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The background of the slide features a photograph of two people in business attire sitting at a table, looking at documents. A semi-transparent blue rectangular overlay covers the middle portion of the image, serving as a backdrop for the text.

# Effective Buy/Sell Agreements for A/E Firms

Presented by:

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*“Planning is bringing the future into the present so that  
you can do something about it now.”*

*~ Alan Lakein*

## ... Introduction to Buy-Sell Agreements The “Baby Boomers”

“Baby Boomers” - 78 million people in the U.S. born between January 1, 1946 and December 31, 1964

Beginning on January 1, 2011, 10,000 “Baby Boomers” will reach the age of 65 everyday for the next 19 year

Approximately 9% of the “Baby Boomer” generation are business owners

- As a result, approximately 7 million “Baby Boomer” companies in the United States are estimated to be transitioned during this period

The Exit Planning Institute has projected that over the next 12-15 years, more than 8 million closely-held U.S. companies will be sold

## ... Introduction to Buy-Sell Agreements Family-Owned Businesses

In 2021, PWC updated its *Family Business Survey* which surveyed nearly 3,000 closely-held owners and managers.

- The survey indicated that only 30% of the businesses surveyed have a robust succession plan – a documented and communicated leadership transition strategy – formally in place. This is up from 15% in 2018.
- According to PWC's *Global NextGen Survey 2022*, this number has doubled again, to 61%

