Next Generation Disputes in the Family Business:
Navigating the Remedial, Ethical and Tax Quagmires
- A Case Study

Buy-Sell Agreements
For
Closely Held Family Businesses:
Tax and Practical Considerations

By
Morton A. Harris
Hatcher, Stubbs, Land, Hollis & Rothschild, LLP

The Author is grateful to Shawn L. McIntire, Esq., Donelson, Ciancio and Goodwin, Denver, Colorado; to Carl A. Rhodes, Esq. of my firm and to my administrative assistant, Mary G. Ray, for their help in the preparation of this outline.
BUY SELL AGREEMENTS FOR CLOSELY HELD BUSINESSES

By
Morton A. Harris
Hatcher, Stubbs, Land, Hollis & Rothschild, LLP
Columbus, Georgia

TABLE OF CONTENTS

I. INTRODUCTION ........................................................................................................................................... 1
  A. In General .................................................................................................................................................. 1
  B. Overview of Matters to Consider ........................................................................................................... 2
  C. Matters Covered by Agreement ............................................................................................................. 3
     1. Retention of Control ............................................................................................................................. 3
     2. Creation of Market and Funding Mechanism ....................................................................................... 3
     3. Establish Purchase Price and Estate Tax Value ................................................................................... 3
     4. Restrictions on Business Operations and Voting ............................................................................... 3

II. ESTABLISHMENT OF ESTATE TAX VALUE .......................................................................................... 3
  A. In General ................................................................................................................................................ 3
  B. Chapter 14 -Special Valuation Rules ..................................................................................................... 3
     1. In General ............................................................................................................................................. 3
     2. Section 2703 ...................................................................................................................................... 4
     3. Legislative History ............................................................................................................................... 4
     4. Treatment of Existing Agreements ....................................................................................................... 5
     5. Practical Considerations ...................................................................................................................... 5
  C. Current Law (Including §§2031 and 2703) .......................................................................................... 5
  D. Review of §2031 Requirements ............................................................................................................. 5
     1. Estate’s Obligation to Sell ..................................................................................................................... 6
     2. Methods for establishing the purchase price ....................................................................................... 6
        a. Fixed Value ...................................................................................................................................... 7
        b. Appraisal Value ............................................................................................................................... 7
        c. Formula Method of Value ............................................................................................................... 7
        d. Agreed Value ................................................................................................................................. 8
     3. Lifetime Transfers .............................................................................................................................. 8
        a. Practical Considerations ............................................................................................................... 9
        b. Adoption of Agreement by New Purchaser ................................................................................... 9
     4. “Bona Fide Business Arrangement” and “Device” Tests ................................................................... 9
III. SELECTING TYPE OF BUY-SELL AGREEMENT ................................................... 10

A. Life Insurance Considerations ........................................................................ 10
   1. Amount of Insurance .............................................................................. 10
   2. Multiple Policies .................................................................................... 10
   3. Ownership .............................................................................................. 11
   4. Proportionality ........................................................................................ 11

B. Tax Considerations .......................................................................................... 11
   1. Basis ....................................................................................................... 11
   2. Alternative Minimum Tax ...................................................................... 11
   3. Accumulated Earnings ............................................................................ 11

C. Other Factors ................................................................................................... 12

IV. DESIGNING THE AGREEMENT - BUSINESS, FINANCIAL AND PERSONAL FACTORS ............................................................................................................................... 12

A. In General ........................................................................................................ 12

B. Restrictions on Lifetime Transfers .................................................................. 12
   1. Transfer with Consent ............................................................................ 12
   2. Permitted Transfer to a Limited Class ..................................................... 12
   3. Encumbrances ........................................................................................ 12

C. “Trigger” Events .............................................................................................. 13
   1. Death ...................................................................................................... 13
   2. Disability ................................................................................................ 13
      a. Definition of “Disability” .................................................................. 13
   3. Termination of Employment ................................................................... 13
   4. Voluntary Transfers ................................................................................ 14
   5. Involuntary Transfers ............................................................................. 14

D. Option vs. Obligation ....................................................................................... 14

E. Voting Restrictions ........................................................................................... 15

V. FUNDING THE AGREEMENT ............................................................................ 15

A. In General ........................................................................................................ 15

B. Installment Sales ............................................................................................ 15

C. Funding Delayed until “Trigger” Event .......................................................... 16

D. Accumulation of Funds .................................................................................... 16

E. Shareholders as Purchasers ............................................................................. 17
VI. ALTERNATIVE MINIMUM TAX - EFFECT ON LIFE INSURANCE

A. In General

B. The AMT Formula
   1. The “Book Income” Adjustment
   2. The “Earnings” or “ACE” Adjustment
   3. Accounting for Life Insurance

C. Effect on Life Insurance
   1. Cash Value
   2. Death Benefit

D. Planning: Suggestions

VII. ROLE OF ADVISOR - POSSIBLE CONFLICT

VIII. PARTNERSHIP BUY-SELL AGREEMENTS

A. Cross-purchase vs. Partnership Purchase

B. Insurance

C. Section 754

IX. SPECIAL CONCERNS OF S CORPORATIONS

A. In General

B. S Corporation Requirements

C. Estates as Shareholders

D. Trusts as Shareholders
   1. Grantor Trusts
   2. Qualified Subchapter S Trusts (QSSTs)
   3. Electing Small Business Trusts (ESBT)
   4. Other Trusts
   5. Conflict of Interest
   6. Inadvertent Terminations

E. One Class of Stock
   1. Letter Ruling 8506114
   2. Letter Ruling 8528049
4. Debt of S Corporation ............................................................................. 24
   a. “Straight Debt .................................................................................. 25
   b. State Laws ....................................................................................... 25
5. History of Proposed Regulations ............................................................. 25
6. Final Regulations.................................................................................... 25

F. Handling Problems Unique to S Corporations ............................................. 26
   1. Voting Restrictions ................................................................................. 26
   2. Restrictions on Transfers ........................................................................ 26
   3. Restrictions on Corporate Activities ....................................................... 27
   4. Distribution of Earnings ......................................................................... 28
   5. Election to “Close the Books” .................................................................. 28
      a. Examples ......................................................................................... 28
      b. Agreement to “Close the Books ....................................................... 29

X. RESTRUCTURING AGREEMENT AFTER S ELECTION ................................. 29
   A. In General .................................................................................................... 29
   B. Continuation of Redemption Agreement .................................................. 29
   C. Cross-purchase Agreement ....................................................................... 30
   D. Changing from “Redemption” to “Cross-purchase .................................. 30
      1. Shareholders as “Partners .................................................................. 31
      2. Buy-out Life Insurance Trust ................................................................ 31
   E. Termination of S Status .......................................................................... 31
   F. Review of Existing Agreements ............................................................... 31

XI. CONCLUSION ............................................................................................. 32
I. Introduction

A. In General. In advising a closely held business, whether a professional or business organization, it is always important that the needs and capabilities of the business be integrated with the personal desires, the business and estate plans, and the retirement needs of each of the owners. Of particular importance are: (1) the need for an adequate amount of liquid funds to be available at the time of an owner’s death or earlier withdrawal and (2) that the owners’ wishes regarding future control and ownership of the businesses be taken into account. The “Buy-Sell Agreement” is a frequently used mechanism for dealing with these and other business, estate and retirement planning issues. In addition to the basic provisions for the purchase and sale of a business or practice interest, the Buy-Sell Agreement will often deal with arrangements affecting control, governance and successor issues among the owners.

A Buy-Sell Agreement is typically a separate document; however, some or all of the “buy-sell” provisions may be contained in a Corporation’s articles of incorporation and by-laws, a partnership agreement, a limited liability company’s operating agreement, and in a company’s employment agreements with owner-employees. In its broadest sense, a Buy-Sell Agreement represents the total of all agreements between the owners of a closely held business or professional group regarding the control of the business, the identities of the owners, the transfer of ownership, restrictions on the operation of the business and a variety of other business and financial matters.

In designing a Buy-Sell Agreement it is important that the personal planning objectives of the owners be incorporated in the agreement only after evaluating the impact of these objectives on the business itself. Care must be given not only to achieving the estate planning, retirement, and post-death goals of the owners but, also, to satisfying the operational and
financial needs of the business or practice and the income needs of the owners during their lifetimes.

Although Buy-Sell Agreements are beneficial in planning for all closely held business ventures operated in any form, this outline will reference issues in the context of a business or professional enterprise operating as a C Corporation except where a partnership, limited liability company, or an S Corporation is specifically indicated. This outline will also reference particular concerns involved in the use of Buy-Sell Agreements in family owned businesses, although most of the factors and considerations involved are equally applicable to all closely held businesses or practices, whether or not family owned.

All section references cited in this outline are to the Internal Revenue Code of 1986 as amended ("the Code") and to Treasury Regulations issued under the Code.

B. Overview of Matters to Consider. Major reasons for having Buy-Sell Agreements are: (1) to establish certainty in the continuity of ownership of the business; (2) to provide a market for otherwise illiquid closely held shares; (3) to establish a funding source and a mechanism for purchasing the shares; (4) to establish certainty as to the value of the shares for estate tax purposes; and (5) to provide restrictions on current owners regarding certain operational matters, e.g., voting control, protection of an S corporation’s status, payment of dividends, etc.

A Buy-Sell Agreement is an enforceable contract under state law; in most states, owners are given broad latitude in determining matters of governance and restrictions on ownership and the transferability of ownership interests.

In evaluating the need to timely adopt a Buy-Sell Agreement, it is important for the advisor and the owners to realize that the “present” may be the last real opportunity for the owners to reach any agreement as to the buyout or retention of ownership or control of the business or practice. At a later time, once changes have occurred in the health or financial circumstances of the parties, or there has been a breakdown in personal relationships, the divergent interests or antagonism among the owners make it difficult, if not impossible, to reach a satisfactory (or any) agreement.

Prior to structuring a Buy-Sell Agreement, the advisor should first investigate and evaluate the needs and capabilities of the business as well as the personal needs, capabilities and desires of all of the people involved, which include the owners and other affected parties, i.e., key employees, wives and children of the shareholders, etc. The advisor must also become aware of the different financial capabilities and the health status of each of the parties for funding the purchase obligations of the Agreement, and the need for and availability of life insurance. In many cases, especially in a family business, the long time advisor of the principal owner (often the lawyer or accountant) will already know a great deal about the personalities and circumstances involved and will be better able to understand the goals, capabilities and needs of the business and its owners.

After the Omnibus Budget Reconciliation Act of 1990 ("OBRA ‘90"), which repealed §2036(c) and adopted a Chapter 14 of the Code, Buy-Sell Agreements among family members have been governed by §2703, effective for agreements made after October 8, 1990. Generally, §2703 will permit a Buy-Sell Agreement to establish the value of an ownership interest for gift, estate and generation-skipping tax purposes only if certain conditions are met.
C. Matters Covered by Agreement. Most Buy-Sell Agreements will contain binding understandings as to the following matters.

1. Retention of Control. The agreement will often restrict both lifetime and death transfers to assure retention of control within the desired ownership group.

2. Creation of Market and Funding Mechanism. Ownership interests in closely held businesses or professional practices are typically highly illiquid. By requiring a purchase of an ownership interest after the occurrence of a specified event, i.e., the owner’s death, disability, retirement or termination of employment (often called “trigger” events), the Buy-Sell Agreement will create a “market” for the interest. In addition, the agreement will often reference how the funds will be accumulated or otherwise provided to pay the purchase price.

3. Establish Purchase Price and Estate Tax Value. A Buy-Sell Agreement, by requiring the estate of a deceased shareholder to sell its stock at a stated or determinable price and meeting the other requirements of §2031 and §2703, will establish the purchase price under the agreement as the estate tax value of the ownership interest to be purchased at death.

4. Restrictions on Business Operations and Voting. The Buy-Sell Agreement will often establish operating guidelines for the business by containing provisions to protect a corporation’s Subchapter S election, to create voting agreements protecting minority owners or maintaining majority control, to establish limits on compensation for owners active in the business, and to protect the business from creditors of insolvent owners.

II. Establishment of Estate Tax Value

A. In General. In addition to providing a “market” for closely held shares at a stated or determinable price, a Buy-Sell Agreement can serve the purpose of establishing that price as the value of a deceased owner’s interest for estate tax purposes. The importance of this issue cannot be over emphasized, since if the agreement provides for a purchase price which turns out to be below the value ultimately determined for estate tax purposes, there could be an unexpected and highly detrimental financial impact on the estate, i.e., the estate could face an estate tax obligation attributable to the ownership interest far greater than anticipated and, in some cases, in excess of the entire proceeds received under the Buy-Sell Agreement.

The current rules governing whether or not a Buy-Sell Agreement will establish the value of an ownership’s interest for estate tax purposes are contained in §2031 as modified by §2703. Section 2703 clarified that the existing “bona fide business arrangement” and the “device” tests applicable under §2031 must be separately met and added a new requirement that the agreement must be “comparable to similar arm’s length arrangements.” Section 2703 did not disturb the other requirements under §2031 which continue in effect.

B. Chapter 14 -Special Valuation Rules.

1. In General. Prior to the passage of §2036, effective December 17, 1987, there was considerable flexibility in the tax laws governing the transfer of ownership in a family owned business. This flexibility was severely restricted by §2036(c); however, following three years of strenuous efforts by many individuals and small business organizations, §2036(c) was repealed, retroactive to its date of enactment. A new Chapter 14 of the Code was adopted in its place, effective for transfers after October 8, 1990. OBRA ‘90. Generally, Chapter 14 operates to determine the value of a gift of an equity interest in a business by valuing the equity interest, if any, retained by the donor and subtracting that value from the total value of the business. This
so-called “subtraction” method is intended to produce a realistic valuation of the transferred interest at the time of the gift. Chapter 14 contains four sections: §2701, dealing with corporations, partnerships and LLC’s; §2702, dealing with trusts and joint purchases; §2703, dealing with options and agreements (including Buy-Sell Agreements); and §2704, dealing with certain lapsing rights and restrictions.

2. **Section 2703.** Section 2703(a) provides that the value of gifted property is determined without regard to any option, agreement (e.g., a Buy-Sell Agreement) or other right to acquire or use property at less than fair market value unless the following requirements of §2703(b) are met: (1) the agreement is a bona fide business arrangement; (2) the agreement is not a device to transfer property to a member of decedent’s family for less than full and adequate consideration; (3) the terms of the agreement are comparable to similar arrangements entered into by persons in arms-length transactions. Section 2703 is not limited to agreements among family members; however, if the agreement is among non-family members, the “device” requirement should be automatically satisfied. Reg. §25.2703-1(b)(3); Estate of Gloeckner 152 F. 3d 208 at 215 (2nd Cir. 1998).

3. **Legislative History.** The Senate Finance Committee’s explanation to Chapter 14 states that the first two requirements of §2703(b) are similar to the tests in previously issued Treasury regulations §20.2031-2(b), “…except that the bill clarifies that the “business relationship” and the “device” requirements are independent tests. The mere showing that the agreement is a ‘bona fide business arrangement’ will not give the agreement estate tax effect if other facts indicate the agreement is a ‘device’ to transfer property to members of the decedent’s family for less than full and adequate consideration.” Senate Finance Committee Report, S. Rep. 100-1, 101st Cong. 2nd Sess. (1990) at 67-68.

The Senate Finance Committee also stated that §2703 adopted the rationale of St. Louis County Bank v. United States, 674 F. 2d 1207 (8th Cir. 1982), where the court held that even where the agreement was supported by valid business considerations, e.g., assuring continuity of management, exclusion of hostile shareholders, etc., it did not eliminate the need to inquire into whether the agreement represented a “device” to pass the value of the business to the decedent’s testamentary beneficiaries for less than adequate consideration. The court interpreted Rev. Rul. 59-60 disjunctively, i.e., the value determined under the agreement will be disregarded if it is either not a “bona fide business arrangement” or is a “device” to benefit the objects of one’s bounty. Both tests must be met independently. See Reg. §25.2703-1 (b)(2). Final regulations were adopted on January 28, 1992. T. D. 8395.

Most significantly, §2703(b)(3) added a new requirement that the terms of the agreement must be comparable to similar arrangements entered into by persons in an arm’s length transaction, which places the burden on the taxpayer to show the agreement is “one that could have been obtained in an arm’s length bargain.” Senate Finance Committee Report, S. Rep. 100-1, 101st Cong. 2nd Sess. (1990) at 68. Factors to be considered include the terms of the agreement, the present value of the property, and the expected value at the time of exercise and the consideration to be paid. In making this determination, the Conference Committee Report states that “…general business practice may recognize more than one valuation methodology, even within the same industry. In such situations, one of several generally accepted methodologies may satisfy the standard…” Conference Report, H. R. 101-964, 101st Cong., 2nd Sess. (1990) at 1137. On this point, the Senate Finance Committee stated that meeting the requirement involves consideration of several factors and “…requires a demonstration of the

4. **Treatment of Existing Agreements.** Buy-Sell Agreements entered into prior to October 8, 1990 were “grandfathered” from the restrictions of §2703 unless “substantially modified” after that date. It has been suggested that a change in the valuation formula for determining the purchase price would jeopardize the grandfathered status of the agreement; whereas, a change in one of the factors used in the valuation formula (e. g., a change in the P. E. multiple) would probably not be a “substantial modification,” nor would the addition of new parties if required by the agreement. Estate of Blount, T.C. Memo 2004-116 (2004), aff’d in part, rev’d in part by Estate of Blount, 428 F. 3d 1338 (11th Cir. 2005); Estate of Godley, T.C. Memo 2000-242 (2000). See Reg. §25.2703-1 (e) and Priv. Ltr. Ruls. 200407006, 2000100015, 9620017, 9322035, and 9248026.

5. **Practical Considerations.** Since §2703(b)(3) places the burden on the taxpayer to show that third parties would have entered into the agreement, it is advisable to have an independent appraiser determine the value of the business. Recognizing that each business is unique, the valuation method used in the agreement to determine the purchase price should clearly reflect the facts and circumstances of the business and the valuation method described in the appraisal. The need to determine an appropriate valuation method strongly suggests the advisability of obtaining the opinion of an experienced professional. See Estate of Hall, 92 T.C. 312 (1989). See also Estate of Lauder, T.C. Memo 1992-736, where the absence of a valuation professional was detrimental to the taxpayer’s claims; Lance S. Hall, *Lack of Outside Appraisal Dooms Buy-Sell Formula Value for Estate Tax Purposes*, 8 VALST 37 (March/April, 2005).

C. **Current Law (Including §§2031 and 2703).** The following six (6) basic requirements currently determine whether or not a Buy-Sell Agreement will establish the value of a deceased owner’s stock interest for estate tax purposes: (1) the stock must be subject to an obligation or option to purchase that is a binding obligation against the estate of a deceased shareholder; (2) the valuation method must establish the purchase price with certainty; (3) the stock must not be subject to lifetime transfers that could defeat the option or obligation to purchase; (4) the agreement to purchase must represent a “bona fide business arrangement”; (5) the agreement must not be a “device” to transfer the shares to the natural objects of the decedent’s bounty at lower than market value; and (6) the agreement (its terms, purchase price, restrictions, etc.) must be comparable to similar arrangements between persons in an arm’s length transaction. §§2031 and 2703(b). For a discussion of the requirements for establishing estate tax value prior to adoption of §2703, see M. Harris, “Buy-Sell Agreements for the Family Business: Selected Problems and New Concerns,” 24th Southern Federal Tax Institute (1989) at pp. J3-8. For a discussion of the requirements needed for a Buy-Sell Agreement to establish value for estate tax purposes following the adoption of §2703, see L. M. Johnson and B. R. Greenstein, “Using Buy-Sell Agreements to Establish Value of a Closely Held Business,” J. of Tax (Dec. 1994); Zaritsky, *Structuring Buy-Sell Agreements: Analysis with Forms*, Warren, Gorham & Lamont, 2nd Edition §6.02 (2002 and 2007 Cum. Supp.).

