Methods to Fund Buy-Sell Agreements

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Webinar
April 1, 2021

Types of Buy-Sell Agreements

- Stock/ownership Redemption
- Cross-Purchase
- Hybrid Method

Types of Buy-Sell Agreements

1. Stock/ownership Redemption

   A. Funding in entity

   B. Guaranty by other members

   C. Impact upon balance sheet of entity

Types of Buy-Sell Agreements

2. Cross-Purchase

   A. Funding by members

   B. Multiple policies or escrow/trust

   C. Basis step up and no impact upon balance sheet

   D. How is premium payment accounted for?

Types of Buy-Sell Agreements

3. Hybrid Method

   A. Whom do we want to have the preference

   B. Do we want entity to have mandatory obligation

   C. Where is the funding done?

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What are the Triggers in a Buy-Sell Agreement

1. Death
2. Disability
3. Departure
4. Discord

Triggers

1. Death

   A. Is the estate obligated to sell?

   B. Is either the entity or members required to buy or only given an option?

   C. What if deceased member is not insurable?

   D. What if decedent wants to pass it on?

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Triggers

2. Disability

   A. What constitutes sufficient disability?

   B. Will disability be insured for full amount?

   C. Will portion of salary/payment/wage continuation be applied to stock purchase?

Triggers

3. Departure

   A. Must be employed to be owner?

   B. "Put" terms more liberal than other triggers with potential discounts, lower interest rate and extended installments?

   C. Installments; use life insurance as cost recovery or down payment?

Triggers

4. Discord

   A. Exit Strategy a good idea?

   B. Push-pull mechanism

   C. Terms need to be in place

   D. Funding is installments; insurance may be cost recovery, down payment credit if transferred or just cancelled

Covenants Appropriate in Buy-Sell Agreements

1. Non-compete by selling Shareholder/Member
2. Personal guaranty of remaining Shareholders/Members
3. Look forward provision if entity is sold within review period at premium
4. Limitation on salary, bonus, benefits and reorganization while installment payments remain outstanding
5. Annual review of financial statements and tax returns
6. Possible subordination by selling Shareholder/Member to entity's lender
7. Acceleration of note of seller if entity sold

Covenants

1. Non-compete by selling Shareholder/ Member

   A. Offset against payments if violated
   B. Length of time and hiring
   C. Define what is prohibited (ie. Non-compete or anti-piracy)

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Covenants

2. Personal guaranty of remaining Shareholders/Members

   A. Absolute condition to get commitment
   B. Multiple members proportionate or joint and several
   C. Secure the guaranty with a second mortgage; spouse?

Covenants

3. Look forward provision if entity is sold within review period at premium

   A. How long (3 years; 5 years)
   B. Percentage of deal proceeds sliding scale
   C. Define proceeds (ie. Consulting and non-compete)
   D. Purpose of a look forward strategy

Covenants

4. Limitation on salary, bonus, benefits and reorganization while installment payments remain outstanding

   A. Motivate the buyers to pay the note

   B. Limit the cash flow until Seller/estate paid

   C. Similar to loan covenants because it is a loan

Covenants

5. Annual review of financial statements and tax returns

   A. Covenant: review of financial stability

   B. Verification of compliance

   C. Need to be aware of risks and desire for confidentiality is a motivator

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Covenants

6. Possible subordination by selling Shareholder/Member to entity's lender

   A. Almost certain in a redemption

   B. If seller has any collateral necessary

   C. Limits the legal remedies of seller

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Covenants

7. Acceleration of note of seller if entity sold

   A. Should be in agreement

   B. Ultimate collateral; business is gone

   C. Need buyer to know that upon a sale the note is accelerated

Alternative Provisions in Close Corporation Agreements, Operating Agreements and Partnerships:

1. Drag along by Majority Members
2. Tag along by Minority Members
3. Super majority issues
4. Dilution and capital calls
5. Employment status and ownership conditions

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Alternative Provisions:

1. Drag along by Majority Members

   A. Buyer does not want minority owners

   B. Majority can't make a deal without minority participation

   C. Minority does not take a discount or less favorable terms

Alternative Provisions:

2. Tag along by Minority Members

   A. Majority wishes to get liquid

   B. Minority wants to participate proportionately

   C. The terms are identical and minority retains similar ownership participation

Alternative Provisions:

3. Super majority issues
   A. Sale of Company or assets

   B. Entity borrowing if personal guaranty required

   C. Change in any substantive terms of agreement

   D. Dismissal of member/employees

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Alternative Provisions :

4. Dilution and capital calls

   A. Treatment as loan
   B. Failure results in dilution; could there be a penalty
   C. Hybrid provision (either loan or dilution; who decides what are terms of loan?)