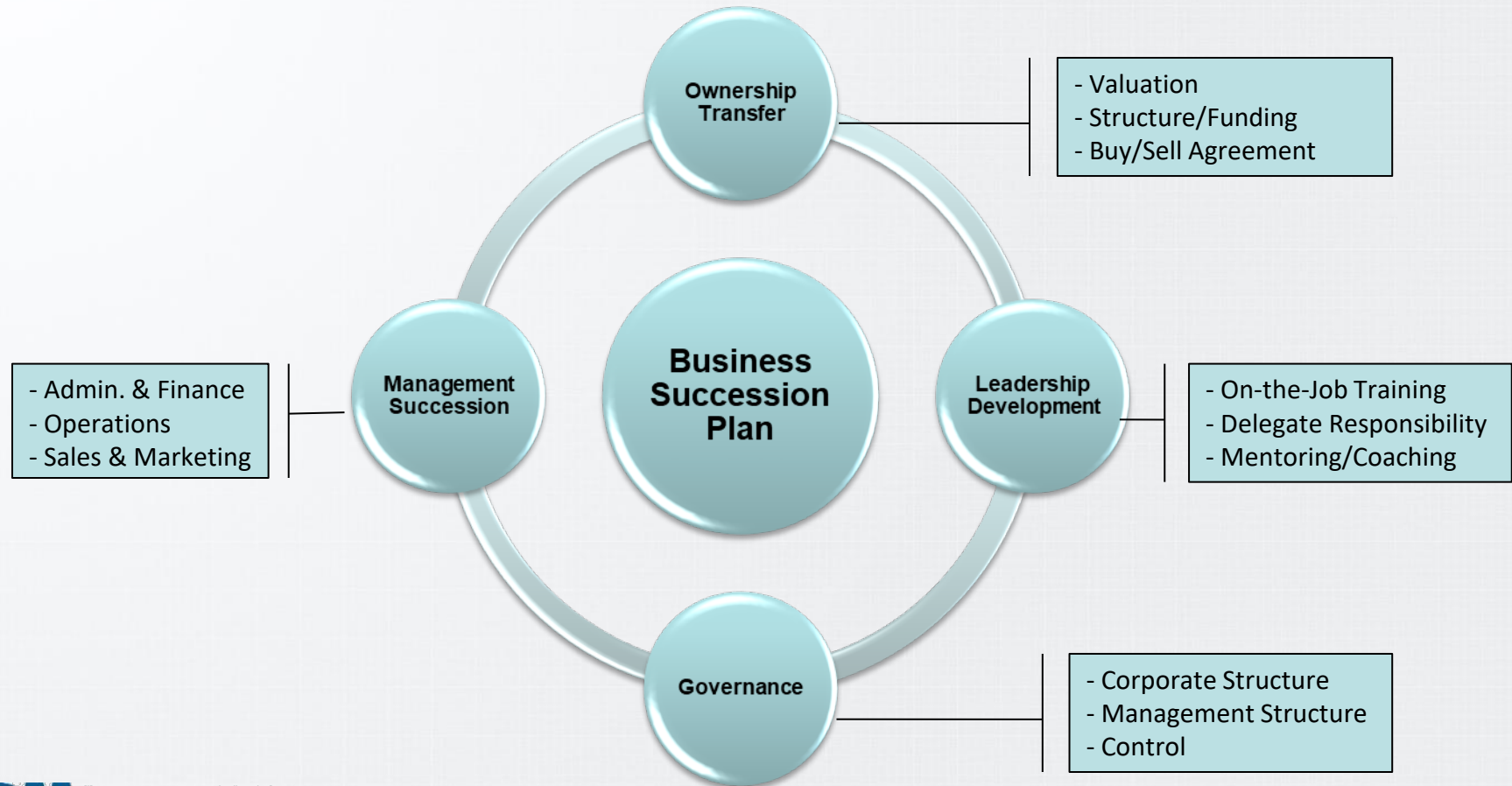


## ... The Need for a Review of Existing Buy-Sell Agreements

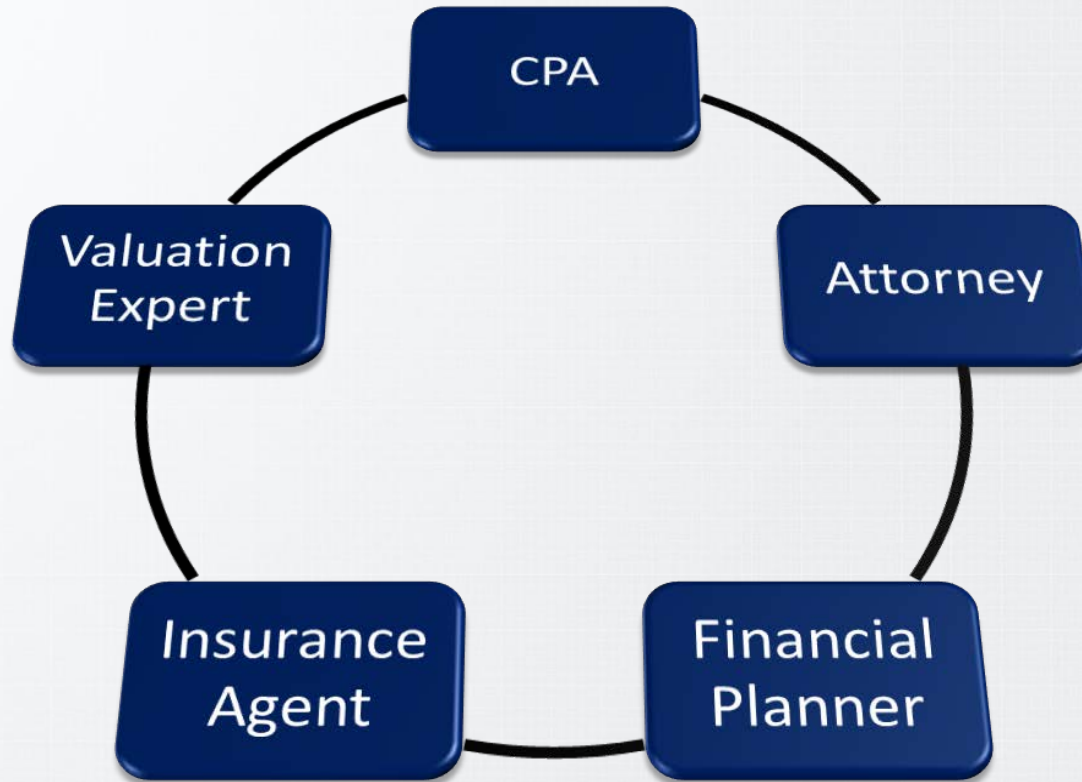
Companies with buy-sell agreements already in place should undertake a detailed review of the agreement **annually** to ensure that the agreement does not yield unintended consequences relating to transferability, valuation, funding or corporate governance.