D. **Review of §2031 Requirements.** Since §2703 serves only to clarify and add to the previously existing requirements for establishing value for estate tax purposes, it is necessary to review the rules established by the case law, IRS Regulations and the Rulings under §2031 which deal with the determination of when an agreement to purchase a shareholder’s...
ownership interest will establish the value of that interest for estate tax purposes. See also, Rev. Rul. 59-60, Sec. 8, 1959-1 C.B. 237.

Prior to the effective date of §2703, October 8, 1990, there were only four (4) basic requirements which governed when a Buy-Sell Agreement would establish the value of a deceased owner’s stock or other ownership interest for estate tax purposes: (1) the interest must be subject to an obligation or option to purchase that is a binding obligation on the estate of the deceased shareholder; (2) the valuation method (or fixed value) must establish the purchase price with certainty; (3) the interest cannot be subject to a lifetime transfer that could defeat the option or obligation to purchase; (4) the option or obligation to purchase must represent a “bona fide business relationship” and not be a “device” to transfer the shares to the natural objects of the decedent’s bounty at less than full and adequate consideration.

1. Estate’s Obligation to Sell. To establish a value for estate tax purposes, the estate must be obligated to sell; however, there is no requirement for the purchaser to buy. Therefore, an option held by a corporation or surviving shareholders is sufficient as long as the estate is obligated to sell if the option is exercised. In the case of an option, it could be argued that the shares were worth even less than the option price since the option holder could elect not to exercise the option. In addition, an option (rather than an obligation) can result in a liquidity problem for the estate since, even if the agreement sets the value for estate tax purposes, no cash will be generated for the estate unless the option is exercised and a sale actually occurs. For this reason, a Buy-Sell Agreement will typically provide, if adequate funding is available, that upon the death of an owner, the survivors are “obligated” to purchase. And, even where funding the purchase is a problem, making it necessary to pay a portion of the purchase price in installments, an “obligation” to purchase (rather than an “option”) is often provided as the best way to protect the estate’s need for liquidity and, in many situations, to protect the deceased shareholder’s family from the vagaries of the ongoing business.

2. Methods for Establishing the Purchase Price. The purchase price of shares must be established with certainty by the valuation method contained in the Buy-Sell Agreement. Establishing the value and an appropriate method of valuation for a closely held business is one of the most difficult issues in designing a Buy-Sell Agreement since each business or practice is unique. Further, even if the valuation method selected is appropriate at the time of the agreement, unforeseen conditions in the future (when the value of the business is actually determined under the agreement, upon a shareholder’s death, disability, etc.) will almost always result in some unintended benefit or detriment to the various parties to the agreement. Therefore, in establishing an appropriate valuation method, the goal is to keep this unintended benefit or detriment as small as possible.

To fairly deal with and satisfy the competing needs of the parties, the advisor should emphasize the need to select a valuation method which results in a realistic value of the business and one which will allow for changes in value in the future. The advisor should also suggest that a valuation of the business be made by an independent party (accountant, attorney, or appraisal company) prior to the finalization of the agreement. This is important to satisfy the added requirements of §2703 and to help determine a good estimate of the potential funding obligation of the “purchaser,” as well as the liquidity expectations of the “seller” for his retirement and estate planning. See Rev. Rul. 59-60, supra, which can be used as a guide for valuing many closely held businesses, as amplified by Rev. Rul. 83-120, 1983-2 CB 170.
In establishing a method for valuing the business, all of the relevant factors for valuing business interests must be considered, with the added difficulty that the valuation method selected must take into account that it will likely be applied years, if not decades, after it is agreed upon. There are several general valuation methods typically used in Buy-Sell Agreements, each method having a number of variations.

a. **Fixed Value.** An unchanging “fixed value,” with no provision for adjustment, is rarely used today since the fixed value becomes unrealistic over time and is generally perceived by the parties as being inherently unfair. In addition, this method would not meet the tests under §2703(b) and the IRS regulations to establish gift and estate tax values for tax purposes. Reg. §25.2703-1(b). See Estate of Blount, T.C. Memo 2004-116 (2004), aff’d in part, rev’d in part by Estate of Blount, 428 F. 3d 1338 (11th Cir. 2005).

b. **Appraisal Value.** A Buy-Sell Agreement can avoid troublesome valuation issues by providing for independent appraisers to value the business upon death or when other “trigger” events occur. However, the “appraisal method” is rarely used in valuing an operating business since business appraisals take considerable time, are expensive, and give little guidance for advance funding of the obligation. However, certain types of businesses are good candidates for using the appraisal method as the fairest way to satisfy all the owners. One such type is the business that has real estate as a significant asset since going concern value, goodwill and other operating business factors are not usually involved. In this case, the appraisal is really an appraisal of fixed assets rather than an operating business. If the appraisal method is used, a so-called “triple appraisal” method is often adopted (where the purchaser and estate each appoint an appraiser who in turn selects a third if the first two cannot agree). This approach, however, can result in unexpected delay, litigation and added expense. The appraisal method, in essence, defers the determination of value until the date of the triggering event, thus leaving the owners and their advisors with little current guidance as to funding decisions. See Exhibit “A” for example of the appraisal method of valuation used in a Buy-Sell Agreement for a real estate partnership.

c. **Formula Method of Value.** If the objective is to establish a realistic fair market value of a business based on factors which would be considered by a outside purchaser, then some type of formula method of valuation will most likely be used.

For many years during earlier times, the most commonly used formula method of valuation for an operating business was the use of the company’s “book value” as shown in the company’s regularly prepared financial statements. Although “book value” is relatively easy to determine, it can result in a significant deviation from fair market value unless adjusted for such matters as: (1) the company’s accounting method, (2) differences between book value and fair market value of the company’s real estate, equipment and other tangible assets, (3) the difference between the book and fair market value of intangible assets, (4) adjustments to value of accounts receivable to reflect collectibility, and (5) adequacy of various reserve accounts. See Exhibits “A-1” and “A-2” for examples of a modified “book value” method used in valuing a medical professional corporation.

Another formula method often used is one based on “earnings” where earnings are capitalized to arrive at a proper value. However, an unadjusted earnings formula would not be an appropriate method of valuation for many closely held businesses where most of the company’s earnings are distributed to shareholder-employees as compensation and other benefits; although adjustments to earnings can be made to take these expense distributions into account. An
important determination in utilizing an “earnings” approach is the selection of an appropriate “earnings multiple” (or capitalization rate); however, even if the earnings multiple selected is appropriate at the time of the agreement, a change in the dynamics of the business or in the economic environment can significantly affect the capitalization rate from the viewpoint of an outside purchaser and the owners.

Often a formula method based on both “asset values” and “earnings” (or some variation, such as “EBITA” or “cash flow”) is employed to determine the value of a closely held business. If it is important to prove the agreement is a “bona fide business arrangement” and not a “device” to pass the decedent’s shares to the natural objects of his bounty for less than an adequate and full consideration, it will be helpful to have a written valuation report prepared at the time the agreement is made to demonstrate the appropriateness of the valuation method used. For examples of formula valuation methods, see Exhibit “B-1” pertaining to a construction and real estate development company; and Exhibit “B-2” pertaining to a management consulting firm.

d. Agreed Value (with “back-up”) A frequently used method of valuation is the “agreed value,” which requires periodic adjustments by the parties, often coupled with a “back-up valuation” method to take effect if an agreed value has not been adopted within a certain period of time (usually 18 months or less) prior to the “triggering” event. The “agreed value” method allows the parties to periodically update the value based on changing circumstances. It is important that a “back-up” value be provided since owners will often forget or may find it difficult to unanimously agree on future adjustments, especially where there are significant disparities in age, health, or levels of active participation in the business which often result in disagreements as to business objectives and distribution of profits to owners or the perception by an owner that he or she will likely be the “seller” (or the “buyer”) under the agreement. The mere existence of an “automatic back-up” value will often facilitate the shareholders reaching an agreement adjusting the value (which they might not otherwise do). The “back-up” provision will generally state, “If the parties have not agreed to a value within 18 months prior to the death of a shareholder, a formula method (book value, average earnings, etc.) will automatically be used to establish a value for purposes of the agreement.” See Exhibit “C” for example of an “agreed value” with a “back-up” adjustment for income and loss for a medical corporation; and Exhibit “C-1” for an “agreed value” with automatic “back-up” valuation formula for a physician owned real estate partnership.

3. Lifetime Transfers. To be effective in establishing a value for estate tax purposes, the Buy-Sell Agreement must provide that the corporation and shareholders are either obligated or have an option to purchase the shares of a shareholder (who desires to sell during lifetime), at the same price and on the same terms as provided for upon the death of a shareholder. If only a right of “first refusal” is provided, it will not be effective in establishing the estate tax value since the price paid during the selling shareholder’s lifetime could exceed the purchase price at death. Reg. §20.2031-2(h). Further, the right of “first refusal” is not generally satisfactory to the parties because it permits a premium price to be offered by a third party which could force the remaining shareholders to either meet the price or suffer the consequences of a new and potentially hostile owner. From the selling shareholder’s viewpoint (especially a minority shareholder), both the right of first refusal and the option may be unattractive because of their failure to guarantee a “market” for the shares.
a. Practical Considerations. A right of first refusal or an option at a fixed or determinable price during lifetime frequently operates to depress the value of the stock and may have such a “chilling” effect on a prospective purchaser as to prevent any offers from being made. In addition, a right of first refusal or an option will typically slow the process for the closing of a stock purchase even if the other shareholders permit the transfer or do not exercise their option.

b. Adoption of Agreement by New Purchaser. A right of first refusal or an option will often be coupled with a provision stating that any outside purchaser is required to adopt the Buy-Sell Agreement or that the stock transferred to an outside party will automatically be subject to the terms and conditions of the agreement. See Exhibit “D” for requirement that an assignee of a membership interest in a limited liability company must adopt the operating agreement (including the buy-sell provisions) before becoming a member. Either of these provisions will effectively restrict the subsequent transfer of the shares and protect the remaining owners. See Exhibit “D-1” for option granted to a corporation and its shareholders to purchase during the lifetime of a selling shareholder.

4. "Bona Fide Business Arrangement" and "Device" Tests. The long-established position of the Service is that “It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts to determine whether the agreement represents a bona fide business arrangement or a device to pass the decedent’s shares to the natural objects of his bounty for less than an adequate and full consideration in money or money’s worth.” Rev. Rul. 59-60, 1959-1 C.B. 237, at 244 (emphasis added). See Estate of True, T.C. Memo 2001-167 (2001), aff’d 390 F.3d. 1210 (2004), distinguished by Estate of Blount, T.C. Memo 2004-116 (2004).

The Service did not specify in Rev. Rul. 59-60 “when” the agreement must meet the “bona fide business arrangement” test and the Regulations did not elaborate on this point; and with no guidance from the Service, the test was leniently applied by the courts which consistently held that if the agreement was reasonable at the time it was signed, subsequent changes in the value of the business would not impair the ability of the agreement to determine the estate tax value. This result was achieved even where agreements among family members were frequently adjusted from time to time to meet the family’s economic and personal circumstances. The “or a device” test was largely ignored by the courts. For example, (1) a closely held corporation owned solely by father and son enters into a stock redemption agreement with the two shareholders to purchase a certain portion of the shares of a deceased shareholder; (2) the agreement meets all of the required tests of §2031; and (3) the father’s will bequeaths to his son all of his shares in the corporation not redeemed under the agreement. In these circumstances, there is often an identity of interests between father and son regarding the valuation method used in the agreement in order to minimize the purchase price and the estate’s tax liability. Clearly, a value determined at arm’s length by unrelated parties might reach a different result. Despite opportunities for such manipulation, the courts prior to the adoption of §2703 generally accepted agreements that were supported by adequate consideration at the time executed and which achieved a valid business purpose, e.g., assuring continuity of management, exclusion of hostile shareholders, etc. See Estate of Seltzer, T. C. Memo 1985-519; and Estate of Bischoff, 69 T. C. 32 (1977).

However, in St. Louis County Bank v. United States, 674 F. 2d 1207 (8th Cir. 1982), the court held that even where the agreement was supported by valid business considerations, it did
not eliminate the need to separately inquire into whether the agreement represented a “device” to pass the business to the decedent’s testamentary beneficiaries for less than adequate consideration. For the first time, the court interpreted Rev. Rul. 59-60 disjunctively, i.e., the value determined under the agreement would be disregarded for estate tax purposes if it was either: (1) not a “bona fide business arrangement” or (2) was a “device” to benefit the objects of one’s bounty. Both tests must be independently met. The facts in St. Louis County Bank were unusual and the case did not give rise to a large number of new cases in the area; however, it did stand for the proposition that an agreed formula valuation which was subject to manipulation by lifetime decisions within the control of family members could create a situation where a “facts and circumstances test” would be applied in reviewing, and perhaps not recognizing, the valuation agreed to by the parties. This same analysis could also apply where the Buy-Sell Agreement was frequently amended to meet changing estate planning needs. The principle established in the St. Louis County Bank case (codified in §2703(b)) does not apply where there are unrelated parties to the agreement. Reg. §25.2703-1(b)(3).

III. Selecting Type of Buy-Sell Agreement

An important decision at the outset is to determine the type of agreement to be used, i.e., who will be the purchaser -- the corporation in a “redemption” type agreement, the other shareholders in a “cross-purchase” type agreement, or a combination of the two types? This determination should be made only after evaluating certain key factors.

A. Life Insurance Considerations. Since many Buy-Sell Agreements are partially or fully funded with life insurance on the lives of the shareholders, the availability or affordability of insurance, the number of policies needed and the source of available funds needed to pay the insurance premiums (or otherwise fund the obligations of the agreement) will often dictate the type of agreement to be utilized.

1. Amount of Insurance. If affordable insurance is available, the amount of the insurance to fund the agreement will be determined primarily by the valuation of the company (both current and anticipated), limited by the financial abilities of the corporation or the shareholders to pay the premiums, and influenced to some degree by the credit risk (inherent in the unfunded amount of the buyout price) which the shareholders (as potential “sellers”) are willing to assume, tempered by their wish (as potential “purchasers”) to avoid paying out-of-pocket funds or incurring debt at the time of the purchase. Unless it is desirable (and affordable) for a shareholder’s entire interest to be purchased for cash, without any out-of-pocket expenditure of funds by the corporation or other shareholders, it is not necessary to fully fund the purchase price with insurance. If, however, a shareholder (as a potential “seller”) wants certainty that his estate will receive the entire purchase price for his stock following his death, by eliminating the credit risk of payments which are dependent on the future success of the business or the financial capabilities of the surviving shareholders, then full funding of the obligation with insurance becomes necessary, even if not easily affordable.

2. Multiple Policies. In a “cross-purchase” agreement among the shareholders, unless a partnership can be utilized to own the insurance, each shareholder must hold a policy on the life of every other shareholder (e.g., if there are three shareholders, there would need to be 6 separate policies; if 4 shareholders -- 12 policies; if 6 shareholders -- 30 policies). Therefore, the existence of more than 3 or 4 shareholders without a partnership to hold the policies can make it impractical to use a “cross-purchase” agreement among the shareholders. A single policy on each shareholder will suffice when funding a corporate redemption
agreement. A possible solution to the “multiple policy” problem in “cross-purchase” arrangements (if no partnership exists) may be found in the use of a “buy-out insurance trust” which owns the policies. See discussion in Subsection D of Section X, infra.

3. Ownership. In a redemption agreement, the policies are owned by the corporation which permits the corporation to borrow against the cash surrender value of the policy if needed. The cross-purchase agreement, if no trust or partnership is used, leaves the payment of premiums and borrowing on the policy in the control of the individual shareholders; and consideration should be given to the fact that creditors of an owner of insurance may assert claims against the cash surrender value of the policy. Depending on the relative creditworthiness of the parties, this factor alone could determine which form of agreement is most desirable.

4. Proportionality. Where the shareholder interests are not equal, e.g., a 10% and a 90% shareholder, the minority shareholder would, in a cross-purchase arrangement, be required to fund the much higher value of the majority owner’s interest. In fairness, the minority owner should fully pay for his purchase of the majority owner’s shares; however, the minority owner may not be financially able to do so or there may be other factors which suggest he should not have to do so. If the same disparity in ownership (10% and 90%) exists under a redemption agreement, the majority owner is, in essence, paying for 90% of the buyout of his own shares since he would otherwise be entitled to (or be benefited by) 90% of the funds used to satisfy the agreement. In other words, where a redemption agreement is used and the corporation purchases the stock, through payment of insurance premiums or from its other assets, the shareholders are from an economic standpoint bearing this cost in proportion to their relative stock interests.

B. Tax Considerations. The cross-purchase agreement will result in “sale or exchange” treatment to the selling shareholder; however, since the sale is most often triggered by the shareholder’s death, there will typically be no gain or loss. To achieve capital gain treatment under a redemption agreement, the corporation’s purchase would have to meet the rules of §302 or §303. This may be a problem in a family-owned corporation because of the attribution rules of §318. See Exhibit “E” for Redemption of Stock in Family Owned Clinic from a shareholder’s surviving spouse, to avoid §318 attribution to the deceased shareholder’s estate where children also own shares.

1. Basis. Under a cross-purchase agreement, the purchaser’s basis in the stock acquired will be equal to his cost; however, in a redemption by a C corporation the surviving shareholders will have no increase in basis. In a redemption by an S corporation the amount of increase in basis to the remaining shareholders will depend on the time of year when the “triggering” event occurs and whether or not an election is made to “close the books” and other factors, i.e., whether on cash or accrual method of accounting. See discussion of “basis” considerations where an S corporation is involved, in Section X, infra.

2. Alternative Minimum Tax. In a C corporation with little taxable profits (as is the case in most professional and personal service corporations), the risk that life insurance proceeds will result in a significant additional tax under the “alternative minimum tax” (AMT) rules favors the use of a cross-purchase arrangement. See discussion of the effect of the AMT on corporate owned life insurance, in Section VI, infra.

3. Accumulated Earnings. In a redemption agreement, the corporation may be exposed to the tax on “unreasonable accumulation of earnings” on the accumulations of liquid
assets necessary to satisfy the agreement, especially where the corporation is accumulating funds to purchase a majority shareholder’s interest. §531. See IRS §531 Audit Guidelines at ¶637(3)(a) and (f); Callahan, Estate and Personal Financing Planning ¶23:11; and W. Byrne, 796 2nd T.M., Accumulated Earnings Tax (2002), at A-33, et seq.

C. Other Factors. Other factors which influence the type of Buy-Sell Agreement utilized include availability (or affordability) of credit arrangements, the insurability of individual shareholders, and problems resulting from refusal of a shareholder to participate. If a cross-purchase agreement is not fully funded, the unfunded portion of the obligation will continue to be a personal liability of each surviving shareholder which to some shareholders will be objectionable. On the other hand, the cross-purchase agreement does protect the insurance proceeds from the claims of creditors of the corporation. In addition, the relative tax rates of a C corporation (which is not a “personal service corporation”) and the various shareholders can be significant. A factor which should always be considered is the likelihood that the buy-out could occur during the lifetime of a shareholder rather than at death. For additional factors, See discussion of special concerns for S corporation buy-out agreements, at Section IX, infra.