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Alternative Provisions :

5. Employment status and ownership conditions

   A. Does loss of employment trigger sale
   B. Who may dismiss an owner
   C. Will there be a mechanism to determine cause for dismissal

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Funding Methods Life Insurance

1. Stock Redemption
2. Cross-Purchase Arrangement
3. Hybrid Plans
4. Uninsurable and Under Insured

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Funding Methods Life Insurance

1. Stock Redemption

   A. Life insurance owned by entity.

   B. Elimination of alternative minimum tax and new low “C” corporation tax rate

Funding Methods Life Insurance

2. Cross-Purchase Arrangement

   A. Life insurance owned by Members on each other Member

   B. Requires multiple policies and funding mechanism usually through bonus plan/addition to W-2

Funding Methods Life Insurance

2. Cross-Purchase Arrangement

   C. May consider escrow/trust/partnership arrangement to eliminate multiple policies
   D. Must be cognizant of possible transfer for value considerations upon transfer of a deceased Member's policies to surviving Members

Funding Methods Life Insurance

3. Hybrid Plans

   A. The option is first to Members in proportion to their ownership

   B. Default is mandatory purchase by the entity (a redemption)

   C. Where will the insurance be owned

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Funding Methods Life Insurance

4. General provisions

   A. Require the proceeds of life insurance to be used 100% for purchase as down payment
   B. Balance of purchase price paid in installments
   C. Installments must bear interest to avoid imputed interest rules

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Lifetime Funding Methods

1. Disabled Shareholder
2. Departing Shareholder
3. Discord Among Shareholders/Members
4. Puts & Calls
5. Modification of Mandatory Terms to Facilitate Funding if the Buy-out Upon a “Put” Exercised Early.

Lifetime Funding Methods

1. Disabled Shareholder

   A. Insurance paid by entity ordinary income to recipient

   B. Disability insurance designed to facilitate transition with credit applied to purchase price

Lifetime Funding Methods
1. Disabled Shareholder

C. Wage continuation plan funded from cash flow

D. Impacted by cost of replacement

E. Portion of payment (percentage after certain number of months) applied to purchase price and disabled

F. Member must relinquish ownership with perhaps a stock pledge agreement

Lifetime Funding Methods

2. Departing Shareholder

   A. May use cash surrender value of policy as down-payment

   B. May use the value of the policy transferred to the departing Shareholder;

   C. Must be willing to abandon the death benefit (transfer to insured an exception to transfer for value concern)

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Lifetime Funding Methods

2. Departing Shareholder

D. Installment payments bearing interest; usually the Applicable Federal Rate at minimum

E. Collateral for installment payments

F. Restrictions on management activities during installment period to incentivize accelerated payoff of installment note

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Lifetime Funding Methods

3. Discord Among Shareholders/Members

    A. May use cash surrender value

    B. May use policies transferred

Lifetime Funding Methods

3. Discord Among Shareholders/Members

   C. Provide mandatory terms for lifetime buy-out
      i. Percent of down payment
      ii. Number of installments
      iii. Interest rate on installments
      iv. Non-compete from selling Shareholders/Members
      v. Personal guaranty from remaining Members

Lifetime Funding Methods

3. Discord Among Shareholders/Members

   D. Once the mandatory terms are contractual

      i. Set price by push-pull mechanism

         a. Offering Shareholder states in writing the price he will accept as either a buyer or as a seller

         b. Receiving Shareholder has number of days to accept the offer as either buyer or seller

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Lifetime Funding Methods

4. Discord before a certain date may also require a modification of the mandatory terms to facilitate funding the buy-out upon a “Put” exercised early:

   A. Example, if number of installments is normally 60 months, if put comes early installments in discretion of buyer/entity might be up to 120 months

Lifetime Funding Methods

4. Discord before a certain date may also require a modification of the mandatory terms to facilitate funding the buy-out upon a "Put" exercised early:

   B. Example, if percentage of down payment is 20%, if put comes early percentage may become only 10%

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Lifetime Funding Methods

4. Discord before a certain date may also require a modification of the mandatory terms to facilitate funding the buy-out upon a "Put" exercised early:

   C. Example, if interest rate is 6%, if put comes early rate is 200 basis points below or 4%

Lifetime Funding Methods

4. Discord before a certain date may also require a modification of the mandatory terms to facilitate funding the buy-out upon a “Put” exercised early:

   D. Example, if non-compete is 3 years, if put comes early non-compete becomes 5 years

Lifetime Funding Methods

4. Discord before a certain date may also require a modification of the mandatory terms to facilitate funding the buy-out upon a "Put" exercised early:

   E. Example, if personal guaranty is entire amount, if put comes early guaranty is limited to 50%

Lifetime Funding Methods

- The Call
  - All of the mechanisms cited for a put would be reversed in a Call
    - Fewer installments
    - Greater down payment
    - Possible premium price
    - Premium interest rate
    - Absolute personal guaranty
    - Shorter non-compete

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