

sale will be treated as a dividend. However, the cross purchase agreement may be more difficult to administer where the purchase is to be funded by life insurance, since each shareholder will need to own policies on all of the other shareholders. Further, if there are significant differences among the ages of the shareholders, the younger shareholders will have a greater financial burden because they will have to buy more expensive insurance on the lives of the older shareholders. If there are few shareholders, arrangements can be made to "trustee" the life insurance or otherwise ameliorate these practical obstacles.

C. The "hybrid agreement" combines elements of A and B. Typically, the corporation has the first option to purchase the interest of the transferring shareholder, then the remaining shareholders have the option to purchase the interest, and, if that option is not exercised, the corporation is obligated to make the purchase. It is important for tax purposes that the shareholders do not have an obligation to purchase the interest; if the corporation then carries out the purchase, there will be a "dividend" to the shareholders.

5. Should I have a buy-sell agreement even though my business is conducted as a partnership or limited liability company?

A buy-sell agreement is necessary for *any type of business organization* that has more than one owner and that wants to plan for succession, whether a C corporation, an S corporation, a general partnership, a limited partnership, a limited liability company or any other form of organization. A buy-sell agreement for a corporation usually is a separate document; a partnership or limited liability company

typically will make the arrangement in the partnership/operating agreement.

6. I am the principal owner of my business. Can you give me some examples of how a buy-sell agreement could help me as well as my co-owners?

A. *Creating a market.* By definition, a closely-held business is not readily marketable. In the event of your death, disability or retirement, the agreement provides a plan for the purchase of your interest in the business by the business itself or by the other owners. This would provide funds for your retirement and or disability and help provide liquidity to your estate in the event of your death (for the payment of estate taxes or other estate planning needs). Note also that the business could provide funds for your retirement with, for example, a pension or profit-sharing plan or a consulting agreement.

B. *Establishing values.* The agreement would establish a value for your interest in the business that would be binding on all parties, thus avoiding disputes.

C. *Planning your estate.* The agreement could help fix a value that would control for estate tax purposes (as long as it provides for "fair market value") and provide cash to pay estate taxes. Further, where all of your children are not active in the business, the buy-sell agreement provides funds to you which can help to equalize your children's inheritances.

Establishing a funding mechanism and payment terms. The agreement can and should provide for funding the purchase of your interest (business assets, life insurance, bank borrowings), thus assuring you that the purchase will take place. The

A buy-sell agreement can provide funds for an owner's retirement or disability.

■ Recent Foreclosure

Hofheimer Gartlir & Gross, LLP became counsel of record in a contested foreclosure action in New York City. Prior to our involvement, the Appellate Division of the Supreme Court reversed the grant of summary judgment in favor of the mortgagee, holding that the mortgagee failed to show its entitlement to foreclose. The balance due under the mortgage at that time was in excess of \$1,400,000. After several depositions were conducted, we obtained evidence that the mortgagee was entitled to foreclose its mortgage, and we were able to negotiate a deed in lieu of foreclosure. As a result, our client took title to the mortgaged premises, which at the time of the conveyance was valued in excess of \$2,000,000.

About Hofheimer Gartlir & Gross, LLP

The firm conducts a general commercial practice. Our principal practice areas are:

- real estate
- corporate and securities law
- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures)
- estate planning
- trust and estate administration
- general litigation and alternate dispute resolution
- matrimonial and family law
- taxation

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.