IV. Designing the Agreement - Business, Financial and Personal Factors

A. In General. Although the need to establish a binding estate tax value will influence the drafting of many Buy-Sell Agreements, the agreement must also reflect the overall needs and financial capabilities of the business as well as the lifetime and estate planning needs and personal goals of the owners. In addition to meeting the requirements necessary to establish the value of the stock for estate tax purposes, the Buy-Sell Agreement will often contain restrictions on the transfer of stock, voting rights and the operations of the business. The advisor must obtain as much information as possible to effectively integrate a workable and realistic business structure for achieving both the estate planning and personal needs of the shareholders and the operational needs of the business or practice.

B. Restrictions on Lifetime Transfers. The type of restrictions on lifetime transfers will be influenced by several factors.

1. Transfer with Consent. The agreement can prohibit any (or only certain) transfers by a shareholder during lifetime, or the agreement may permit certain transfers only with the consent by a majority or “super majority” of the other shareholders.

2. Permitted Transfer to a Limited Class. The agreement will often permit a gift of shares (during lifetime and/or at death) to family members, or to some other specified limited class, subject to the restrictions in the agreement. However, even though limited, these “permitted” transfers can jeopardize the effectiveness of the valuation under the agreement for estate tax purposes, since systematically planned transfers by an older transferor to a younger transferee could result in a practical avoidance of the buy-sell restrictions (and could therefore be considered a “device”) even though the transferred shares remain subject to the shareholders agreement. §2703(b)(2). See TAM 8710004; and Estate of Gloeckner, 152 F 3d 208, at 214-215 (2nd Cir. 1998). See generally, Successor Strategies for the Family Business, Planning Issues and Techniques, ALI-ABA, 2006. See Exhibit “E-1” for provisions allowing the transfer of membership units of a limited liability company to only a limited group of permitted transferees.

3. Encumbrances. A Buy-Sell Agreement will often provide that the shares cannot be encumbered to secure the personal debts of a shareholder. However, occasionally such encumbrances are permitted subject to the creditor becoming subject to the same restrictions as
the shareholder. Therefore, the foreclosure by a creditor would be a “trigger” event under the agreement which would activate the requirement to sell under the agreement. See Exhibit “E” for provisions permitting the gift of shares to family members and the pledge of shares as security for loans.

C. “Trigger” Events. Advisors should carefully analyze the various events which call for shareholders to sell and the requirement or option for the corporation or shareholders to purchase. The selection of these so-called “trigger” events will be influenced by a number of factors which involve tax, personal and financial considerations.

1. Death. The agreement will typically provide that upon the death of a shareholder, there will be an obligation for the deceased shareholder’s estate to sell and the remaining shareholders or the corporation to be obligated or have an option to purchase. See Exhibit “F” for a paragraph requiring the sale and purchase of a deceased shareholder’s stock.

2. Disability. Where a shareholder is also an employee of the business (which is often the case), it is important both to the business and to the shareholder that “disability” be one of the triggering events. Upon disability, the disabled shareholder’s stock will be purchased under the agreement and cash will be paid in a lump sum or a series of payments to the disabled shareholder. This not only protects the disabled shareholder but also eliminates future conflicts with a non-contributing shareholder who no longer has the same needs and desires regarding future operations and distributions from the business, and would likely prefer to receive a dividend distribution rather than using the funds to grow the business, which is typically contrary to the needs of the business or practice and the desires of the remaining active shareholder-employees.

   a. Definition of “Disability”. The corporation can purchase disability buy-out insurance to aid in funding its obligation. In doing so, it is important that the definition of “disability” in the agreement be the same as the definition of “disability” in the insurance policy used to fund the obligation. It is equally important that the definition of “disability” meets the personal needs of the shareholders. In addition, the employee may be covered by disability insurance owned personally to replace his or her lost compensation from the business or practice. For a good discussion of disability insurance, see Reif, “Severance and Disability Arrangements,” Ali-Aba Course of Study, Qualified Plans, P.C.’s and Welfare Benefits (1989) 627 at 731-750; Zaritsky, Structuring Buy-Sell Agreements: Analysis with Forms, Warren, Gorham & Lamont, 2nd Ed. §7.06 (2000); and Arrowood, “Disability Provisions and the Buy-Sell Agreement,” 30 Col. Law 37 (April, 2001). See Exhibit “G” for a provision requiring purchase of a disabled shareholder’s stock.

3. Termination of Employment. Upon termination of employment, even if not disabled, a non-working shareholder may desire that significant dividends be paid by the corporation -- a desire likely to be in conflict with the needs of the business or practice and the desires of the other shareholders whose income is primarily in the form of compensation, director’s fees, etc. More likely, the terminated employee will be anxious to have his stock purchased, especially if a minority shareholder and/or not a family member. Typically, the initial purchase of stock in a family business by a non-family key employee is coupled with a Buy-Sell Agreement containing a mandatory buy-back provision upon termination of employment at a formula price which reflects the growth of the business. This gives the key man the incentive to enhance the value of the corporation while employed and the protection of knowing that his investment will be liquidated upon termination of employment. See Exhibit “G-I” for a provision
requiring the purchase of a physician’s interest in a partnership owning the medical office utilized by the practice upon his termination of employment with the professional corporation.

4. Voluntary Transfers. Buy-Sell Agreements typically provide that the corporation and the remaining shareholders have the option (not the obligation) to purchase the shares of a shareholder who wishes to transfer his shares during lifetime. The agreement should clearly specify: (1) whether the option can be exercised to purchase all or only a part of the shares of the selling shareholder; (2) if the corporation does not purchase the proportion that each of the remaining shareholders are allowed to purchase and whether there is a second round to purchase shares available due to unexercised options by some of the remaining shareholders; (3) the method for exercising the option; and (4) what happens to the unpurchased shares if the corporation or remaining shareholders fail to purchase all of the offered shares. Typically, the requirement is that all (and not less than all) of the shares must be purchased in order to protect the selling shareholder. However, this requirement can result in the corporation or remaining shareholders being forced to come up with significant resources at a time which may not be financially convenient or possible. A compromise is often reached regarding the terms of payment to permit installment payments for all or a portion of the purchase price. See Exhibit “G-2” for provisions dealing with lifetime sales to non-permitted persons of a limited liability company where the remaining members are granted options to purchase.

5. Involuntary Transfers. It is generally desirable for the agreement to include an option (not an obligation) to repurchase shares if the shares become subject to an involuntary transfer, e.g., a transfer to a trustee in bankruptcy, to a guardian of an incompetent shareholder, to a spouse incident to a divorce, or to a lender upon foreclosure. The option to purchase may be important since the transferee may take positions inconsistent with the general goals of the business, i.e., seeking to force payment of dividends, unwilling to provide funds for capital needs, and the like. It is especially desirable in a professional practice for the agreement to provide for an option to purchase in the event the shares are subject to an involuntary transfer since most state laws require ownership only by a licensed professional. Special care should be taken in drafting such an option in a divorce proceeding since the issue as to the enforceability of such a provision is likely to be raised, with the likelihood that the corporation and its shareholders will become embroiled in the marital proceedings, especially if the spouse feels the purchase price under the Buy-Sell Agreement is inadequate. See Zaritsky, Structuring Buy-Sell Agreements: Analysis with Forms, Warren, Gorham & Lamont, 2nd Ed. §7.05 (2002).

D. Option vs. Obligation. In each circumstance which “triggers” a purchase under the agreement, consideration must be given to whether or not the purchaser should be “obligated” or merely have an “option” to purchase. The objectives of the decedent or withdrawing shareholder are almost always best served by a mandatory purchase if adequate funding is available. To establish the value for estate tax purposes, the agreement need only provide that the estate of the deceased shareholder is obligated to sell, with no requirement that the corporation or remaining shareholders are obligated to purchase. However, to accommodate the estate’s liquidity needs, the agreement should provide for a mandatory purchase on death. Similar considerations in the case of disability make a mandatory purchase desirable if funding is available, which most often is not the case. A mandatory purchase would not typically be provided in the event of a voluntary or involuntary lifetime transfer (except where a non-family minority shareholder terminates employment) since in either event, such a fixed obligation would represent a contingent liability and an uncertain funding requirement unacceptable to the
corporation or the remaining shareholders. See Exhibit “G-3” for provision effective upon termination of a physician’s employment, granting a series of options to acquire a physician’s interest in a related real estate partnership owning medical office, followed by an obligation to purchase if options not exercised after five (5) years.

E. Voting Restrictions. In addition to purchase obligations and restrictions on transfer of shares, the Buy-Sell Agreement can also effectively deal with the voting rights of the owners. The advisor, while determining the facts necessary to prepare the Buy-Sell Agreement, should review the voting patterns and any existing agreements among the shareholders which could affect the buy-out arrangement. Such agreements could include a voting trust to assure consolidation of voting power in a single shareholder or a group of shareholders, or restrictions pertaining to the corporation’s “S” election, or the required payment of a minimum level of dividends. Any voting agreements or restrictions should be reviewed to make sure they are enforceable under state law and are consistent with the other provisions of the Buy-Sell Agreement. For a comprehensive discussion of voting agreements and other general business provisions to be considered for inclusion in Buy-Sell Agreements, see Zaritsky, “Forgotten Provisions in Buy-Sell Agreements,” 19 U. Miami Est. Plan. Inst. (1985).

V. Funding the Agreement

A. In General. One of the most important provisions in a Buy-Sell Agreement deals with the source and method of funding the obligations created by the agreement. The issue of funding must take into account both the needs of the shareholders and their estates as potential “sellers” as well as the financial and cash flow capabilities of the shareholders and the corporation as potential “purchasers.” Methods of funding should be determined at or prior to the time the agreement is signed (to begin the process of accumulating funds or paying life insurance premiums), taking into account an estimate of the likely time in the future that a “triggering event” (i.e., death, disability, termination of employment, etc.) might occur. Although life insurance will often solve the funding problem for purchasing a deceased shareholder’s stock, and disability insurance may be available to fund the stock purchase in the event of permanent disability, insurance proceeds (except to the extent of cash values) are not available in lifetime purchase situations, i.e., retirement, termination of employment, or a voluntary or involuntary transfer. Also, in many cases, the life or disability insurance may be unavailable or unaffordable because of the age or poor health of the shareholder or because of limited financial capabilities of the purchasing corporation or other shareholders. The basic determinations in the Buy-Sell Agreement, i.e., (1) whether or not to obligate or give the buyer an option, (2) the events that will “trigger” a sale and purchase, and (3) the extent to which the liquidity needs of the potential seller can be provided for -- must all be evaluated in light of the funding capabilities of the parties. Where life insurance is not available or not affordable, there may not be a reasonable alternative funding method available which will adequately satisfy all of the divergent needs of both the buying and the selling parties. However, in many situations, non-insurance methods of funding coupled with installment payments of the purchase price can meet many of the major needs of the potential “purchasers” and “sellers.”

B. Installment Sales. If the “purchaser” is given the right to pay part or all of the purchase price in installments, the obligation should be evidenced by a promissory note, with the rate of interest and the length of time for payment depending on the comparative financial needs and capabilities of the parties. If possible, the promissory note should provide for a competitive
rate of interest to encourage early payoff or at least high enough to avoid attribution of taxable interest under §483. The agreement should also contain the specific requirements as to the security for the note and any restrictions to be placed on the operation of the business while the note remains unpaid. See Exhibit “H” for provisions providing for an installment purchase from a deceased shareholder’s estate which requires security for the indebtedness payable to the estate and imposes restrictions on corporate activity. Since the deferral of payment permits the purchaser to fund the purchase price out of future earnings, the ability of the business to handle these purchases must be carefully evaluated. Although the installment sale by a deceased shareholder’s estate may not satisfy its liquidity problems, it is often the only solution when insurance is not available. Nevertheless, before finalizing the terms of the agreement providing for an installment sale, it should be clearly understood that the estate is not only at risk in meeting its cash flow needs (taxes and other expenses) but is also subject to a “credit risk” measured by the purchaser’s ability to pay, a risk ultimately borne by the deceased shareholder’s family. Similar considerations must be evaluated in the case of disability and other “triggering” events where the purchaser is permitted to pay the purchase price in installments.

C. Funding Delayed until “Trigger” Event. The Buy-Sell Agreement can provide that the full purchase price will be paid in cash on the date of purchase even though there is no plan for funding through insurance or other sources. By doing this, the parties anticipate that the corporation (or purchasing shareholders) will be able to arrange to borrow or otherwise obtain the needed funds to satisfy the cash obligation when the time arrives even though the purchase price then payable is not presently known. In drafting such an agreement, adequate time between the “trigger” event and the closing of the purchase should be provided to allow time for the sale of assets, if needed, to raise cash or to complete the necessary dealings with lenders. Generally, the difficulties and risks imposed on the purchasing corporation (or shareholders) to raise the necessary funds (by selling assets or borrowing) at an unspecified time in the future (when the availability of credit cannot be assured) makes this approach less than satisfactory in most cases. However, in some situations, a Buy-Sell Agreement using this approach can satisfy the cash needs of the selling shareholder and help resolve a difficult problem, albeit the purchaser may wind up heavily in debt. Where the purchase price is unfunded, the method of payment, i.e., lump sum or installments, will always involve a balancing of interests between “sellers” and “purchasers.”

D. Accumulation of Funds. If no insurance or outside funding is available, the corporation can seek to accumulate funds internally in advance of the anticipated obligation. However, since the obligation can occur at any time, this method cannot insure the corporation will have the necessary funds in time to meet its obligations. From a tax standpoint, the self-funding accumulation may cause an “unreasonable accumulation of surplus” problem, especially where the funding is to purchase the interests of a majority shareholder. See generally §531, “Buying Out 50% or More Shareholders,” Fed-Tax Cord. 2nd. §2826 (2003). Note that the §531 rate was reduced to 15% by the 2003 Tax Act. Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. 108-27, 117 Stat. 750 (JGTRRA).

Generally, the self-funding accumulation of liquid funds to satisfy a future purchase obligation is utilized only as a supplement to other funding alternatives since self-funding does little during the early years of the agreement (when the accumulation is small) to be of significant help.
E. Shareholders as Purchasers. Where the corporation is not capable of funding the purchase, a cross-purchase agreement can shift the burden to the individual owners who may be more financially capable of handling the obligation. In most cases, however, this merely shifts and does not resolve the problem. The shareholder’s liability under a cross-purchase agreement can be unlimited or it can be limited to the value of assets pledged as security for the shareholder’s promissory note if an installment purchase is permitted. Typically, shareholders do not want to obligate their personal estates for stock purchase obligations, especially where the amount of the purchase price is unknown at the time of the agreement. This concern also influences whether an “option” or a “required” purchase will be utilized in the agreement.

F. Hybrid Funding. The Buy-Sell Agreement will often provide that cash will be paid at closing to the extent of the insurance proceeds (or up to a specified percentage of the purchase price if no insurance is available) with the balance payable over a term of years evidenced by a promissory note. The provisions for cash and deferred payments could, for example, call for a “down payment of the greater of 25 percent of the purchase price or the net proceeds from life insurance, with the balance, if any, being deferred over a five-year term.” See Exhibit “I” for a provision requiring payment in cash to the extent of life insurance with installment payments of the balance; and Exhibit “J” for a provision which requires security for an installment note and restrictions on corporate operations.

VI. Alternative Minimum Tax – Effect on Life Insurance

A. In General. The law contains a corporate alternative minimum tax (AMT) for the stated purpose of eliminating situations where C corporations pay little or no tax in years in which they report substantial earnings and may have paid substantial dividends to their shareholders. §55 et. seq. See General Explanation of Tax Reform Act of 1986 (1986 Blue Book) at 432. “Small” corporations having less than $7,500,000 in average annual gross receipts for the preceding three years ($5,000,000 for new corporations during first three years) are exempt from AMT. §55(e).

B. The AMT Formula. The tax base for calculating AMT is the corporation’s “alternative minimum taxable income” (AMTI) which is its regular taxable income increased (or decreased) by various adjustments and reduced by an exemption of $40,000. §55(d)(2). The AMTI is then subject to a tax at a 20% rate and the amount of tax so calculated (the “tentative minimum tax” (TMT)) is the applicable tax if it exceeds the corporation’s regular income tax for that year. In arriving at AMTI, a corporation’s taxable income is recalculated based on “adjustments” and “preferences.” “Adjustments” can either increase or decrease taxable income, whereas a “preference” will only increase taxable income. In addition, a “book income adjustment” (known since 1989 as “adjusted current earnings” or “ACE” adjustment) is provided to ensure that all corporations with substantial financial income will pay some tax.

1. The “Book Income” Adjustment. For years through 1989, an adjustment was made to the corporation’s tax base (AMTI) which has the result of increasing AMTI by one-half of the amount by which the “adjusted net book income” exceeds AMTI; this difference was then added to the AMTI so that, in effect, the corporation’s tax base was calculated twice (once without and then again with the “book income” adjustment). §56(f)(1) (repealed).

2. The “Earnings” or “ACE” Adjustment. For taxable years since 1990, corporations use an “earnings” adjustment (instead of a “book income” adjustment), whereby
AMTI is increased by 75% of the amount by which the corporation’s “adjusted current earnings” exceeds AMTI, i.e., the ACE adjustment. §56(g)(l); Reg. §1.56(g)-1(c)(6).

3. Accounting for Life Insurance. The generally accepted accounting method for corporate owned, cash value life insurance is expressed in Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, which requires that the annual increase in the cash surrender value of the policy be charged to an asset account and the annual premium charged to expense. The net result is that the premium is offset by the increase in cash value which typically results in a net non-deductible expense during the early years of a policy (premiums higher than cash value increases) and non-taxable income in later years when the annual increase in cash value exceeds the premium. See EITF 06-5 (effective after 12/15/06).

C. Effect on Life Insurance. The ACE adjustments impact two aspects of corporate owned life insurance -- (1) the annual increase in the cash value of the policy and (2) the death benefit.

1. Cash Value. The annual increase in cash value (inside build-up) will generally not result in AMT unless the net annual increase, i.e., the increase in cash value less premium paid, exceeds $54,000 (depending on other ACE adjustments). Therefore, the increase in cash surrender value is not likely to result in AMT for the majority of corporate taxpayers except where a large, high cash value policy is involved. §56(g)(4)(B)(ii). Regarding increases in cash value, the Conference Committee Report to TRA-86 stated that the “inside build-up,” minus a portion of the premium attributable to the mortality charge, is includible in earnings and profits. Conference Report No. 99-841 at II-278.

2. Death Benefit. The death benefit from life insurance is nontaxable income to the corporation but does increase its “book income” and the ACE adjustment after the corporation has recovered its basis (premiums paid) in the contract. Since 1990, 75% of the insurance proceeds would be an ACE adjustment and would be taxed at an effective rate of 15% (i.e., 20% (tax rate) x 75% (ACE inclusion) = 15%). Regarding death benefits, Rev. Rul. 54-230, 1954-1 C.B. 114, held that life insurance proceeds in excess of the aggregate premiums paid was includible in “earnings and profits”. Although “earnings and profits” is not defined in the Code, the fact that insurance proceeds increase corporate resources available to shareholders makes it likely that the holding of this ruling will be followed in the AMT calculation.

D. Planning: Suggestions.

1. Since the effective tax rate on insurance proceeds (depending on several factors) can be as high as 15%, one option is to purchase more insurance to cover the tax.

2. In establishing a new Buy-Sell Agreement, the use of a cross-purchase agreement (which avoids AMT) may be advisable if other factors are also favorable.

3. Since the AMT does not apply to S corporations, the elimination of AMT exposure is an incentive for the corporation to make an S election.


