with respect to the time and manner of paying any balance due of the purchase price in excess of the insurance proceeds (and vice versa).

e. Where the valuation standard on FMV, there should be a provision that requires a revaluation of the interest so the parties can know how much life insurance will be required to fund the buy-sell agreement.

f. If the company is required to maintain the insurance, the company should be responsible for payment of any amounts in excess of available insurance out of its own assets.

g. There should be a commitment that the surviving partners will assume all obligations of the partnership and will hold harmless and identify the deceased partner’s estate.

2. Agreement not funded by insurance.

a. If the agreement is not funded by insurance, but instead out of company profits, the agreement must contain provisions to allow for payment of the purchase price over time.

b. Provisions should comply with IRC § 6166 in order to allow the deceased owner’s estate to defer the payment of estate taxes as a result of the inclusion of the interest.

H. SECURITY PROVISIONS.

1. Provide the departing owner with security for payment if there is a payment deferral arrangement (i.e. stock provided as security until payment).

2. Parties may provide for personal guarantees from the other owners for the purchase price.

3. Parties could also include a mortgage on real estate owned by the company.

4. Beware of business profitability issues due to death or departure of the selling owner.
I. DISPUTE RESOLUTION PROBLEMS.

1. Include a forum selection clause. What is the best or most appropriate forum?

2. Use of arbitration of disputes (less expensive; more limited discovery).
   a. American Arbitration Association
   b. JAMS
   c. National Arbitration and Mediation.

3. The parties may want to provide limited dispute resolution provisions, especially on the issue of valuation.
   a. Agree to use FMV and for an independent appraisal.
   b. Each side can appoint their own appraiser and agree on a third.
   c. An independent party such as a local judge could appoint the appraisers.

J. OTHER DRAFTING CONSIDERATIONS

1. Make sure the Buy-Sell Agreement is coordinated with other documents. If there is a conflict with an owner estate planning documents, some jurisdictions may provide that such documents take precedence over a Buy-Sell Agreement.

2. One should be careful when selecting the type of Buy-Sell Agreement. Make sure to coordinate rights, options and timing issues, especially with cross-purchases.

3. One should tailor the associated rights and obligations following triggering events.

4. Consider using non-compete provisions for certain trigger events.

5. Consider using a formula to determine value, especially in a company where assets are expected to increase in value.

6. Make sure payments terms are flexible in anticipation of an unexpected change in circumstances (e.g. another partner dies a short time later after the first).