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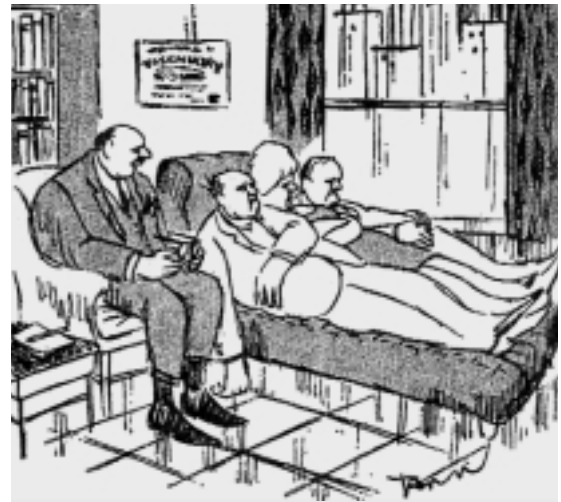
The Buy-Sell Agreement—An Essential Element of a Business Succession Plan

Recent studies indicate that less than 25% of closely-held businesses have a management succession plan that includes a formal buy-sell agreement. Many owners rely on a “handshake” or an “oral agreement” that is either unenforceable or impossible to prove. The result is that there is no definite plan in place that governs the transfer of ownership and/or control of a business in the event of various occurrences, whether expected or unexpected, normal or out of the ordinary.

1. What is a buy-sell agreement?

A buy-sell agreement is a *legally enforceable written arrangement* among the owners of a closely-held business that typically provides for the transfer of ownership and/or control as a result of the occurrence of certain events involving an owner. A typical but not exhaustive list of such events includes the following:

- A. Death
- B. Retirement
- C. Disability
- D. Bankruptcy
- E. Irresolvable disputes
- F. Divorce
- G. Withdrawal because of a desire to diversify or other reason
- H. Loss of a professional license.



...And after Mildred proposed that the average of the three valuations be submitted to the original valuation firm's astrologist for comparison against the departing shareholder's third notarized offer, how did each of you feel about signing the buy/sell agreement?

A buy-sell agreement is a legally enforceable arrangement.

Reprinted from *Someday It'll All Be...Who's?*, a book of cartoons on the lighter side of the family business by Donald J. Jonovic, Ph.D. (c) King Features Syndicate, Inc., and Jamieson Press, P.O.Box 201400, Cleveland, Ohio 44120; 216/752-7970. Case bound, 202 pp., 228 cartoons \$28.95 U.S.

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2. Is there a “standard” agreement that would apply to most cases?

No. A buy-sell agreement truly is a “custom-made suit.” Because of the wide variety of variables in each closely-held business situation, each case stands on its own.

There is neither a “standard” agreement nor a “standard” provision to deal with a particular event. What works for one business or one set of circumstances might very well not work for another.

In one case, the owners of a business may decide that upon the retirement, death or disability of a shareholder, the corporation and/or the remaining shareholders should have an *obligation to purchase* that shareholder’s interest. In another case, the owners may decide that the corporation and/or the remaining shareholders should have an *option to purchase*, but should not be obligated to exercise the option. In a third case, the withdrawing shareholder (or his or her estate) might have an *option to “put”* the shares to the corporation and the other shareholders. If it is possible that the purchase might not be consummated because the option route is chosen, consideration may be given to possible restrictions on the voting rights of the retired or disabled shareholder (or the shareholder’s estate). This is especially important if the shareholder has been active in the business. There are various techniques that can be employed to achieve this result.

3. When should I enter into a buy-sell agreement?

The best time to work out the buy-sell arrangement is at the inception - when the business is being organized. This timing minimizes the possibility of disputes and disruption arising after the business is operating. But even if the business has

been conducted for a long time, it is never too late to prepare a business succession plan that contains a buy-sell agreement.

4. What are the basic types of buy-sell agreements?

There are three fundamental types of buy-sell agreements:

A. The *“redemption agreement”* or *“corporate purchase agreement”* provides that the corporation will purchase the ownership interest of the deceased or retired shareholder. This is the simplest type of agreement to administer. Under this arrangement, corporate funds are used to make the purchase. The purchase may be funded by insurance, in which case the corporation purchases a policy on the life of each shareholder. Alternatively, the corporation may accumulate profits to use for a future purchase or may borrow when the time comes.