VII. Role of Advisor - Possible Conflict
In evaluating the need for and the design of a Buy-Sell Agreement, the advisor will often be representing the corporation and several shareholders, all with competing interests. Even if each party has an equal chance of being either a “buyer” or a “seller” at the time of the entering the agreement, there are always circumstances where the corporation or certain shareholders will have competing interests that make it difficult for the advisor to represent all parties effectively. In all such cases, the attorney should (as soon as possible) explain the potential conflicts and suggest the opportunity for separate counsel to be involved. See American Bar Association, Model Rules of Professional Conduct, Rules 1.2(e), 1.7(b), 1.13(d) and (e), and 2.2(a) and (b), which replaces provisions of the Model Code of Professional Responsibility, E.C. 5-16, which stated as follows:

“EC 5-16. In those instances in which a lawyer is justified in representing two or more clients having different interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires. Thus before a lawyer may represent multiple clients, he should explain fully to each client the implications of the common representation and should accept or continue employment only if the clients consent. If there are present other circumstances that might cause any of the multiple clients to question the undivided loyalty of the lawyer, he should also advise all of the clients of those circumstances” (emphasis added).

In attempting to strike a balance between competing interests, the planner must be sensitive to any conflict among the parties and must evaluate the issues for all parties at the time of planning the agreement. If after discussions with the shareholders the attorney determines he can effectively represent all parties, it is desirable that a written consent and acknowledgement be obtained from all the shareholders and the corporation (1) acknowledging that the potential conflicts were revealed and discussed and that separate counsel was recommended; and (2) consenting to the single representation. See Exhibit “K” for a form of engagement letter dealing with this issue for a real estate limited liability company with two members.

VIII. Partnership Buy-Sell Agreements

Most of the non-tax considerations in analyzing and preparing a corporate Buy-Sell Agreement are equally applicable in the partnership context. Often the buy-sell provisions are contained in the partnership agreement itself; however, if there is a separate Buy-Sell Agreement, the partnership agreement should be carefully analyzed to make certain that its provisions are not in conflict with the desired effect of the Buy-Sell Agreement. While most considerations in drafting partnership Buy-Sell Agreements are largely the same as those involved in a C corporation, there are significant differences.

A. Cross-purchase vs. Partnership Purchase. The capital gain vs. ordinary income concerns involved in a corporate redemption agreement are different in a partnership. The sale of a partnership interest to other partners is covered under §§731 and 751 which provide that proceeds received by the selling partner are considered to be from the sale of a capital asset except to the extent of ordinary income treatment under §751. If, however, the partnership (rather than the other partners) purchases the selling partner’s interest, the transaction can be structured to permit deductible payments by the partnership which will be received by the
withdrawing partner as ordinary income. The payments to the withdrawing partner will be treated as “guaranteed payments” of a portion of the partner’s distributive share under §736(a). However, if the payments are not specifically designated as “guaranteed payments,” the payments would be considered to be in exchange for the partner’s partnership interest. §736(b).

With the current large difference in tax rates applicable to capital gains and ordinary income (15% versus 35%), the retiring partner would, of course, prefer for the transaction to be characterized as a capital transaction under §736(b). In some situations, it may be beneficial to structure the transaction so that payments for a retiring partner’s interest up to the partner’s basis in the partnership be paid in exchange for the partnership interest, with the balance being “guaranteed payments” deductible by the partnership under §736(a). This split method of payment, i.e., the amount paid up to the selling partner’s basis being a capital transaction under subsection 736(b), with the remaining payments being “guaranteed payments” deductible by the partnership under §736(a), can in some cases be beneficial. If payments for “goodwill” are called for in the partnership agreement, they will be treated as being made in exchange for the partnership interest under §736(b) and, therefore, not deductible.

B. Insurance. The “transfer for value” problem in partnership Buy-Sell Agreements is substantially less than in the case of a corporation since §101(a) provides an exception to the “transfer for value” rules for transfers of life insurance between partners. Therefore, the cross-purchase form of Buy-Sell Agreement can often be more easily utilized in a partnership.

C. Section 754. To avoid uncertainty and future conflict, the permitted election under §754 should be considered at the time of preparing the Buy-Sell Agreement so the agreement can contain provisions which make it clear which events will trigger the election and which partner (or partners) can compel the election. For a discussion of issues involving the §754 election, see Levison, “The Partnership Basis Election Analyzed,” 14 Estate Plan 138 (May, 1982).

IX. Special Concerns of S Corporations

A. In General. The reasons and purposes for having a Buy-Sell Agreement apply similarly to all types of entities, i.e., “C” and “S” corporations, partnerships, and limited liability companies (LLCs). However, since an S corporation must satisfy certain statutory restrictions (at the time of the “S” election and during each year of its operation) in order to obtain and retain its “S corporation” status (a limitation not imposed on other “pass-through” entities, i.e., partnerships and LLCs), a Buy-Sell Agreement becomes even more important for the S corporation. The Buy-Sell Agreement involving an S corporation must deal with additional restrictions uniquely effecting S corporations, i.e., the prevention of an inadvertent termination of the S election, protocol for the payment of a minimum level of dividends, and certain shareholder elections upon the termination of a shareholder’s interest in the corporation. With a growing number of closely held corporations electing S status in recent years, (beginning most significantly after 1986), the special provisions in Buy-Sell Agreements for S corporations are applicable to a large number, if not a majority, of all closely held corporations.

B. S Corporation Requirements. The statutory requirements for S corporations affecting Buy-Sell Agreements are:

1. Must have only one class of stock. §1361(b)(l)(D), modified by §1361(c)(4) which clarified that differences in voting rights shall be disregarded.
2. Cannot have more than 100 shareholders. §1361(b)(1)(A). A husband and wife and family members are treated as one shareholder. §1361(c)(1).

3. An S corporation’s shareholders can only be individuals (who are United States citizens or resident aliens), estates, and certain trusts and tax-exempt organizations. §1361(b)(1). See §1361(c) which defines the types of permitted trusts and exempt organizations.

C. Estates as Shareholders. Both a decedent’s and a bankrupt’s estate are a permitted shareholder of an S corporation and count as only one shareholder during the existence of the estate, regardless of the number of beneficiaries. However, upon distribution of the estate (i.e., the designated beneficiaries of a decedent or the creditors of a bankrupt), the transferee beneficiaries will each count as a shareholder, thus, creating a potential for violating the shareholder requirements for maintaining S status. The Buy-Sell Agreement should cover these circumstances by providing purchase rights for the corporation or other shareholders, although it is not certain under the bankruptcy laws if it is possible to bind the trustee of a bankrupt’s estate. See Bankruptcy Code §1365(a) and (c); and Countryman, “Executor Contracts in Bankruptcy,” Part I, 57 Minn. L. Rev. 439, 460 (1973), which is often cited to describe an “executor’s control.” The trustee cannot, however, accept the benefits and reject the burdens of the agreement. In Re UAL Corp, 293 B.R. 183 (ND Ill 2003); and In Re Nitec Paper Corp., 43 B.R. 492 (D.C.N.Y. 1984). See Exhibit “L” for special provisions which protect the S status of the Corporation.

D. Trusts as Shareholders. Voting trusts are allowed as owners of S corporation stock and each holder of a voting trust certificate is counted in determining the 100 shareholder limitation. §1361(c)(2)(B)(iv). From an estate planning standpoint, three types of trusts are permitted as shareholders of S corporations, a “grantor trust,” a “qualified subchapter S trust (QSST)” and an “Electing Small Business Trust (ESBT).”

1. Grantor Trusts. A “grantor trust” is an inter vivos trust where the grantor (or a beneficiary) of the trust is treated as the owner of the trust assets for income tax purposes by reason of having the power to vest corpus or income in himself. §1361(c)(2)(A)(i). See §671-677 which treats the grantor as the owner of the trust and §678 where a non-grantor is considered the owner. Upon the death of the grantor, the trust is permitted to continue as a shareholder for two (2) years after the grantor’s death if the entire trust corpus is includible in the grantor’s estate for estate tax purposes. If the entire corpus is not included in the grantor’s estate, the trust can continue as a permitted shareholder for only 60 days after the grantor’s death. §1361(c)(2)(A)(ii). Therefore, it is advisable for the Buy-Sell Agreement to provide that the trustee must, after the shareholder’s death, transfer the stock to a beneficiary who is a permitted shareholder or sell the shares to the corporation or other shareholders. To prevent an unintended termination of the S election, the agreement should require the shareholders to notify the corporation of any stock transfers made to trusts so that it can be determined at that time whether or not the trusts are “grantor trusts;” and, if they are, whether the corpus of the trusts will be includible in the grantor’s gross estate. This information is necessary in order to determine whether a distribution of the stock from the trust would be required within 60 days or two (2) years following the shareholder’s death. It is also advisable for the Buy-Sell Agreement to require that counsel for the corporation be appointed to make these determinations. This, of course, requires constant monitoring by the attorney or accountant and is a responsibility for which the attorney or accountant should be fully protected by written indemnification.
2. **Qualified Subchapter S Trusts (QSSTs).** A trust will qualify as a QSST if it must distribute all of its current income to a sole beneficiary who is a United States citizen or resident alien, who signs a separate election for each S corporation owned by the trust, and who is the only person who can receive a corpus distribution during his or her lifetime. The income interest of the sole beneficiary must end on the earlier of the beneficiary’s death or the trust’s termination; and upon termination of the trust, the corpus of the trust must be included in that beneficiary’s estate for estate tax purposes. §1361(d). Typical trusts which qualify as QSSTs are a QTIP marital deduction trust, a life income trust with the beneficiary having a testamentary general power of appointment, and a §2503(c) trust for minors if income is distributed (or required to be distributed) to the minor.

3. **ELECTING SMALL BUSINESS TRUSTS (ESBT)** The “electing small business trust” was added to the Code in 1996 to provide flexibility in the planning of estates of S corporation shareholders. To qualify as an ESBT, the trust must meet the requirements of §1361(e)(1): (i) the beneficiaries must be individuals, estates, or certain nonprofit organizations; (ii) no interest in the trust may have been acquired by purchase; (iii) the trust must make a proper election to be treated as an ESBT; (iv) the trust does not make a QSST election; and (v) the trust is not tax exempt. An ESBT is taxed on the income from the S corporation stock at the highest individual tax rate without the benefit of personal exemption. A typical trust which can qualify as an ESBT is a GRAT which makes the proper election. For a general discussion, see C. Wells Hall, III, “Can You Spell ‘Trust’ with an S in It? Fiduciary Administration of S Stock,” 42nd Southern Federal Tax Institute (2007).

4. **OTHER TRUSTS.** If the trust is not a “grantor trust,” a QSST, or an ESBT, it can own S corporation stock for only 60 days after the date of transfer to the trust. Types of trusts precluded from owning S corporation stock are: (1) the typical “sprinkling” trust where the trustee determines annually the amount of income to be distributed among the various beneficiaries; and (2) a charitable remainder or other trust where the income of the trust could exceed the amount distributable to the beneficiary. It should be noted that prior to 1987, a grantor retained income trust (GRIT) could also satisfy the S corporation rules as a grantor trust.

5. **CONFLICT OF INTEREST.** The need for continuous involvement by the advisor to the S corporation in matters pertaining to an individual shareholder’s personal planning can create a conflict of interest for the attorney who attempts to represent both the corporation and its shareholders. Advising S corporations and their shareholders presents more problems than C corporations in this regard primarily because carrying out one shareholder’s plans may, in addition to other conflicts, adversely affect the S election and, therefore, the other shareholders. The Buy-Sell Agreement can help reduce this conflict by providing that a shareholder must, on a confidential basis, disclose his or her personal estate and trust planning documents to the counsel for the S corporation so that an inadvertent termination of its status will not occur.

6. **INADVERTENT TERMINATIONS.** Section 1362(f) of the Code deals with inadvertent termination of the S election by granting the Commissioner broad relief powers to reinstate the S election. A number of private letter rulings illustrate the Service’s liberal interpretation of this power in granting relief by reinstating the S election. See Priv. Ltr. Ruls. 200218007 (termination caused by ineligible stockholders); 200103022 (termination caused by two classes of stock); 199939043 (corporation violated passive income rules); 200750003 (termination caused by improper stock transfer); 200746008 (inadvertent termination due to
ownership of stock by trust); and 200632001 (termination due to failure to file a timely QSST election).

E. One Class of Stock. The regulations under §1361(b)(1)(D) interpret the “One Class of Stock” requirement as permitting both voting and non-voting common stock as long as the shares have identical rights in the “profits” and “assets” of the corporation. Reg. §1.1361-1(1)(1) and (2). Following the Subchapter S Revision Act of 1982, there were a number of rulings by the Service on the issue of whether or not a Buy-Sell Agreement itself created a second class of stock. The first such ruling in 1984, Ltr. Rul. 8506114, involved a Buy-Sell Agreement with broad and varied restrictions; nevertheless, the Service ruled the agreement did not result in creating a second class of stock.

Final Regulations dealing with this issue were adopted in March of 1992, however, a review of several earlier rulings will help to illustrate the types of provisions in a Buy-Sell Agreement which can be utilized without violating the “second class of stock” rule. See Reg. §1.1361-1(1)(2).

1. Letter Ruling 8506114. In this ruling, the agreement was designed primarily to cover certain key employees who had an ownership interest in an S corporation. The agreement restricted the shareholders’ ability to transfer stock and any transfer made in violation of the agreement was stated to be void and without effect. The S corporation was given the right to purchase the employee’s stock at book value if it were notified of a proposed transfer; and if the corporation did not purchase the stock, it could be sold only to a person who had executed the Buy-Sell Agreement and who would be an eligible S corporation shareholder. The agreement also provided that the corporation was obligated to purchase the stock (or cause others to purchase) if: (1) a shareholder died, was adjudicated incompetent, insolvent or bankrupt; (2) there was an involuntary transfer; (3) the shareholder’s employment was terminated; (4) the shareholder became disabled; or (5) there was a determination by the executive committee or the directors of the corporation that the shareholder should sell all or a portion of his stock. The agreement had specific provisions affecting the purchase of stock owned by the Corporation’s largest two shareholders. The agreement also provided that shareholders could be required to make capital contributions or loans to the corporation on a pro rata basis; and, as to this provision, the ruling stated that since all shareholders were subject to this provision, this requirement did not create a different class of stock. The agreement also covered the corporate decision making process, granting the majority shareholder a veto right in preventing any reduction in his proportionate interest in the corporation (indicating the shareholders did not have preemptive rights). Further, the founding shareholder was not subject to all of the transfer restrictions affecting the other shareholders. The agreement also contained a provision whereby the corporation had an option to purchase certain shareholders’ stock at “fair market value” if the shareholder voted against or abstained from corporate actions requiring shareholder approval. The purchase price for the stock was subject to an automatic adjustment if certain events occurred within two years after the purchase. The agreement also required shareholders to return a certain portion of the funds distributed to them by the corporation to be managed by the corporation, the prime purpose being to require all shareholders to maintain sufficient funds which could be available for loans to the corporation should they be needed. The Buy-Sell Agreement specifically allowed the corporation to retain a portion of its earnings.

The concern was that the various provisions, taken as a whole, created a second class (or more classes) of stock in light of the differences among the shareholders as to transfer
restrictions, purchase obligations, price determinations, the difference in rights, i.e., the executive committee’s right to require some but not all shareholders to sell their stock, the obligation of shareholders to vote their shares to effectuate decisions made by the executive committee, the special founder’s rights possessed by only one of the shareholders, and the required reinvestment obligations.

Notwithstanding all the varied restrictions and rights, the Service determined there was not a second class of stock, thereby establishing the rule that variations in voting, transfer and price restrictions are not prohibited as long as the rights to dividends and to the assets of the corporation on liquidation are equal among all shares. This remains the position of the Service even though the restrictions will, as a practical matter, result in the shares being worth more or less to various shareholders. The only determinative factor is that a shareholders’ rights to the assets of the corporation (not the value of the shares) are on an equal basis among all shareholders.

Given the broad nature of the Buy-Sell Agreement involved in this Ruling, it is highly unlikely that the typical Buy-Sell Agreement would create a second class of stock as long as the rights to profits in the form of dividends and distributions on liquidation are on an equal basis among the shareholders.

2. Letter Ruling 8528049. In April of 1985, the Service issued its second ruling on whether or not a Buy-Sell Agreement created a second class of stock. In this ruling, the S corporation and the voting shareholders had a right of first refusal if a non-voting shareholder attempted to transfer his stock. The Service held that the voting and non-voting stock, both having the same rights to dividends and to distributions on liquidation was not a second class of stock and that the agreement itself did not create a second class of stock. The Service ignored the difference in treatment between the two types of stock as to the right of first refusal on lifetime transfers and the obligation of the non-voting shareholders to sell their stock if their employment with the corporation was terminated for any reason.

3. Revenue Ruling 85-161, 1985-41 I.R.B. 22 (declared obsolete by Rev. Rul. 95-71, 1995-2 C.B. 323). This ruling involved a restriction which prevented only one of several shareholders from selling his stock without obtaining the consent of the other two shareholders. If consent could not be obtained, the shareholder could only sell his stock to the corporation or the other shareholders at book value. Since all stockholders had identical rights in the profits and assets of the corporation, the Service ruled that the restriction did not affect the shareholder’s interest in the corporate profits or assets so as to create a second class of stock. Thus, the Service again literally applied the “interest in profits and assets” rule established under §1361(b)(1)(D) and §1361(c)(4) notwithstanding that one shareholder could never receive more than book value for his or her stock without the other shareholders’ consent except on liquidation of the Corporation. See Committee Report on P. L. 97-354. Therefore, even though the restrictions in the agreement may make a particular shareholder’s stock worth less than the shares of other shareholders, the Service has stated that this alone will not be considered a difference in “interest in profits and assets.” See Ltr. Rul. 8908069 which cites Rev. Rul. 85-161 in holding that a Buy-Sell Agreement did not affect the shareholder’s rights to profits and assets of the corporation and was, therefore, not a second class of stock.

4. Debt of S Corporation. Prior to the S Corporation Revision Act of 1982, the Service often contended that loans to an S corporation made by shareholders on a prorata
basis were really a second class of stock. The Revision Act specifically addressed this problem and enacted the so-called “Straight Debt” safe harbor provisions. §1361(c)(5).

a. “Straight Debt.” If a corporation issues a debt instrument to evidence a shareholder loan and it: (1) provides for an unconditional promise to pay a specified sum; (2) bears a specified interest rate and interest payment dates which are not contingent upon profits, corporate discretion or similar factors; (3) is not convertible into stock; and (4) the creditor is eligible to own S corporation stock, irrespective of whether the debt is issued on a pro-rata or non-pro rata basis, the debt will not be considered a second class of stock. Reg. §1.1361-1(d)(5)(iv). If the S corporation anticipates future losses and the shareholders anticipate lending funds to the corporation to create “basis” so they can deduct the losses on their individual returns, the following provision should be in the Buy-Sell Agreement:

“Any debt owed to a shareholder of the corporation shall be evidenced by written instrument, shall be payable on demand or mature at the end of a specified time, shall bear a specific rate of interest and payment dates which are not contingent on any event or circumstance, will not be convertible into corporation stock, and will not be transferable either during the shareholder’s life or by his or her estate after death unless the transferee is a permitted shareholder of an S corporation.”

b. State Laws. If state law creates a difference in shareholders’ rights to receive distributions or liquidation proceeds, a second class of stock generally exists. For example, California has imposed restrictions on so-called “promotional stock,” i.e., stock issued without the transfer of tangible assets to the corporation. Under California law, such promotional stock is restricted as to the payment of dividends and liquidating distributions, and this legislatively imposed restriction has been held to create a second class of stock. See California Corporation Code §25141 and 10 California Administrative Code §260.141; Paige v. United States, 580 F. 2d 960 (9th Cir. 1978); Rev. Rul. 71-522, 1971-2 CB 316, declared obsolete by Rev. Rul. 95-71, 1995-2 CB 323 (shareholders’ rights in control, profits and assets differed because of California law). See discussion in Alan J. Baley, 69 TC 234, 240-241 (1977), aff’d per curiam, 624 F2d 884 (9th Cir. 1980).