Changing economic conditions nationally, regionally or within a particular company, coupled with ever-changing federal and state tax laws and rates, also mandate a periodic review of existing buy-sell agreements.

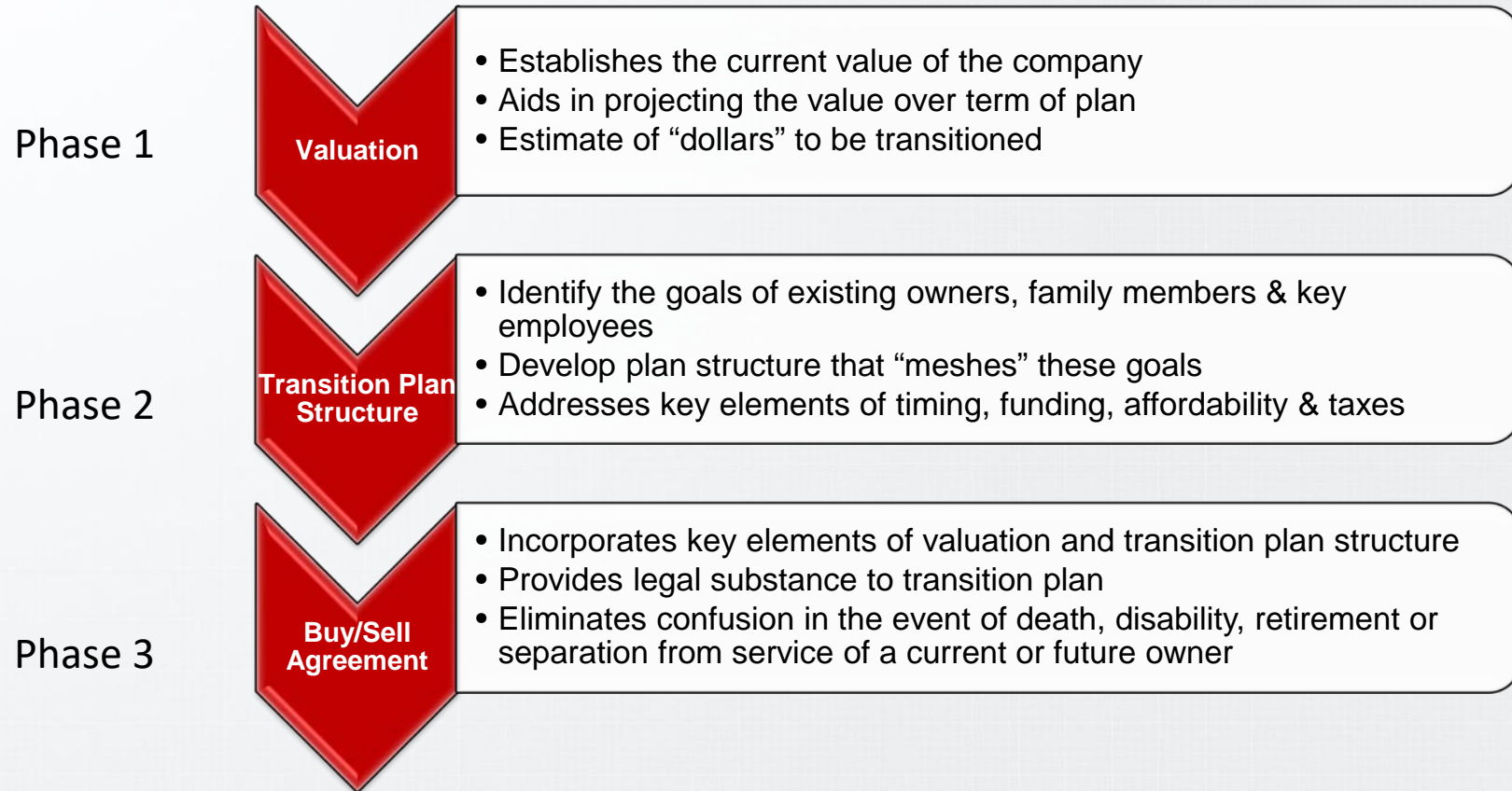
# ... Components of a Business Succession Plan