Note that although life insurance proceeds typically are exempt from income tax, they may be subject to the “alternative minimum tax” if the policy owner is a C corporation. Further, because the corporation is the purchaser, the remaining shareholders do not receive a “stepped-up basis” for the interest purchased. Due to the complexity of the tax law, careful planning must be done to ensure that the purchase is not treated as a dividend for tax purposes, which could have adverse tax consequences to the seller.

B. The *“cross purchase agreement”* provides that the remaining shareholders will purchase the interest of the deceased or retired shareholder. This arrangement generally is more tax-favorable than the corporate purchase — the purchasing shareholders do receive a stepped-up basis, and the seller does not run the risk that the

A buy-sell agreement can be prepared at any time.

either side does not agree with the appraisal, the agreement might provide for an additional appraisal with the results of the two appraisals averaged in some manner.

B. Book value. This is based on the costs reflected on the books and records of the business and in most cases will not arrive at FMV. The result is that it would not be respected for tax purposes and in most cases would not be satisfactory to the seller.

C. Capitalization of "earnings." This usually is determined by the accountants for the

business. The definition of how "earnings" are to be computed would be contained in the agreement.

D. Replacement cost of hard assets. This would be determined by independent appraisal and is unlikely to arrive at FMV.

E. As agreed upon annually. This has the potential for arriving at the correct result, provided that the parties can come to an agreement on valuation on a regular basis. In practice, it is rarely done regularly, with the result that the values are out of date when a triggering event occurs.

Although the buy-sell agreement is not the exclusive technique for withdrawing funds from a business upon a dissociation of a shareholder, it remains an invaluable tool that no business should be without. For more information on this topic or other issues related to your business, please call Bob Howard or any other member of our firm.

This is the second in a series of articles on Business Succession Planning.

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A buy-sell agreement can be the means of avoiding conflict among the owners.

terms of payment should also be set forth; these might vary depending upon the particular event (e.g., an installment payment at retirement, a lump-sum payment upon death).

D. *Avoiding conflicts.* The agreement can provide assurance to all of the owners that the control of the business will be passed on to the intended parties.

E. *Restricting transfers of interests.* It is very typical for shareholders in a closely-held business to restrict the transfer of shares to "outsiders." The agreement should define the person or class of persons to whom shares may be transferred without the consent of the other shareholders. In some cases, the permitted transferees may be members of the shareholder's family (or trusts for their benefit); a shareholder might want this provision in order to make gifts of shares in the business during lifetime that would reduce the taxable estate. In other cases, the owners might decide to bar all transfers without shareholder consent. In addition, if the business is owned by an S corporation, the agreement should prohibit transfers to "disqualifying" persons (for example, corporations, partnerships, foreign persons). Whatever the type of business entity, it may be advisable to require the transferor to secure an opinion of counsel to the business that the transfer is permitted under the agreement and under the law.

7. How will the purchaser pay for my interest?

The buy-sell agreement should make provision for the payment of the purchase price of the selling owner. The typical methods are:

A. Cash generated from operations of the business, payable in installments over a specified period;

B. A sinking fund established by the business under which funds from the business are invested over time to provide for the future purchase;

C. Cash from borrowings at the date of purchase;

D. Distribution of "excess" business assets (reserves, investment portfolios, etc.);

E. Life insurance.

Life insurance generally is considered to be the safest method of assuring that the proceeds will be available in the case of death. The others generally are subject to the claims of the creditors of the business.

The buy-sell agreement also can provide for escrow arrangements or other security devices that would enable the seller to take back the business interest if the purchase price is not paid in full.

8. How will the price of my interest be determined?

It is critical that the agreement specify a method to determine the price of the departing owner's interest. The method used should be the one most likely to achieve the goal of arriving at the "fair market value" (FMV) of the seller's interest, both for purposes of assuring that an equitable price is paid and that the arrangement will be respected for tax purposes. The most frequently used methods are:

A. Appraisal. This usually is done by an independent third party, who charges a fee for the service. Appraisal generally is thought to be the method most likely to accurately determine FMV. In the event that