5. History of Proposed Regulations. The Internal Revenue Service issued proposed regulations (“first proposed regulations”) regarding the single class of stock requirement on October 4, 1990. These regulations were severely criticized, and in response to almost unanimous negative reaction, the Service withdrew these first proposed regulations on August 13, 1991, and replaced them with a second version of the regulations regarding the single class of stock requirement (“Second Proposed Regulations”). 56 Fed. Reg. 38,391 (August 13, 1991). Following publication of the Second Proposed Regulations, additional comments and testimony were received, after which the proposed regulations were revised and issued in final form on May 29, 1992. 57 Fed. Reg. 22,646 (May 29, 1992).

6. Final Regulations. The final regulations state that a corporation is generally considered to have only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock are disregarded in determining whether a corporation has more than one class of stock. Reg. §1361-l(I)(I).
a. The determination is based on the corporate charter, articles of incorporation, bylaws, applicable state law, and any binding agreements relating to distribution or liquidation proceeds (referred to as the “governing instruments”). Reg. §1.1361-1(1)(2)(i).

(1) A commercial contractual arrangement such as a lease, employment agreement, or loan agreement is not a “binding agreement relating to distribution and liquidation proceeds” and thus is not a “governing instrument,” unless a principal purpose of the agreement is to circumvent the one class of stock requirement. Reg. §1.1361-1(1)(2)(i).

b. If substantially nonvested stock (within the meaning of Treas. Reg. §1.83-3(b)) is treated as outstanding, the forfeiture provisions that cause the stock to be substantially nonvested are disregarded. Reg. §1.1361-1(1)(2)(iii)(B).

c. Bona fide agreements to redeem or purchase stock at the time of death, divorce, disability, or termination of employment are disregarded in determining whether a corporation’s outstanding stock confers identical rights. Reg. §1.1361-1(1)(2)(iii)(B).

d. Buy-Sell Agreements among shareholders, and redemption agreements are disregarded in determining whether a corporation’s outstanding stock confers identical distribution and liquidation rights unless both of the following conditions are met:

(1) A principal purpose of the agreement is to circumvent the one class of stock requirement; and

(2) The agreement establishes a redemption or purchase price that, at the time the agreement is entered into, is significantly in excess of or below the fair market value of the stock. Reg. §1.1361-1(1)(2)(iii)(A).

(a) Agreements that provide for the purchase or redemption of stock at book value or at a price between fair market value and book value are not considered to establish a price that is significantly in excess of or below the fair market value of the stock. Reg. §1.1361-1(1)(2)(iii)(A).

(i) A determination of book value will be respected if the book value is determined in accordance with generally accepted accounting principals (including permissible optional adjustments) or the book value is used for any substantial nontax purpose. Reg. §1.1361-1(1)(2)(iii)(C).

(ii) A good faith determination of fair market value will be respected unless it can be shown that the value was substantially in error or the determination of the value was not performed with reasonable diligence. Reg. §1.1361-1(1)(2)(iii)(A).

F. Handling Problems Unique to S Corporations. The many requirements for maintaining a corporation’s S status suggest that the corporation and its shareholders utilize agreements and techniques which will help maintain the election as long as it is desirable.

1. Voting Restrictions. Absent agreement to the contrary, shareholders of an S corporation can terminate the S election by majority vote. §1362(d)(1)(B). The Buy-Sell Agreement may contain provisions requiring a super majority or unanimous vote to terminate the S election.

2. Restrictions on Transfers. The Buy-Sell Agreement can contain statements, to which reference is made on the stock certificates, that the intent of the parties is to
maintain the corporation’s S status and that the transfer of shares (except to permitted persons or trusts) are prohibited. If possible under state law, the agreement should state that any such transfer shall be void ab initio. Although the enforceability of an absolute prohibition against transfer may be questioned, it is beneficial to have the statement to serve both as a reminder and a deterrent to the shareholders and to support the argument for rescission of any transfer in violation of the agreement. An example of such an expression of intent and prohibition is as follows:

"Whereas it is the intent of the parties to maintain the S election of the corporation and to prevent any inadvertent and unintended termination of the election until properly revoked by the parties;

"Therefore, notwithstanding anything in this agreement to the contrary, no shareholder shall transfer any stock of the Corporation to:

"(1) Any person if such transfer would make the total number of shareholders exceed one hundred (100) or such other number provided under I.R.C. §1361(b)(l)(A); or

"(2) Any individual who is not a United States citizen or a resident alien of the United States; or

"(3) Any trust which is not a ‘grantor trust,’ a Qualified Subchapter S Trust (QSST), or an ESBT, or another trust that does not satisfy the requirements of I.R.C. §1361(c)(2) or (d); and,

"Any such transfer if made in violation of this agreement, shall be void ab initio and of no force or effect."

3. Restrictions on Corporate Activities. Since the S corporation is a party to the agreement in a redemption or hybrid type of agreement and can be a consenting party to a cross-purchase agreement, the agreement should deal with certain corporate activities that could result in the termination of the S election. For example, the agreement should include a prohibition against the corporation engaging in certain passive types of activities if the S corporation has previously been a C corporation with earnings and profits. When an S corporation has earnings and profits from C corporation years, the S election will terminate if passive investment income exceeds 25% of its gross receipts for three consecutive tax years. §1362(d)(3). Section 1362(d)(3)(C)(i), as amended by the 2007 Small Business Act effective for tax years beginning after May 25, 2007, generally defines passive investment income as gross receipts derived from royalties, rents, dividends, interest and annuities. Gains on the sale of stock and securities are not considered passive investment income. However, the gross receipts
from capital gains transactions that reduce the passive investment income percentage does not include the entire amount realized, but only the gains. §1362(d)(3)(B)(ii).

4. Distribution of Earnings. Typically, shareholders of an S corporation will need to receive a portion of the corporation’s annual income in order to have sufficient funds to pay their taxes on the taxable income attributable to them from the corporation. To protect the shareholders’ need for dividends, a required minimum level of dividend distribution should be provided for in the Buy-Sell Agreement. See Exhibit “M” for a provision requiring dividend distributions by an S corporation.

5. Election to “Close the Books”. The corporation, with approval of all its shareholders who own shares at any time during the corporation’s taxable year, can elect to treat income and losses for the year in which a shareholder transfers all of his stock as if the books of the corporation were “closed” on the date of sale §1377(a)(2). If the election is made, the shareholders will be treated as if the corporation had two short taxable years within its full taxable year. If the election is not made, income or loss of the corporation is allocated on a pro rata, per share, per day basis for the entire year. §1377(a)(1).

   a. Examples. The two optional tax treatments are illustrated as follows:

The Facts: Widget, Inc., an S corporation with a calendar tax year, incurred a loss of $100,000 during the six-month period January 1 through June 30, 2006, and earned a profit of $75,000 during the next six months ending December 31, 2006, thus incurring a net loss for the entire 2006 year of $25,000. On January 1, 2007, the stock of Widget, Inc. was owned equally by John and Bob. On July 1, 2007, John sold all of his stock in Widget, Inc. to Charles.

The Pro-rata (“per share, per day”) rule of §1377(a)(1). The $25,000 loss for 2006 would be allocated equally to each day of the corporation’s taxable year as follows: $12,500 to the first half of the year and $12,500 to the second half of the year. Since John owned 50% of the stock of the corporation during the first half of the year, he would be allocated $6,250 of the loss to be taken on his individual tax return for 2006. Bob, who owned 50% of the stock for the entire year, would be allocated $12,500 of the loss, and Charles, who owned 50% of the stock during the second half of the year, would be allocated $6,250 of the loss.

The Two taxable-year (“close the books”) rule of §1377(a)(2). The $100,000 loss incurred during the first half of the year would be allocated entirely to the short taxable year ending June 30, 2006. Accordingly, John and Bob would each be entitled to $50,000 of the loss. Since Widget, Inc. earned a $75,000 taxable profit during the second half of its taxable year, July 1 through December 31, 2006, Bob and Charles would each be attributed with $37,500 of taxable income for this period. Thus, for the year 2006, Bob is attributed with a $12,500 loss ($37,500-$50,000); John has a taxable loss of $50,000, and Charles has taxable income of $37,500.
b. **Agreement to “Close the Books”**. In some cases, it is desirable for the Buy-Sell Agreement to provide that shareholders must consent to the election to “close the books” and to specifically state who will bear the accounting and other costs incurred in making the necessary computations for the year of sale. In addition, if the parties agree to protect the interest of a terminating shareholder, the buy-out agreement should provide for the distribution of the entire year’s income (or an amount equal to the taxes); otherwise, under general corporation law, the corporation’s Board of Directors may or may not declare dividends in its discretion. See Exhibit “N” for a provision requiring shareholders to elect to “close the books” if any shareholder requests.

**X. Restructuring Agreement After S Election**

A. **In General.** Upon the enactment of TRA-86, many C corporations elected S status primarily because of the then relatively low maximum individual tax rate of 28% as compared with the top corporate rate of 39%. Since then, many C corporations have continued to elect S status, other reasons being: (1) the avoidance of the corporate alternative minimum tax; (2) the avoidance (after ten years) of the corporate tax on “built-in gains;” (3) the avoidance of unreasonable compensation issues; and (4) the perceived notion that S corporations need less administration and are easier and less expensive to operate. Many of these corporations, while operating as a C corporation, had entered into Buy-Sell Agreements that provided for the corporation to purchase the stock of a shareholder upon his death. The obligations created by many of these agreements were funded by life insurance on the lives of the shareholders, with the corporation being the owner and beneficiary.

Prior to TRA-86, it was often desirable to use stock redemption (rather than “cross-purchase”) agreements, since C corporations were typically in lower income tax brackets than the top marginal brackets of their shareholders. The only significant drawback of the stock redemption agreement was the fact that the surviving shareholders would not receive a step up in the basis of their stock upon the purchase by the corporation.

B. **Continuation of Redemption Agreement.** If a stock redemption type of Buy-Sell Agreement continues after the corporation changes its status from “C” to “S”, the stock basis of the surviving shareholders will be affected by the date during the year on which the deceased shareholder’s death occurs and whether or not there has been an election to “close the books” pursuant to §1377(a)(2), i.e., the shareholders being treated as if the corporation had two short taxable years within the taxable year in which a shareholder dies. See examples, supra. If the deceased shareholder of an “accrual basis” S corporation dies during the beginning of the year and no election to “close the books” is made so that the corporation’s income for its full taxable year (including any life insurance proceeds) is allocated to each shareholder on a prorata, per-day basis, the surviving shareholders will have a higher basis in their stock than would have been the case if there had been an election to “close the books.” Although life insurance proceeds are tax exempt, a shareholder’s basis is increased by an item of income such as tax-exempt income. §§1367(a)(l)(A) and 1366(a)(l)(A). If the S corporation is an accrual method taxpayer and there has been an election to “close the books,” a shareholder’s death will cause the insurance proceeds to be accrued immediately, resulting in the total proceeds being included in the corporation’s short year ending on the shareholder’s death. Thus, in a two shareholder corporation, one-half of the insurance proceeds would be allocated to each shareholder for the short year. If the purpose is to increase the basis of a surviving shareholder to the highest
possible level, it would be preferable not to “close the books” where there is an accrual method S corporation.

If the S corporation is on the “cash method” of accounting, it would be desirable to “close the books” so that the collection of the death proceeds of the insurance will occur in the short taxable year following the shareholder’s death in which the corporation has only the surviving shareholders to whom the income (and the basis increase) will be allocated. This would not be detrimental to the deceased shareholder’s estate since any basis increase resulting from the insurance proceeds would be wasted if allocated to the estate because of the step-up in basis provisions of §1014. See Green, “Tailoring Buy-Sell Agreements to Solve the Unique Problems of S Corporations,” 63 TAXES 978 (December 1985) at 995, fn. 78; and J.W. Blackburn, “Tax Considerations in Designing Stock Transfer Agreements,” 30 Cal. W.L. Rev. 61 (1993).

To preclude the estate of a deceased shareholder from being taxed with a portion of an S corporation’s taxable income during the year without receiving any benefit, (i.e., the estate will typically receive only the fixed buy-out price under the agreement), the Buy-Sell Agreement should provide that upon the death of a shareholder his stock ownership in the corporation will be deemed to have immediately terminated, notwithstanding the fact that his stock will not actually be redeemed from his estate until some time after his death. If this is not desirable, the agreement can still protect the deceased shareholder’s estate by providing that the deceased shareholder’s estate will receive an additional distribution from the corporation (either as part of the purchase price or as a dividend distribution) equal to all or a part of the income attributed after death to the deceased shareholder’s estate. It is important that the “one class of stock” rule of §1361(b)(1)(D) be carefully examined before drafting any such provision. See generally Gorfinkle, “Should Redemption Agreements Be Changed When S Corporation Status is Elected?”, 69 J. of Tax. 220 (October 1988); and Mittelman, “S Corporation Buy-Sell Agreements After the Tax Reform Act of 1986,” J. of Am. Soc. of CLU and ChFC (May 1988) at 36. See also Gray and Bravenec, “Buy-Sell Agreements of S Corporation Stock Affected by Corporation’s Special Tax Status,” 63 J. of Tax. 202 (October 1985).

C. Cross-purchase Agreement. If a cross-purchase agreement exists among the S Corporation’s shareholders, the surviving shareholders will have a basis in the stock purchased from a deceased shareholder’s estate equal to the amount paid for the stock plus the surviving shareholders’ portion of the corporation’s income during the year of death. See example in Gorfinkle, “Should Redemption Agreement Be Changed When S Corporation Status is Elected?”, 69 J. of Tax. 220 (October 1988) at 223. The cross-purchase agreement funded entirely by life insurance will, in most cases, result in the surviving stockholder’s basis in the purchased stock being substantially higher than it would be under a stock redemption agreement. However, if the buy out is fully funded by life insurance, the basis increase of the surviving stockholder under a stock redemption agreement can approach the basis increase under a cross-purchase agreement if a deceased shareholder of an accrual basis S corporation were to die very early in the taxable year and the election to “close the books” is not made, or the election is made and the corporation is on the cash basis. Thus, the stock redemption agreement creates uncertainty as to the surviving shareholder’s basis, depending on the date of the death of the deceased shareholder and whether or not the election to “close the books” is made, whereas the cross-purchase agreement guarantees a basis which is equal to the purchase price.

D. “Redemption” to “Cross-purchase” (avoiding “transfer for value”). If a decision is made to terminate an existing stock redemption agreement and create a new cross-purchase
agreement, the “transfer for value” rule of §101(a)(2) could be an obstacle. Unless the shareholders of the corporation are also partners in an existing partnership, a transfer of the insurance policies from the corporation to each shareholder on the other shareholder’s life will be a “transfer for value.” If the shareholders are all insurable and the life insurance policies used to fund the agreement are relatively new or are term policies, it may be advisable for the corporation to cash in the policies and for the shareholders to take out new policies on each other. However, in most cases this is not practical because of relatively old policies (which would result in a higher premium for the new policies) or because a shareholder is not currently insurable.

1. Shareholders as “Partners”. If the shareholders of a closely held corporation are also partners in an existing enterprises, e.g., a real estate partnership which leases personal or real property to the corporation, the transfer of the policies to the non-insured shareholders will meet the “partner of the insured” exception of §101(a)(2)(B). If no such partnership exists, the shareholders could form an equipment leasing partnership to lease equipment to the corporation. So long as the partnership is a valid partnership under state law and engages in a business activity, it will be recognized. See Moline Properties, 319 U. S. 436 at 438-39 (1943); Saba Partnership, T.C. Memo 2003-31; and F.S.A. 199913009.

2. Buy-out Life Insurance Trust. If the corporation has more than two shareholders, the cross-purchase agreement (even if newly created) will only temporarily solve the “transfer for value” problem if the shareholders are not also partners, since after the death of the first shareholder, the remaining shareholders would need to purchase the policies on the other shareholders’ lives from the deceased shareholder’s estate. It may be possible to avoid the “transfer for value” problem and solve many of the administrative problems involved in maintaining a large number of insurance policies (i.e., 4 shareholders would require 12 policies; 5 shareholders would require 20 policies) by creating a “buy-out life insurance trust” to own the policies. The trust, established in conjunction with a cross-purchase agreement, would own a single policy on each shareholder, all of whom would be beneficiaries of the trust. Upon a shareholder’s death, the insurance proceeds would be collected by the trustee and distributed to each of the surviving shareholders as beneficiaries to use in purchasing the shares from the deceased shareholder’s estate in accordance with the cross-purchase agreement. See Exhibit “O” for a buy-out life insurance trust used in conjunction with a cross-purchase agreement prepared by Ronald D. West, Esq., Washington, D.C.

E. Termination of S Status. If it becomes desirable to terminate the corporation’s S election where there is a cross-purchase agreement in place which provides for the surviving shareholders to make installment payments to a terminated shareholder, the termination of the election could cause a problem if the shareholders are relying on funds to be distributed from the S corporation in order to make the payment. Although increased salaries to working shareholders may be an answer in some cases, the required payments could exceed a “reasonable compensation” level under §162. This same problem could also result in the event the purchase price at death exceeds the insurance available, leaving the surviving shareholders with a large continuing installment obligation to pay. Recent legislation lowering the tax to 15% on dividend income from C Corporations will help to reduce, but not eliminate, this concern. Jobs and Growth Tax Relief Reconciliation Act of 2003, amending §1(h) of the Code.

F. Review of Existing Agreements. All existing stock redemption agreements of S corporations which were previously C corporations, especially those funded with life insurance,
should be reviewed to determine whether it is practical and desirable to restructure them as cross-purchase agreements. The change to a cross-purchase agreement could be of benefit to the surviving stockholders due to the increase in tax basis of the purchased shares. If more than two shareholders are involved, the “transfer for value” problem remains a deterrent unless there is an existing partnership among the shareholders. A buyout life insurance trust can eliminate “transfer for value” problems in a cross purchase agreement but would not avoid the problem when policies are transferred from the corporation to the shareholders at the time of conversion from a “redemption” agreement to a “cross-purchase” agreement.

XI. Conclusion

The use of buy-sell agreements to protect the differing relationships among shareholders and the business or practice entity can provide both tax and financial certainty and flexibility in meeting the needs of the shareholders, whether a “buyer” or a “seller” (or the “seller’s” estate), as well as enhancing the ongoing operations of the business or practice. Like a well drawn will or trust can be beneficial to the success and protection of a family, a well prepared Buy-Sell Agreement can be beneficial to the success of a business enterprise and its owners, especially in transitioning ownership and control to the next generation.
EXHIBIT “A”

APPRAISAL METHOD VALUATION OF REAL ESTATE PARTNERSHIP

Within 30 days after the date of termination of employment, the Selling Partner shall select and appoint one appraiser and shall give written notice of such selection or appointment to the Partnership. Within 15 days after the receipt of the written notice of the selection or appointment of said appraiser, the Partnership shall select and appoint an appraiser and shall give written notice of such selection or appointment to the Selling Partner. It shall then be the duty of said two appraisers to determine the fair market value of the interest of the Selling Partner in the Partnership as of the aforesaid date. Said two appraisers shall meet within 10 days after the appointment of the second appraiser, and if within 15 days after the appointment of the second appraiser, the said two appraiser are unable to agree upon the fair market value of the Selling Partner’s Partnership interest, said two appraisers shall appoint a third appraiser within 5 days after their failure to agree upon the fair market value of such interest and said third appraiser shall determine the fair market value of said Selling Partner’s Partnership interest within 15 days after his appointment.