## .... Successful Ownership Transition Planning is a “Team Sport”



## Internal Ownership Transition Planning Process



## ... Internal Ownership Transition Plans

When owners of closely-held companies approach retirement, they are often faced with a dilemma. Common questions they may ask themselves are:

- **Who** should be admitted as new owners?
- **What** percentage ownership should I sell?
- **When** should I retire?
- **Where** will the funds come from to purchase my ownership interest?
- **Why** should I sell my interest and relinquish control of the company?
- **How** should the sale be structured?



## ... Internal Ownership Transition Plans

Long-term strategic ownership transition plans are designed to answer these questions and provide a framework for ownership transition within a company which addresses both foreseen and unforeseen events.

As each company is unique, so too is each ownership transition plan.

-There is no “standard” ownership transition plan.

## ... The Buy-Sell Agreement

- A mandatory step in the plan for ownership transition is the adoption of a comprehensive agreement among the shareholders that is often referred to as a **buy-sell agreement**.
- A buy-sell agreement is a contract providing for the sale of a shareholder's ownership interest in the company upon the occurrence of a specified event
- Commonly referred to as **Events of Transfer**, these include the retirement, death, disability or separation from service (voluntary or involuntary) of a shareholder.
- Other **Events of Transfer** can include bankruptcy, divorce, conviction of a crime (especially a felony), loss of professional license or accreditation, loss of residency status, etc.

## ... The Buy-Sell Agreement

There are generally three types of buy-sell agreements:

- 1) **Cross-Purchase Agreement** – This is a buy-sell agreement solely among owners where, for instance, upon the death of a shareholder, the remaining shareholder(s) must purchase the stock of the deceased shareholder.
- 2) **Stock Redemption Agreement** – This is an agreement in which the company, as well as the owners, are parties. In these agreements, the company agrees to buy (redeem) the shareholder's interest on the occurrence of a specified event.
- 3) **Hybrid or Combination Agreement** – In this type of agreement, the company and the shareholders agree to buy the shareholder's ownership interest. Such an agreement has a provision that consists of both (i) a cross-purchase and (ii) a redemption agreement. Upon an event of transfer, other shareholders first have the right to purchase the shares. Any shares remaining unsold after the "right of first refusal" are then redeemed by the company or vice versa.

## ... Cross-Purchase Agreements

- A **Cross-Purchase** is a transfer of stock that occurs between two individuals; the company is not a party to the transaction and the remaining shareholders are unaffected by the transaction.

	<b>Beginning Ownership</b>		<b>Cross-Purchase</b>		<b>Resulting Ownership</b>	
	<b>Shares</b>	<b>%</b>	<b>Shares</b>	<b>%</b>	<b>Shares</b>	<b>%</b>
Bill Adams	500	50.00%	(250)	-25.00%	250	25.00%
Cindy Bates	500	50.00%	-	0.00%	500	50.00%
Jim Collins	-	0.00%	250	25.00%	250	25.00%
<b>Total</b>	<b>1,000</b>	<b>100.00%</b>	<b>-</b>	<b>0.00%</b>	<b>1,000</b>	<b>100.00%</b>

## ... Cross-Purchase Agreements

**Cross-Purchases** of closely-held stock enable the purchasing shareholders to increase their tax basis in their stock holdings thereby reducing their individual long-term capital gain exposure when the stock is sold or otherwise transferred in the future.

**Cross-Purchases** serve to foster internal ownership transition as individual family members and/or key employees are directly purchasing stock from retiring owners.

Properly structured cross-purchase transactions can result in a tax-deductible alternative to ownership transition if a bonus/compensation funded plan is implemented to address purchasing shareholder affordability.

Since cross-purchase transactions occur between individuals, selling shareholders may be at greater risk of potential default; however, this risk can be minimized with a bonus/compensation funded **Cross-Purchase** arrangement as well as corporate guarantees.