The appraised value of said Selling Partner’s Partnership interest as determined by the first two appraiser appointed, assuming they shall be able to agree, shall be the decision of the appraisers, and said decision shall be binding upon the Selling Partner and the Partnership. In the event said two appraisers are unable to agree, the appraisal by the third appraiser shall be binding upon the Selling Partner and the Partnership. After reaching a decision concerning the valuation of said Partnership interest, the appraisers or appraiser, as the case may be, shall give written notice thereof to the Selling Partner and the Partnership.

The Selling Partner and the Partnership each shall pay all fees and charges of the appraiser of its own selection, and one-half of those of any third appraiser whose services might be needed as above provided.
EXHIBIT “A-I”

MODIFIED BOOK VALUE METHOD
(ADJUSTED FOR ACCOUNTS RECEIVABLE AND TERMINATION PAY)
FOR VALUING A MEDICAL PROFESSIONAL CORPORATION

Section 3. Purchase Price of Shareholder’s Stock. The purchase price to be paid by this professional corporation to a shareholder, or his personal representative, as the case may be, if such shares are transferred to this Corporation in accordance with the provisions of either Section 1 or 2 of this Article shall be equal to the book value of said terminated shareholder’s stock as of the first day of the calendar month during which said shareholder terminates his employment with the Corporation; said book value to be determined from the books and records of the Corporation by the Corporation’s regular accountant utilizing normal and consistent accounting procedures and, further, to be increased by an amount equal to 80% of the Corporation’s accounts receivables attributable to said employee’s services as of the valuation date and reduced by any amounts payable to shareholder following the date of shareholder’s termination of employment with Corporation pursuant to said shareholder’s Employment Agreement with Corporation. Said amount, as so determined, shall be conclusive and binding upon all the shareholders and upon this Corporation unless and until a new purchase price is established as herein provided. The Board of Directors at its annual meeting, or at any special meeting called for the purpose, may establish a new purchase price for the shares of stock of this Corporation. Any new purchase price thus established shall supersede any price theretofore fixed, and shall thereafter be conclusively determined to be the true value of said stock and shall be binding upon all of the shareholders and upon this Corporation. Failure to establish a new purchase price at any annual or special meeting of the Board of Directors shall have no effect upon the purchase price existing at such time, and such failure shall not prevent a new purchase price from being fixed at any succeeding annual or special meeting of the Board of Directors.
EXHIBIT “A-2”

MODIFIED BOOK VALUE METHOD
(ADJUSTED FOR LEASEHOLD UPROVEMENTS)
FOR VALUING A MEDICAL PROFESSIONAL CORPORATION

Section 3. Purchase Price of Shareholder’s Stock. The purchase price to be paid by this professional corporation to a shareholder, or his personal representative, as the case may be, if such shares are transferred to this Corporation in accordance with the provisions of either Section 1 or 2 of this Article shall be equal to the book value, less the cost of leasehold improvements, of said shares as of the beginning of the calendar month during which said shareholder terminates his employment with the Corporation; said book value to be determined from the books and records of the Corporation by the Corporation’s regular accounting procedures; and said amount, as so determined, shall be conclusive and binding upon all the shareholders and upon this Corporation unless and until a new purchase price is established as herein provided. The Board of Directors at its annual meeting, or at any special meeting called for the purpose, may establish a new purchase price for the shares of stock of this Corporation by amendment to this Section in the manner provided for in Article IX of these Bylaws. Any new purchase price thus established shall supersede any price theretofore fixed, and shall thereafter be conclusively determined to be the true value of said stock and shall be binding upon all of the shareholders and upon this Corporation. Failure to establish a new purchase price at any annual or special meeting of the Board of Directors shall have no effect upon the purchase price existing at such time, and such failure shall not prevent a new purchase price from being fixed at any succeeding annual or special meeting of the Board of Directors.
EXHIBIT “B-1”

FORMULA METHOD (BASED ON ASSET VALUE AND EARNINGS)
FOR VALUING CONSTRUCTION AND
REAL ESTATE DEVELOPMENT COMPANY

FIFTH

The purchase price for each share of Company’s common stock shall be determined from
the earnings and assets of Company as shown on its regularly prepared financial statements and
its books and records in the following manner:

(a) Determine the value of Company based on “Earnings” as follows:
   (i) Determine the net earnings (or loss) of Company as shown on the financial
       statements of Company for each of the most recent five (5) full fiscal years of Company
       and weight said earnings on a 5-4-3-2-1 scale, using the weight of “5” for the most recent
       full fiscal year, a weight of “4” for the next prior year, a weight of “3” for the next prior
       year, a weight of “2” for the next prior year, with the earliest fiscal year used in the
       computation being given a weight of “1.”
   (ii) Divide the total of the weighted earnings of Company, as computed in
        (i)above, by fifteen (the total of weighting factors) to determine the “Average Annual
            Earnings” of Company.
   (iii) Multiply the “Average Annual Earnings” by five (5) to determine the value
        of Company based on Earnings.

(b) Determine the value of Company based on its “Assets” by determining the value
    of the assets of Company as of the end of the month immediately prior to the date of a
    Shareholder’s death or as of the end of the fiscal year of Company immediately prior to the date
    of the Senior Managing Shareholder’s notification of Company of his election to sell part or all
    of his stock, or as of the end of the fiscal year of Company immediately prior to the date of
    Company’s exercise of its option to purchase the stock of a Junior Managing Shareholder
    following the Junior Managing Shareholder’s termination of employment for reasons other than
    death, or as of the end of the fiscal year of Company immediately prior to the date on which
    Company’s option to purchase the stock of a Junior Managing Shareholder lapses (due to
    Company’s failure to exercise its option), in the following manner:
    (i) Determine the “Book Value” of the current assets;
    (ii) Determine the fair market value of the fixed assets, which shall be the
         greater of the depreciated “book value” of each fixed asset or the value of each fixed
         asset approved by the insurance carrier insuring the fixed assets; and
    (iii) Add the amounts determined in subparagraphs (b)(i) and (ii) of this
         paragraph and subtract therefrom the total of all liabilities of Company to determine the
         value of Company based on “Assets.”

(c) Add the values of Company based on “Earnings” and “Assets” as determined in
    subparagraphs (a) and (b) of this Paragraph Fifth and divide the sum by
    two to determine the “Value” of Company.

(d) The purchase price for each share of Company’s Class “A” Voting Common
    Stock shall be determined in the following manner:
    (i) Divide the Value of Company (as determined in subparagraph (c) of this
        Paragraph Fifth by the number of “Equivalent Shares.” The number of “Equivalent

592824 36
Shares” is determined by summing the number of Class “A” Voting Common Stock multiplied by one hundred percent (100%) and the number of Class “B” Non-Voting Common Stock multiplied by ninety percent (90%).

(ii) Multiply the final amount obtained in subparagraph (d)(i) of this Paragraph by seventy-five percent (75%) (which reflects a fifteen percent (15%) discount for lack of marketability of the stock and a ten percent (10%) discount for the “minority interest” status of each share to be purchased, if appropriate) to determine the purchase price for each share of Company’s Class “A” Voting Common Stock.

(e) The purchase price for each share of Company’s “B” Class Non-Voting Common Stock shall be ninety percent (90%) of the value of the Class “A” Voting Common Stock before the application of the “minority interest” discount (as determined in subparagraph (d) of this Paragraph Fifth). (This discount reflects the fact that this Class “B” Common Stock is worth less than the Class “A” Common Stock because of the Class “B” Common Stocks incapacity to vote.)

(f) The parties hereto intend to arrive at the true fair market value of Company’s stock and intend the foregoing method of valuation to reflect the guidelines regarding valuation as set forth in Internal Revenue Service Ruling 59-60, 1959-I C. B. 237.

(g) The purchase price for each share of Company’s Class “A” Voting Common Stock and Class “B” Nonvoting Common Stock as determined under this Paragraph Fifth shall be conclusive and binding upon the Shareholders.
EXHIBIT “B-2”

FORMULA METHOD OF VALUATION (BASED ON HIGHER OF “FIXED PRICE” OR “EARNINGS” VALUE) FOR MANAGEMENT CONSULTING COMPANY

SEVENTH

The purchase price for Shareholder’s common stock of the Company shall be Five Hundred Dollars ($500.00) per share or an amount per share equal to 10 times the net earnings per share after the payment of income taxes of the Company, as shown on the annual audited statement of the Company, prepared by the Company’s regular independent auditors for the fiscal year of the Company immediately preceding the year in which the death of Shareholder occurs, or in which Shareholder gives written notice of his desire to sell his stock, whichever amount per share is greater; and said amount, as so determined, shall be conclusive and binding upon the parties unless and until a new purchase price is established, as hereinafter provided in Paragraph Eighth.
4. Purchase Price. As of the date hereof, the value of all of the issued and outstanding shares of Stock for the purpose of this Agreement shall be $250,000.00. The Shareholders and the Corporation agree to re-determine the value of all of the issued and outstanding shares of Stock on at least an annual basis and within seventy-five (75) days following the end of each fiscal year of the Corporation, and the value so agreed upon shall be entered on the Valuation Schedule attached hereto as Exhibit “A” and made a part hereof. The value of all the issued and outstanding shares of Stock shall be the value last entered on the Valuation Schedule unless more than twenty-four (24) months shall have elapsed since the effective date of the last determination of value, in which event the value of all the issued and outstanding shares of Stock last entered on the Valuation Schedule shall be (i) increased by an amount equal to the profits of the Corporation since the end of the fiscal year immediately preceding the date on which the last value was entered, or (ii) decreased by an amount equal to the losses of the corporation since the end of the fiscal year immediately preceding the date on which the last value was entered.

The profits or losses of the Corporation shall be determined by the accountant regularly employed by the Corporation in accordance with accounting principles normally used by him in the preparation of the financial statements of the Corporation, and his determination shall be binding and conclusive upon the parties hereto, their personal representatives and successors and all other persons involved.
AGREED VALUE WITH AUTOMATIC BACK-UP VALUATION METHOD FOR
PHYSICIAN OWNED REAL ESTATE PARTNERSHIP

14. PURCHASE PRICE OF PARTNERSHIP INTERESTS.

(a) Purchase Price Generally. The purchase price to be paid by a Purchasing Partner or to a Selling Partner for his or her Partnership Interest in the Partnership (if not mutually agreed upon by the parties) shall be determined as follows:

(i) Provided the Partners have established in writing an Agreed Value for the Partnership Units within thirteen (13) months prior to the effective date of purchase by Purchasing Partner or a Termination Event, as the case may be, the purchase price shall be based on the Agreed Value. If no timely determined Agreed Value is then in existence, the following formula shall be used to determine the purchase price for a Partnership Unit:

\[
\text{Net cash flow ÷ 11\% capitalization rate} = \text{Base Value of the Partnership. To the “Base Value” there shall be added the book value of all cash and personal property assets and there shall be subtracted therefrom the face value of all Partnership liabilities. The result shall be the value of the Partnership. The value of the Partnership shall be divided by the then number of Partnership Units owned by the Partners to arrive at a value for each Partnership Unit. Such value shall then be multiplied by the number of Partnership Units owned by the Selling Partner to determine the purchase price to be paid to the Selling Partner. In applying this formula, the “book value” of the Partnership’s assets as of December 31st of the Partnership’s immediately preceding fiscal year prior to the effective date of the Termination Event shall be utilized.}
\]

Provided there does not exist an Agreed Value established within thirteen (13) months prior to the effective date of purchase by a Purchasing Partner or the date of a Termination Event for a Selling Partner, as the case may be, the Partnership’s regular Certified Public Accountant shall determine, within sixty (60) days of such event, the purchase price for the Purchasing or Selling Partner’s Partnership Interest in accordance with the valuation formula contained in this Paragraph 14, and said Certified Public Accountant’s decision shall be final and binding on all parties.

After determining the purchase price, the Partnership’s Certified Public Accountant shall give written notice thereof to the Partnership, which shall then notify the Purchasing or Selling Partner within three (3) business days of its receipt of such value.
(b) **Purchase Price in Certain Events.** Notwithstanding anything herein to the contrary, the purchase price of a Selling Partner’s Partnership Interest who has been terminated from employment by Jones Medical Clinic “for cause” (as that term may be defined in said Partner’s Employment Agreement with Jones Medical Clinic) shall be one-half (1/2) of the Agreed Value or the value determined pursuant to this Paragraph 14, however, such amount shall in no event be less than the amount paid by the Partner to the Partnership for the purchase of his or her Partnership Interest.
EXHIBIT “D”

REQUIREMENT FOR ASSIGNEE OF A MEMBERSHIP INTEREST
TO ADOPT OPERATING AGREEMENT BEFORE BECOMING A MEMBER

12.02 Conditions of Transfer by Members. A transferee who receives a Membership Interest in accordance with Section 12.01 shall become a Member only when the following conditions have been satisfied:

(a) the Transferring Member, or his legal representative or authorized agent, must have executed a written instrument of transfer of such Membership Interest to the Permitted Transferee or Approved Assignee in form and substance reasonably satisfactory to the Managers, including certification that the transfer is exempt from registration under the federal and state securities laws;

(b) the Permitted Transferee or Approved Assignee must have executed a written agreement, in form and substance reasonably satisfactory to the Managers, to assume all of the duties and obligations of the Transferring Member under this Operating Agreement with respect to the transferred Membership Interest (including the assumption of the Transferring Member’s Capital Account, where appropriate) and to be bound by and subject to all of the terms and conditions of this Operating Agreement.
EXHIBIT “D-1”

OPTION IN CORPORATION AND SHAREHOLDERS TO PURCHASE DURING LIFETIME

THIRD

In the event Shareholder desires to sell all or any part of his common stock in Company during his lifetime, Shareholder shall notify the Company and the other shareholders in writing of his desire to sell. In such event, the Company shall have the option within a period of sixty (60) days after the receipt of such notice to purchase such stock at the price and upon the terms hereinafter provided in Paragraphs Seventh and Ninth. Upon the failure of the Company to exercise its option hereinafore given to purchase such stock within the time provided, such shares shall be offered for sale pro rata to the other shareholders of Company and such other shareholders shall have the right to purchase all (and not less than all) of such stock at any time within thirty (30) days after receipt of such offer at the price hereinafter provided in Paragraph Seventh, such price to be paid in cash. Upon the failure of the Company and such other shareholders to exercise the options hereinafore given to purchase such stock within the times provided, this agreement shall terminate as to such stock and Shareholder shall then have the full right and privilege of disposing of such stock in any manner or to whom he desires; and Shareholder may surrender to the Company, within ten (10) days after the expiration of the thirty (30) day period last above referred to, the certificates representing the shares offered for sale and not purchased under the terms hereof, and the Company shall issue to him in lieu thereof new certificates for an equal number of shares without the endorsement hereinafter set forth in Paragraph Sixth.
WHEREAS, the parties desire to provide a method for the redemption of all shares of the Corporation’s stock now owned by Mr. Jones and which will pass to Mrs. Jones, if she survives Mr. Jones, under Mr. Jones’ Last Will and Testament; and,

NOW, THEREFORE, in consideration of the mutual covenants and agreements contained herein, the parties hereto agree as follows:

1. Redemption Following Death of Mr. Jones. Following the death of Mr. Jones, Mrs. Jones agrees, if she survives Mr. Jones, to sell to the Corporation, and the Corporation agrees to purchase from Mrs. Jones, all of the shares of the Class “A” voting common stock and all of the shares of the Class “B” non-voting common stock of Corporation passing to Mrs. Jones under Mr. Jones’ Last Will and Testament. The Corporation shall purchase and redeem all (but not less than all) said shares of stock at the price and upon the terms hereinafter provided, within thirty (30) days after the transfer of such shares to Mrs. Jones by the personal representative of Mr. Jones’ estate. If Mrs. Jones does not survive Mr. Jones, this Agreement and the obligations hereunder following Mr. Jones’ death shall be void and of no force and effect.
EXHIBIT “E-1”

RESTRICTION ON TRANSFER OF MEMBERSHIP INTEREST TO A NON-PERMITTED TRANSFEREE

12.01 General Prohibition and Limited Exceptions.

(a) Except as otherwise provided in this Article XII, or by separate written agreement between the Company and any Member, no Member may assign, give, devise, bequeath, convey, sell, transfer, liquidate, encumber, or in any way alienate (hereinafter a “Transfer”), all or any part of his Membership Interest without the written approval or consent of Members holding seventy-five percent (75%) of the Membership Interests in the Company (with said seventy-five percent (75%) determined without regard to the Membership Interests held by the Member who wishes to Transfer), which consent may be given or withheld in the sole discretion of each Member.

(b) Notwithstanding the restrictions contained in paragraph (a) of this Section 12.01, each Member without the consent of any other Member, and without triggering the provisions in this Article XII regarding options or a right of first refusal, may during a Member’s life, or upon death, Transfer all or any part of his Membership Interest to another Member or to a member of the Transferring Member’s Family (as defined below in paragraph (c) of this Section 12.01), or to an Entity for the sole benefit of a Member or members of such Member’s Family (for example, a partnership in which all partnership interests are held by or on behalf of a Member or members of such Member's Family).

(c) For purposes of this Article XII, a “Family” member is defined as a Member’s lineal descendant by birth or adoption, or the spouse of a Member.

(d) The right of Transfer provided above in paragraph (b) of this Section 12.01, to other Members and to members of his Family (hereinafter a “Permitted Transferee”) is limited exclusively to the Members and to any Permitted Transferee who acquires a Membership Interest and becomes a Member by satisfying the condition of Section 12.02. Any Membership Interest Transferred to a Permitted Transferee shall remain fully subject to the provisions and prohibitions contained in this Article XII as to any subsequent Transfers by such Permitted Transferee. A Permitted Transferee of any Membership Interest and any assignee of a Membership Interest approved by the Members as provided for in paragraph (a) of this Section 12.01 (an “Approved Assignee”) shall become a Member and succeed to the transferor’s Membership Interest only by complying with the conditions in Section 12.02.
EXHIBIT “F”

OBLIGATION TO SELL AND OBLIGATION TO PURCHASE SHARES
UPON DEATH OF A SHAREHOLDER

FIRST

Upon the death of any Shareholder, the estate of the deceased Shareholder shall sell, and
Company shall purchase, all of the stock of Company owned by such Shareholder at the time of
such Shareholder’s death. The amount of the purchase price and the terms of payment for the
stock of Company purchased pursuant to this paragraph shall be in accordance with the
provisions as they are hereinafter set forth in Paragraphs Sixth and Seventh.
EXHIBIT “G”

OBLIGATION TO PURCHASE STOCK ON DISABILITY OF SHAREHOLDER

(2) In the event a stockholder who is party to this agreement becomes totally and permanently disabled before reaching age 55, and remains so for a period of 12 months from the onset of such disability, then the Company shall purchase and the disabled stockholder shall sell, as of the end of such period, all of such disabled stockholder’s stock in the Company. “Disability” or “total and permanent disability” for purposes of this agreement shall be considered that disability of an insured stockholder which is described and determined by the insurer as “total and permanent disability” in the insurance policies on such insured stockholder listed in Article 4 below and/or Schedule “B” attached hereto. The purchase price shall be that which is established in Article 3 below, provided, however, that such purchase price shall not be paid in a lump sum but instead shall be paid in installments of $5000.00 per month plus interest in an amount equal to 8 1/2% per year of the declining balance of such purchase price until the total purchase price shall have been paid in full. If a disabled stockholder ceases to be totally and permanently disabled at any time after such installment payments have commenced but prior to the time they have been completed, then such installments shall thereafter be paid at the rate of $2500.00 per month until the balance of said purchase price and interest at the rate of 8 1/2% per year on the declining balance shall be paid in full. If the disabled stockholder shall die prior to the time that the purchase price has been paid in full, the balance of the purchase price plus any accrued interest then due shall be paid to shareholder’s estate in one lump sum.*

*Other alternatives can be provided; i.e., the parties could agree to stop the buy-out upon a disabled shareholder ceasing to be disabled; could agree to let the disabled partner buy back in again; could provide for the installment obligation of the Company to be evidenced by a promissory note (with or without security), or could provide that the disabled shareholder will remain a shareholder until the purchase price is paid in full.
13. Purchase of Partnership Interest. Upon the termination of any Partner’s employment with Jones Clinic, P. C. (the “Clinic”) for any reason, including death, disability, retirement or otherwise, whether voluntary or involuntary, said terminating Partner or the Partner’s estate (“Selling Partner”) shall sell to the Partnership or to the other Partners (as the Partners owning a majority of the Common Interests of the Partnership may elect) his entire interest in the Partnership, and the Partnership or the other Partners, as the case may be, shall purchase said terminating Partner’s interest in the Partnership for such purchase price and upon such terms and conditions as hereinafter provided.

(a) Purchase Within Five Years. If a Selling Partner’s termination of employment with the Clinic occurs within five (5) years from the date of this Agreement, i.e., prior to December 31, 1997:

(1) is for any reason except as provided in subparagraph (2) of this subparagraph or subparagraph (c) of this Paragraph, the purchase price of a Selling Partner’s interest in the Partnership shall be an amount equal to one hundred percent (100%) of the outstanding capital balance of the Selling Partner’s Preferred Interest, if any, and one hundred percent (100%) of the Selling Partner’s Capital Account reflecting his Common Interest in the Partnership;

(2) is due to the Clinic’s termination of his employment for “cause” (as that term is defined in the Partner’s Employment Agreement with Clinic) or the Selling Partner terminates his employment with Clinic with the intent or purpose of continuing the private practice of medicine in the field of orthopedics within an area which is within one hundred (100) miles of any office of Clinic, the purchase price of a Selling Partner’s interest in the Partnership shall be an amount equal to one hundred percent (100%) of the outstanding capital balance of the Selling Partner’s Preferred Interest, if any, and fifty percent (50%) of the Selling Partner’s Capital Account reflecting his Common Interest in the Partnership.

(b) Purchase After Five Years. If a Selling Partner’s termination of employment with the Clinic occurs after December 31, 1997:

(1) is for any reason other than as set forth in subparagraph (2) of this subparagraph, the purchase price of a Selling Partner’s interest in the Partnership shall be an amount equal to one hundred percent (100%) of the outstanding capital balance of the Selling Partner’s Preferred Interest, if any, and one hundred percent (100%) of the fair market value of the Selling Partner’s Common Interest determined in accordance with the provisions of Paragraph 14.

(2) is due to the Clinic’s termination of his employment for “cause” (as that term is defined in the Partner’s Employment Agreement with Clinic) or Selling Partner terminates employment with Clinic with the intent or purpose of continuing the private practice of medicine in the orthopedics field of within an area which is within 100 miles of any office of Clinic, the purchase price of a Selling Partner’s interest Partnership shall be an amount equal to one hundred percent (100%) of the outstanding capital balance of the Selling Partner’s Preferred Interest, if any, and fifty percent (50%) of the Selling Partner’s Capital Account reflecting his Common Interest in the Partnership.
Interest, if any, and fifty percent (50%) of the fair market value of the Selling Partner’s Common Interest determined in accordance with the provisions of Paragraph 14.

(c) Purchase Due to Death or Disability or Retirement After Age 65. If a Selling Partner’s termination of employment with the Clinic is due to death or disability or retirement after age 65, the purchase price of a Selling Partner’s interest Partnership shall be an amount equal to one hundred percent (100%) of the outstanding capital balance of the Selling Partner’s Preferred Interest, if any, and one hundred percent (100%) of the fair market value of the Selling Partner’s Common Interest determined in accordance with the provisions of Paragraph 14.
EXHIBIT “G-2”

OPTIONS TO PURCHASE UPON PROPOSED SALE TO NON-PERMITTED TRANSFEREES

12.04 Other Transfers by Members.

(a) Sale of a Membership Interest to a Non-Permitted Transferee. If a Member desires to sell his Membership Interest (the “Selling Member”) to a person who is not a Permitted Transferee under Section 12.01(b), the Selling Member must first give written notice to the other Members (the “Remaining Members”) and to the Company of his desire to sell his entire Membership Interest and stating the amount of the offering price (the “Offering Price”). The notice by the Selling Member shall constitute an offer to sell and transfer all of his Membership Interest to the Remaining Members and the Company. For a period of sixty (60) days from the latest date of receipt of such notice by the Remaining Members, the Remaining Members shall have the right and option to purchase the entire Membership Interest of such Selling Member, on a pro rata basis in accordance with their respective Membership Interests, at the Offering Price. Any Remaining Member electing to exercise his option to purchase shall so notify the Selling Member, with a copy to the Managers, within the sixty (60) day period. If any Remaining Member does not wish to purchase his pro rata portion of the Selling Member’s Membership Interest (such portion being hereinafter referred to as the “Excess Interest”), the other Remaining Members, who have elected to purchase, shall have the right, within thirty (30) days from the end of the prior sixty (60) day period, to accept the offer of the Selling Member to purchase such Excess Interest on a pro rata basis in accordance with the respective Ownership Interests of such Remaining Members. If, at the end of such thirty (30) day period, there remains any unsold portion of such Excess Interest, then the Company, acting through its Managers, shall have fifteen (15) additional days to exercise its option to purchase such Excess Interests. The closing of any sale and purchase under this paragraph shall be held in accordance with the provisions of paragraph (b) of this Section 12.04. In the event neither the Remaining Members nor the Company exercise their option to purchase all of the Selling Member’s entire Membership Interest, the Selling Member shall, for a period of thirty (30) days from the end of said fifteen (15) day period, have the right to sell the unpurchased amount of his Membership Interest to any person who is not a Permitted Transferee for a price not less than the Offering Price; provided, however, such transferee shall not become a Member until approved by the Remaining Members and complying with the other provisions of Section 12.01(a) and 12.02. If the Selling Member does not sell all of his Membership Interests within said thirty (30) day period, he shall continue to hold his Membership Interest subject to the terms of this Agreement.
EXHIBIT “G-3”

OPTIONS TO PURCHASE PHYSICIAN’S INTEREST IN PARTNERSHIP OWNING MEDICAL OFFICE UPON TERMINATION OF EMPLOYMENT BY PROFESSIONAL CORPORATION WITH REQUIREMENT TO PURCHASE IF OPTIONS NOT EXERCISED IN FIVE (5) YEARS

(3) Options to Purchase Upon Termination of Employment for any Reason Except Death.

(a) Options in favor of Partnership. In the event any Partner ceases to be an employee of Smith & Associates, P.C., at any time during the term of the Partnership for any reason except death, the Partnership shall have five (5) consecutive annual options to purchase the interest of said Partner (hereinafter referred to as the "Selling Partner") in the Partnership, the first of such options to be exercised by the Partnership by written notice to the Selling Partner within ninety (90) days after the date on which said Selling Partner's employment shall terminate (such date being hereinafter referred to as the "Employment Termination Date"), and each of the remaining four (4) annual options to be exercised by the Partnership by written notice to the Selling Partner within ninety (90) days after each of the next four (4) consecutive annual anniversaries of the Employment Termination Date.

(b) Options in favor of Other Partners. In the event the Partnership shall fail to exercise any of its options given in Paragraph A (3)(a) hereinabove to purchase the Selling Partner's Partnership Interest within the applicable ninety (90) day period, then after the expiration of each such annual option in favor of the Partnership, each of the remaining Partners willing to purchase the Selling Partner's Partnership Interest shall have the option to purchase said Partnership Interest within the thirty (30) day period immediately following each of the aforesaid ninety (90) day periods; and in such case, all references to the Partnership in the provisions of Paragraph A (3)(c) herein below regarding the determination of the value of such Partnership Interest, by mutual agreement or by appraisal, shall be construed to mean the Partners desiring to purchase such Partnership Interest. Each of the remaining Partners willing to purchase a portion of the Selling Partner's Partnership Interest shall be entitled to purchase the portion thereof determined (unless otherwise agreed by all purchasing Partners) by dividing the Partnership Interest of each such remaining Partner willing to purchase a portion of said Selling Partner's Partnership Interest by the sum of the Partnership Interests of all such remaining Partners willing to purchase a portion of such Partnership Interest.

(h) Mandatory Purchase of Selling Partner's Partnership Interest on 6th Anniversary of Employment Termination Date. In the event both the Partnership and the remaining Partners shall fail to exercise their respective five (5) consecutive annual options to purchase the Selling Partner's Partnership Interest, then on the sixth (6th) annual anniversary of the Selling Partner's Employment Termination Date, the Partnership shall be obligated to purchase, and the Selling Partner shall be obligated to sell, the Partnership Interest of said Selling Partner during the one hundred eighty (180) day period following said sixth (6th) anniversary of such Employment Termination Date. The Purchase Price for the Selling Partner's Partnership Interest shall be determined in the same manner and according to the same terms and provisions
set forth in Paragraphs A (3)(c) and (d) hereinabove and shall be payable in accordance with the same terms and provisions set forth in Paragraph A (3)(e) hereinabove.
EXHIBIT “H”

INSTALLMENT SALE EVIDENCED BY SECURED PROMISSORY NOTE WITH RESTRICTIONS ON CORPORATE ACTIVITY

FIFTH

Upon a Shareholder’s death, the purchase price of the stock owned by such Shareholder as determined under Paragraph Fourth, shall be paid in the following manner:

(a) Within ninety (90) days after the appointment and qualification of a legal representative for the estate of such deceased Shareholder, Company shall deliver to the deceased Shareholder’s legal representative Company’s secured promissory note (the security for said promissory note and other restrictions being described in Paragraph Sixth), said promissory note to provide for payment of the amount of the purchase price in ten (10) equal annual installments of principal and interest, with the first of such installments being due and payable on the first annual anniversary of the date of the Shareholder’s death. Said promissory note shall provide for interest on the outstanding balance of principal due on said note at the greater of: (a) the Applicable Federal Rate, if any, as determined under the appropriate sections of the Internal Revenue Code in effect on the date the promissory note is executed, or (b) the rate of $7\frac{1}{2}\%$ per annum. Said promissory note shall permit Company to pay any part or all of any amounts due on said note in advance without penalty; shall provide that Company shall pay all costs of collection, including 15% of the unpaid balance of principal and interest as attorney’s fees if collected by law or through any attorney at law; and shall contain such other terms and provisions as are customarily found in commercially acceptable promissory notes.

(b) If any portion or all of the stock to be purchased by Company is subject to any pledge or encumbrance, Company may pay such amount, within the discretion of Company, to discharge any liability under such pledge or encumbrance, which amount when so paid shall be credited against the purchase price to be paid hereunder.

(c) If, at the time Company is required to make payment of the purchase price for the stock of a Shareholder, Company’s capital surplus is insufficient for such purpose, Company’s entire available surplus shall be used to purchase as many shares of such stock as possible; and Company and its Shareholders, including any Shareholder’s legal representative, shall promptly take all required action to reduce the stated capital of Company to the extent necessary to create the additional surplus required for the redemption of such unpurchased stock.

SIXTH

The debt evidenced by said promissory note provided for in Paragraph Fifth above shall be secured by the stock purchased from the deceased Shareholder, pursuant to Paragraph First; and the certificate or certificates representing said stock of the deceased Shareholder shall be held by Shareholder’s legal representative until all principal and interest due under Company’s said promissory note have been paid in full. In the event of default in the payment of any installment of principal or interest, or any part thereof, due on said promissory note, the deceased Shareholder’s legal representative may, at his option, declare the principal sum then remaining unpaid, together with accrued interest thereon, due and payable at once, and shall have the power to sell, at public or private sale, with or without notice or advertisement, and without the order of any court, any and all of said shares of stock, and to convey fee simple title to said stock to the purchaser or purchasers at such sale or sales. Said deceased Shareholder’s legal representative shall not be disqualified to be the purchaser upon such sale of said stock. The proceeds of such
sale shall be applied first to the payment of all expenses of the sale and next to the payment of accrued interest and then to the principal due on said promissory note. If the net proceeds of such sale are not sufficient to satisfy said debt in full, Company shall, immediately upon demand, pay the deficiency in full. If the net proceeds from such sale are in excess of the amount needed to satisfy said debt in full, such excess amount shall be paid to Company.

As long as Company remains indebted on said promissory note provided for in Paragraph Fifth hereof, in any sum whatsoever, Company shall not, without the prior written approval of the holder of said promissory note, declare any dividends on its stock, cause or permit to be taken any action resulting in or seeking to accomplish any recapitalization, reorganization, merger or dissolution of Company or other change in the capital structure of Company; nor shall Company issue any additional shares of stock of Company during such period. In addition to the above restrictions, so long as Company remains indebted on said promissory note in any sum whatsoever, Company shall not, without the prior written approval of the holder of said note, increase the salaries, bonuses, fringe benefits, or compensation of any kind for any of its officers or of any employee (whether or not an officer) who is a shareholder or a member of a shareholder’s immediate family. At all times during the period in question, Company will, unless otherwise permitted in writing by the holder of said promissory note, maintain a ratio of its current assets to its current liabilities of at least one to one.

Should Company violate or be in default under any of the provisions of this Stock Purchase Agreement or any provision of the aforesaid promissory note, then, in addition to all other rights and remedies of the deceased Shareholder as herein provided for, as provided for in Company’s said promissory note, and as may be additionally provided by law, a special meeting of the Board of Directors of Company shall be held within ten (10) days after the Shareholder’s legal representative demands such meeting. At this special meeting of the Board of Directors, the legal representative of Shareholder’s estate shall be entitled to appoint a majority of Directors of Company’s Board of Directors; and the directors so appointed by the legal representative of the Shareholder’s estate shall remain in office until the entire indebtedness due under said promissory note and the entire purchase price for said stock has been paid in full.
EXHIBIT “I”

PURCHASE PRICE PAYABLE IN CASH TO EXTENT OF LIFE INSURANCE WITH BALANCE IN INSTALLMENTS

NINTH

The terms of payment of the purchase price of any common stock purchased by the Company hereunder shall be as follows:

(a) If the common stock to be purchased by the Company is subject to any pledge or encumbrance, the Company shall devote the proceeds of any policies of insurance on Shareholder’s life to the discharge of any liability under such pledge or encumbrance, which amounts when so applied shall be credited against the purchase price to be paid.

(b) In the event the purchase price of such common stock is equal to or greater than the proceeds received or receivable from such insurance policy or policies, the Company shall apply the balance of the proceeds of such life insurance (after applying so much of the proceeds to the discharge of any liability as provided for in subparagraph (a) above), to the purchase price of such stock by paying same to Shareholder or Shareholder’s personal representative; and the Company shall have the right to pay the difference, if any, between the amount of the insurance proceeds and the purchase price either in cash from its surplus, or by giving to Shareholder or Shareholder’s personal representative the Company’s promissory note, payable in sixty $(60)$ equal monthly installments, the first of said installments being due and payable on the ninetieth $(90\text{th})$ day after the date of Shareholder’s death or the date of exercise of the Company’s option, whichever date is applicable. Said note shall bear interest at the rate of Eight Percent $(8\%)$ per annum on any unpaid balance until paid and shall contain a provision allowing the Company to pay any part or all of the unpaid principal balance of said note in advance without penalty. Said promissory note shall also contain such other terms and provisions as are customarily contained in a commercially acceptable promissory note, including without limitation a provision stating that if the Company defaults in making payment of any installment of principal or interest, or any part thereof, then at the option of the holder of said note, the principal sum remaining unpaid with accrued interest shall at once become due and payable, without notice, and said principal sum and accrued interest shall bear interest at the rate of Ten Percent $(10\%)$ per annum from such time until paid; and the Company shall pay all costs of collection including Fifteen Percent $(15\%)$ of the unpaid balance of principal and interest as attorneys’ fees if collected by law or through an attorney at law. In the event the purchase price of such common stock is less than the proceeds received from such insurance policy or policies, the Company shall pay the full purchase price to Shareholder or Shareholder’s personal representative in cash and retain the balance of such proceeds as the property of the Company.

If, at the time the Company is required to make payment of the purchase price for the common stock of Shareholder, the Company’s surplus is insufficient for such purpose, the Company’s entire available surplus shall be used to purchase as many shares of such common stock as possible and the Company and its shareholder including Shareholder or Shareholder’s personal representative, shall promptly take all required action to reduce the stated capital of the Company to the extent necessary to create the additional surplus required for the redemption of such unpurchased common stock. If, at such time, the Company has a deficit, the insurance proceeds, if any, shall first be applied to eliminate the deficit.
EXHIBIT "J"

PURCHASED STOCK HELD AS SECURITY FOR CORPORATION’S INSTALLMENT NOTE AND RESTRICTIONS ON CORPORATE ACTIVITY

SEVENTH

In the event the purchase price for Company’s stock is paid for by Company delivering its promissory note as provided for in Paragraph Sixth, the debt evidenced by said promissory note shall be secured by the stock purchased from such Shareholder and the certificate or certificates representing said stock shall be held by said Shareholder or the deceased Shareholder’s legal representative until all principal and interest due under Company’s said promissory note have been paid in full.

As long as Company remains indebted on its promissory note provided for in Paragraph Sixth, Company shall not, without the prior written approval of the holder of said promissory note, declare any dividends on its stock, cause or permit to be taken any action resulting in or seeking to accomplish any recapitalization, reorganization, merger or dissolution of Company or other change in the capital structure of Company, nor shall Company issue any additional shares of stock of Company during such period.

In addition to the above restrictions, so long as Company remains indebted on said promissory note, Company shall not, without the prior written approval of the holder of said note, increase the salaries, bonuses, fringe benefits, or compensation of any kind for any of its officers or any employee (whether or not an officer) who is a shareholder or a member of a Shareholder’s immediate family. At all times during the period in question, Company will maintain a ratio of its current assets to its current liabilities of at least two to one.

In the event of default in the payment of any installment of principal or interest, or any part thereof, due under said promissory note, a Shareholder or the deceased Shareholder’s legal representative, as the case may be, may, at his option, declare the principal sum then remaining unpaid, together with accrued interest thereon, due and payable at once, and shall have the power to sell, at public or private sale, with or without notice or advertisement, and without the order of any court, any and all of said shares of stock, and to convey fee simple title to said stock to the purchaser or purchasers at such sale or sales. Said Shareholder or deceased Shareholder’s legal representative, as the case may be, shall not be disqualified to be the purchaser at such sale of said stock. The proceeds of such sale shall be applied first to the payment of all expenses of the sale, next to the payment of accrued interest and then to the principal due on said promissory note.

If the net proceeds of such sale are not sufficient to satisfy said debt in full, Company shall, immediately upon demand, pay the deficiency in full. If the net proceeds from such sale are in excess of the amount needed to satisfy said debt in full, such surplus amount shall be paid to Company.

Further, should Company violate or be in default under any of the provisions of this Stock Purchase Agreement or any provision of the aforesaid promissory note, then, in addition to all other rights and remedies of a Shareholder or the deceased Shareholder’s legal representative as herein provided for, as provided for in Company’s said promissory note, and as may be additionally provided by law, Shareholder or the deceased Shareholder’s legal representative, as the case may be, may demand a special meeting of the Board of Directors of Company, which shall be held within three (3) days after said demand. At this special meeting of the Board of
Directors, the Shareholder or the Shareholder’s legal representative, shall be entitled to appoint a majority of Directors of Company’s Board of Directors; and the directors so appointed by the Shareholder or the Shareholder’s legal representative shall remain in office until the entire indebtedness due under said promissory note has been paid in full.
EXHIBIT “K”

ENGAGEMENT LETTER
For attorney representing all parties in preparing a Buy-Sell Agreement.

Dear [Name]:

This will confirm our understanding of your engagement of me and my firm to represent [Company Name]. Our representation will include the formation of your Company, the development of an Operating Agreement (to include a buy-sell arrangement between the two of you), general consultation and advice on legal and tax matters and general representation, all involving periodic meetings and written and telephone communications with you and your agents.

It is anticipated our representation will be primarily handled by myself at an hourly rate of $[Rate] per hour; however, paralegals and other attorneys will, under my supervision, be utilized as appropriate, the hourly charges for whom will vary from $[Rate] to $[Rate] per hour.

The Firm will be reimbursed for out-of-pocket expenses which may include long distance telephone calls, reproduction costs, out-of-town travel costs (subject to your prior approval), non-routine postage, outside professional support (subject to your prior approval), and other out-of-pocket expenses readily identifiable with the Firm’s services on the Company’s behalf.

The Firm’s statement of fees and out-of-pocket expenses will be submitted monthly and is due and payable upon receipt. If any balance of our statement should remain unpaid for more than thirty (30) days after billing, the unpaid amount will bear interest from and after the date originally billed at the rate of 12% per annum for as long as any portion remains unpaid.

We are undertaking our representation of your Company in reliance on your agreement to pay all obligations as reflected on each of our statements upon receipt; however, if you have a question about any statement or disagree with any amount or a matter shown on our statements, then please promptly bring the matter to my attention.

This agreement will remain in effect unless terminated by you or by us in writing. You will at all times have the right to terminate our services; likewise, we reserve the right to terminate our services on your behalf.

In connection with our engagement to perform services for the Company, we will, with respect to certain matters, be representing both of you jointly, especially with regard to preparation of the buy-sell and governance provisions of the Company’s Operating Agreement. In representing both of you, it is our ethical obligation (and in your best interest) to make sure that you understand the considerations involved in our “multiple representation” of each of you and your Company.

In representing the Company and the two of you jointly, we will attempt to do so without bias in favor of either of you or the Company and will encourage a satisfactory resolution of any differing interests which may occur in an equitable manner and in the best interest of your Company. However, from time to time, parties may have differing, and sometimes conflicting, interests and objectives. If you each of you had a separate lawyer, you would have an “advocate” for your position and would receive totally independent advice; and, further, any information given to your own lawyer would be confidential and could not be obtained by anyone without your consent.
In this joint representation of you and your Company, we cannot be advocates for either one of you against the other and any communications and information received from either of you relating to these matters may be shared with the other. Therefore, if at any time either of you wishes to have the advice of separate counsel, you are encouraged to do so and we would, thereby, withdraw from this arrangement and would not represent either of you against the other. Also, in such event, we would continue to represent the Company, subject, of course, to the termination provisions of this engagement letter.

If the above arrangements are agreeable to you, please sign each of the four duplicate original letters and return one original to me, with each of you and the Company retaining an original for your and the Company’s records.

Sincerely,

Morton A. Harris

For: HATCHER, STUBBS, LAND, HOLLIS & ROTHSCILD, LLP

The undersigned hereby agree to the engagement of Morton A. Harris and the Firm of Hatcher, Stubbs, Land, Hollis & Rothschild, LLP upon the terms and conditions hereinabove set forth.

This _____ day of ____________________, 2008.

______________________________________________

By:__________________________________________
SECTION 5 – S CORPORATION STATUS. Corporation is an S Corporation within the meaning of Section 1361 of the Internal Revenue Code of 1986 ("IRC"). No Shareholder may transfer, and no person may acquire, the legal or beneficial ownership of any share of Corporation’s stock if such transfer or acquisition would cause Corporation’s S status to terminate. Specifically, no transfer may be made to, and no acquisition may be made by:

(a) Any person who would cause the corporation to have more than thirty-five (35) shareholders;
(b) Any nonresident alien; or
(c) Any person other than an individual, an estate, or a trust permitted by the Internal Revenue Code to be a shareholder of an S Corporation.

No transfer of stock to a trust shall be permitted unless the Corporation has reviewed the trust instrument and found it to be satisfactory for purposes of IRC §1361. Furthermore, no transfer to a qualified subchapter S trust shall be permitted unless the Corporation has received in advance reasonable assurance that the income beneficiary will elect properly under IRC §1361(c)(2). Finally, no transfer to a qualified subchapter S trust shall be permitted unless the trust instrument requires that the income beneficiary properly elect under IRC §1361(d)(2) with respect to the Corporation and not revoke such election and that any successive income beneficiary not refuse to consent to such election.
SECTION 9 – CORPORATE DISTRIBUTIONS. Each Shareholder agrees that Corporation will use its best efforts to make pro rata distributions of money with respect to its shares sufficient to pay the federal and state income taxes on the income that passes through from Corporation under IRC §1366, net of any tax benefits produced by losses, deductions and credits that pass through under IRC §1366. Corporation will use its best efforts to make such distributions either during its taxable year or during the three months after the end of its taxable year. For purposes of this section, a distribution shall be treated as made with respect to a particular corporate tax year if (1) it is made during the taxable year and not designated by Corporation as made with respect to another taxable year or (2) it specifically designated by Corporation as made with respect to that particular taxable year. The foregoing distribution requirement set forth in this section is subject, however, to the reasonably required needs of Corporation as determined by Corporation to maintain sufficient funds for working capital and business needs so as not to impair the ability of Corporation to continue its business operations.
EXHIBIT “N”

REQUIREMENT OF SHAREHOLDER’S ELECTION TO CLOSE THE BOOKS

SECTION 13 – YEAR OF TRANSFER - TERMINATION OF S STATUS

(a) Complete Termination of Shareholder’s Interest. If Shareholder’s shares are transferred pursuant to this Agreement and such transfer results in the complete termination of Shareholder’s interest in Corporation while Corporation is an S corporation and the effective date of such transfer occurs during the Corporation’s taxable year, and if either the selling Shareholder requests or the purchasing shareholder or shareholders request, then all of the Shareholders agree to take appropriate action to make an effective election under Section 1377(a)(2) of the Internal Revenue Code to close the Corporation’s books on the effective date of the transfer. For purposes of this election, Shareholders shall mean all persons who are or were shareholders in the Corporation at any time during the taxable year in which the transfer occurs.

(b) Termination Of S Status. In the event the Corporation’s S status terminates during the course of a taxable year for any reason whatsoever, and if any Shareholder so requests, all of the Shareholders shall take appropriate action to make an effective election under Section 1366(e)(3) of the Internal Revenue Code to close the Corporation’s books on the date immediately preceding the date on which the termination of S status occurs. For purposes of this election the term Shareholders as a result of the S termination shall mean all persons who are or were shareholders in the Corporation at any time during the S short year and all persons who are or were shareholders in the Corporation on the first day of the C short year.
EXHIBIT “O”

BUYOUT LIFE INSURANCE TRUST
(USED IN CONJUNCTION WITH A CROSS-PURCHASE AGREEMENT)

*The author is grateful to Ronald D. West of Washington, D.C. for permission to use his trust document as an Exhibit to this outline.

INSURANCE TRUST AGREEMENT

THIS AGREEMENT, dated ________________, 198__ is between __________________________ and __________________________ (collectively “Grantors” or individually “Grantor”), a __________________________ corporation (“Corporation”) and __________________________ (“Trustee”). The term “Grantor” or “Grantors” shall also include any additional shareholders of the Corporation required to purchase insurance pursuant to this Agreement.

In consideration of the agreements contained herein, the parties to this Agreement agree as follows:

ARTICLE I

This Agreement may be referred to as the __________________________ SHAREHOLDERS’ INSURANCE TRUST (“Trust”).

ARTICLE II

The Trustee shall, out of the funds of the Trust, purchase life insurance policies on the lives of the Grantors in the amounts required by the Shareholders’ Agreement of even date herewith between the Grantors and the Corporation (“Shareholders’ Agreement”). Each such policy shall irrevocably designate the Trustee as beneficiary. The Trust property shall consist of these policies, and any other property as may be added by any or all of the Grantors or any other person. The Grantors shall have no power to alter, amend, revoke or terminate this Trust, other than upon the unanimous agreement of the Grantors, the Trustee and the Corporation pursuant to Article IX hereof. The Trustee agrees to hold all of this property under the terms and conditions of this Agreement.

ARTICLE III

During the term of this Trust, the Trustee shall utilize contributions by the Grantors to purchase, hold and maintain insurance on the lives of the Grantors in the amounts set forth in the Shareholders’ Agreement.

Each Grantor shall make or cause to be made contributions to the Trust in an amount equal to such Grantor’s Proportionate Share of the premiums required to purchase and maintain insurance coverage on the lives of all of the Grantors which is required to be maintained pursuant to the Shareholders’ Agreement. For purpose of this Agreement, “Proportionate Share” shall mean a percentage equal to the proportion that the number of shares of the Corporation’s issued and outstanding capital stock (“Stock”) owned by the Grantor (or his estate) bears to the total issued and outstanding Stock of the Corporation owned by all of the Grantors as of the date on which any contribution, distribution or payment is to be made except that the Stock of a deceased Grantor shall not be taken into account for purposes of determining the Proportionate Share of a surviving Grantor in the insurance proceeds under a policy on the life of such deceased Grantor. In the event that any Grantor (“Defaulting Grantor”) shall fail to make or cause to be made his

592824 63
Proportionate Share of such contributions prior to the date that is (2 days prior to the date that premiums on such insurance are due, the Trustee or any other Grantor shall have the right to make such contributions and shall be promptly reimbursed therefore by the Defaulting Grantor, with interest from the date such distributions were made by the Trustee or other Grantor until the date of reimbursement, at the rate of eight percent (8%) per annum and such amount, if not reimbursed, may be withheld by the Trustee from the proceeds payable upon the death of the defaulting Grantor. If such premiums are not paid, the Trustee shall allow the policy on the life of the defaulting Grantor to lapse. In such case, the defaulting Grantor shall not be credited with any insurance proceeds upon the death of any other Grantor. Each such policy shall provide that premium reminder notices and all other correspondence shall be sent to the Trustee who shall promptly deliver such notices and correspondence to the Grantors.

ARTICLE IV

Upon the death of any Grantor during the term of this Trust, the Trustee shall make claim as beneficiary under such life insurance policy insuring such Grantor and shall promptly notify the surviving Grantors and the personal representative of the estate of the deceased Grantor upon receipt of the proceeds of such policy. After reimbursement of any advances made by the Trustee or any Grantor pursuant to Article III above (if any), the remaining amount of such insurance proceeds shall be paid on behalf of the surviving Grantors to or on behalf of the estate of the deceased Grantor in full or partial satisfaction of (i) the obligations of the surviving Grantors to purchase the Stock of the deceased Grantor pursuant to the Shareholders’ Agreement, and (ii) the obligation of the Corporation to make deferred compensation payments as set forth in the Shareholders’ Agreement. If required by the Shareholders’ Agreement, all or a portion of such proceeds shall be paid by the Trustee to one of the surviving Grantors as payment against any obligation of the deceased Grantor to such surviving Grantor to the extent set forth in the Shareholders’ Agreement. Each surviving Grantor shall remain obligated, pursuant to the terms of the Shareholders’ Agreement, to pay to the estate of the deceased Grantor the difference, if any, between the price specified to be paid by each such Grantor for the number of shares of Stock of the deceased Grantor required to be purchased by each such Grantor as set forth in the Shareholders Agreement and the amount of such Grantor’s Proportionate Share of the insurance proceeds.

ARTICLE V

In the event that the Trustee (or any successor Trustee) fails to serve or is unable to serve for any reason, then a majority of the Grantors shall appoint a successor Trustee. In the event of any substitution of the trusteeship hereunder, the successor Trustee or Trustees shall execute a document acknowledging and consenting to the terms of this Agreement and such Trustee or Trustees shall then receive all assets then comprising the trust property (including any life insurance policies on the life of any Grantor) together with all books and records relating thereto. Upon such receipt, the successor Trustee or Trustees shall be vested with all rights, powers and privileges relating to the trust property as if such successor were the original Trustee. No successor Trustee shall be liable for any act or omission of their predecessor nor shall they be obliged to inquire into the validity or propriety of any such act or omission, any such successor shall be entitled to accept as conclusive any accounting and statement of assets furnished to them by their predecessor, and they shall be entitled to receipt only for those assets included in such statement.

ARTICLE VI
Except as otherwise provided herein, no beneficial interest under this Trust, whether income or principal, shall be subject to anticipation, assignment, pledge, sale or transfer in any manner, nor shall any beneficiary have the power to anticipate, encumber, or discharge such interest, nor shall such interest, while in the possession of the Trustee, be liable for or subject to the debts, contracts, obligations, liabilities or torts of any beneficiary.

ARTICLE VII
A. No Trustee shall be required to give any bond or other security for the faithful performance of his or her duties.
B. The validity, construction and administration of this Trust shall be determined by reference to the laws of the State of Maryland.
C. Each Trustee shall be entitled to receive the compensation that is customary for a trustee in the State of Maryland.
D. No Trustee shall be liable for any depreciation or loss, through error of judgment or otherwise, of any property at any time constituting the trust property or any part thereof, but shall be liable only for his or her acts or omissions of gross negligence or willful misconduct.
E. This Agreement shall be binding upon and inure to the benefit of the parties and their respective personal and legal representatives, successors and assigns.

ARTICLE VIII
The Trustee is authorized to retain as owner any policies of insurance on the life of any of the Grantors purchased by him at any time, and to purchase, from time to time, as is required in order to permit the Trust to hold sufficient insurance to satisfy the requirements of the Shareholders ‘Agreement, additional policies of insurance on the life of any of the Grantors. The Trustee shall pay out of the funds of the trust all costs, including premiums or other charges of maintaining these insurance policies in force, as an expense of administering the trust and, if it is deemed necessary or advisable, to exercise his power to borrow money for that purpose. However, unless there shall be sufficient funds in the trust for this purpose, the Trustee shall be under no obligation to pay such costs or other charges with respect to any such policy of insurance.

The Trustee is authorized to exercise, in such manner as he shall deem will best serve the interests of the Grantors, any option, election, or other power that an absolute owner of any policy would have with respect to that policy. The Trustee shall have, regarding any policy of life insurance at any time held as part of the trust estate, the exclusive right, exercisable by him from time to time and in his sole and absolute discretion:
A. To apply for and obtain by conversion or otherwise one or more other policies of insurance on the life of the Grantors;
B. To permit the policy to lapse and thereafter to reinstate it;
C. To receive dividends thereon;
D. To take paid up insurance in a reduced face amount or to take extended insurance and to apply the policy reserves for the purpose;
E. To demand, collect, and receive from the insurer all proceeds thereof;
F. To permit the policy to lapse or to cancel, terminate, or surrender the policy and to demand, collect, and receive the cash surrender value or other proceeds that may thereupon become available;
G. To exercise all options, rights, privileges, and elections, including the right to elect modes of settlement and the privilege of conversion, exercisable thereunder or allowed by the insurer;
H. To sell, transfer, assign, pledge, or otherwise dispose of the policy;
I. To exchange the policy for another policy on the life of the Grantor in any amount less than the original face amount thereof and to collect the cash value remaining after the exchange;
J. To borrow upon the policy from the insurer or from any other person for any purpose, including the payment of premiums or other charges, and to pledge or hypothecate the policy for any loan;
K. To take any other action regarding the policy that the Trustee deems to be in the best interests of the trust estate and the Grantors thereof;
L. To do all other acts and things not inconsistent with the provisions of this instrument which it may deem necessary or desirable for the proper management of the Trust herein created, in the same manner and to the same extent as an individual might or could do with respect to his own property; and
M. To exercise all powers conferred in this Agreement without authorization or approval of any court, and such powers shall:
   (a) be exercisable by the Trustee and by any successor or substitute in any jurisdiction whatsoever;
   (b) be exercisable in respect of all assets held by his or under his control;
   (c) remain exercisable as fiduciary powers of administration only, and without affecting the vesting or beneficial interest, until actual and final distribution of all of the assets of the Trust;
   (d) be exercisable without any duty on any person dealing with the Trustee to inquire into its authority;
   (e) be conclusive, when exercised, upon all persons interested in the Trust; and
   (f) remain exercisable as fiduciary powers of administration only, without the vesting of any beneficial interest, until actual and final distribution of all of the assets of the Trust.

Notwithstanding the foregoing, the Trustee may not exercise any of such powers in a manner which results in the interruption or termination of insurance coverage as required by the Shareholders’ Agreement.

On the death of any Grantor, the Trustee shall collect and receive all proceeds payable to the Trustee under any policies of insurance on the life of such Grantor. The Trustee is hereby authorized to make all necessary proofs of death under these policies, to execute and deliver any and all receipts and releases for the net proceeds thereof, to institute any action, suit, or proceeding to collect these net proceeds, and to pay from the trust estate all the expenses thereof, including court costs and counsel fees, and to do and perform any and all other acts that the Trustee deems necessary or advisable to collect these net proceeds, provided, however, that the Trustee shall not be under any obligation or duty to institute such action, suit, or proceeding unless it shall be advisable in the opinion of the counsel of the Trustee and unless the Trustee shall have either adequate funds in the Trust with which to pay the expenses of the action, suit, or proceeding or indemnification to its satisfaction against such expenses. Upon payment to the Trustee of the proceeds due under any such policy, the insurer shall be relieved of any responsibility to see to the application or disposition of those proceeds.

ARTICLE IX

This Trust shall terminate upon the first to occur of the following events:
(1) Each of the Grantors ceasing to be obligated to maintain insurance on the life of any of the other Grantors under the Shareholders’ Agreement; or
(2) The written election of all of the then living Grantors who are shareholders of the Corporation to terminate the Trust, after satisfaction of any obligations hereunder which accrued prior to such election of termination; or

(3) The death of all Grantors within a go-day period.

Upon termination of this Trust, each Grantor (or his estate, as the case may be) who is a shareholder in the Corporation shall receive his Proportionate Share of the Trust property. Each such Grantor shall be entitled to a distribution from the Trust equal to any insurance policies on his life. In such case, the Grantors shall take appropriate adjustments among themselves to assure that each Grantor receives his Proportionate Share of the value of the assets of the Trust.

If a Grantor ceases to be a shareholder in the Corporation other than by reason of his death, he shall receive his Proportionate Share of the Trust property. Such Grantor shall be entitled to a distribution of any insurance policy on his life in which case appropriate adjustments shall be made to assure that such Grantor receives his Proportionate Share of the value of the Trust property.

In the event that this Trust terminates by reason of the death of all Grantors within a 90-day period, then the estate of each Grantor shall receive from the Trust the proceeds payable on the life of each respective Grantor and such estate’s Proportionate Share of the remainder of the Trust property.

ARTICLE X

As used throughout this Agreement, the “Trustee” or “Trustees” shall always refer to the original Trustee and to any successors thereto. All successors to the original Trustee shall have the same rights, privileges, powers, duties and obligations that are conferred in this Agreement on the original Trustee.

IN WITNESS WHEREOF, the Trustee hereby accepts the trust created by this Agreement and agree to carry out the provisions hereof on his part according to the best of his ability. The Grantors, Trustee and the Corporation have executed this Agreement on the date and year first hereinabove written.