## Stock Redemption Agreements

In a **Stock Redemption**, a shareholder sells his/her stock back to the company. In contrast to a **Cross-Purchase**, the remaining shareholders realize a proportionate increase in stock ownership since the issued and outstanding shares of the company are reduced.

	Beginning Ownership		Redemption		Resulting Ownership	
	Shares	%	Shares	%	Shares	%
Bill Adams	250	25.00%	(250)	-25.00%	-	0.00%
Cindy Bates	500	50.00%	-	0.00%	500	66.67%
Jim Collins	250	25.00%	-	0.00%	250	33.33%
Total	1,000	100.00%	(250)	-25.00%	750	100.00%

## ... Stock Redemption Agreements

- In contrast to **Cross-Purchase** transactions, the remaining shareholders in a **Stock Redemption** do not obtain an increase or a “step-up” in basis in their shares even though their individual ownership percentages have increased.
- Everything else being equal, the remaining shareholders are in the same economic position before and after the **Stock Redemption**
- **Stock Redemptions** can be used in tandem with **Cross-Purchase** transactions, **Gifts** or **Stock Bonuses** to permit retention of voting control by existing owners or generations of owners
- By themselves, **Stock Redemptions** generally do not foster ownership transition as new owners are not being added to the Company (must be used in conjunction with **Gifts, Cross-Purchases** or **Stock Bonuses**)
- **Stock Redemptions** are not tax-deductible which creates a significant tax disadvantage when compared with other ownership transition vehicles

## ... Effective Buy-Sell Agreements – Key Objectives

A buy-sell agreement should be a “self-executing” agreement that should accomplish all of the following objectives:

- To provide for the **orderly transfer** of ownership interest upon the death, retirement or disability of an owner;
- To **restrict transferability** to those not employed by the company;
- To **create a market** at a fair price for the interest of owners who desire to transition their ownership in the company for expansion or in contemplation of retirement;
- To **permit retention of control** by the remaining owners, maintaining an identity of interest between ownership and management and eliminating conflicts that might occur between owners active in management and inactive owners;
- To **determine the value** for sale and/or purchase and the related payment terms; and
- To reasonably **assure the continuance of the business** and reduce the risk of dissolution and loss of value.

## ... The Buy-Sell Agreement – An Offering Process

- As shares are available for purchase or new shares are issued under a buy-sell agreement, the agreement should provide for an “offering process” giving approved individuals the right to purchase shares to foster ownership transition.
- Many agreements will contain a “**Shareholders’ Right of First Refusal**” for shares that become available either as approved by the company’s governing body or pro-rata based on existing stock ownership (a **Cross-Purchase** transaction).
- For shares that go un-purchased under the **Shareholders’ Right of First Refusal**, the company will generally have a mandatory **redemption** obligation to redeem any remaining shares, providing for a continuous market for the shares of stock.
- Existing agreements that provide the **Right of First Refusal** on the part of the company as opposed to the individual shareholders may be counterproductive to transition stock ownership to future generations.

## ... The Buy-Sell Agreement – Restrictions on Transfer

- Shareholders of closely-held companies often want to restrict transfers of shares by other shareholders for a variety of reasons, including a desire to ensure that they “know who they are investing with,” to limit the number of shareholders for administrative reasons, and to ensure that competitors or other “undesirable” parties do not become shareholders and thereby gain access to confidential information about the company.
- Generally, they prefer to have stock ownership rest with family members and/or individuals who are taking an active part in the business.
- Professional companies in particular generally agree on and adopt a Criteria for Ownership, which provides a roadmap for individuals developing required technical expertise and skills necessary to be admitted as new shareholders.
- Restrictions on transfer include conveyance of shares to individuals outside the scope of the buy-sell agreement and typically include any pledge, mortgage, encumbrance, gift or other gratuitous assignment of the shares to anyone who is not a party to the agreement or approved by the company’s governing body (including spouses).



## ... The Buy-Sell Agreement – Valuation

Buy-sell agreements generally provide for the valuation of shares in any one of three different methods:

- 1) **Fixed Price** – shares are purchased/redeemed at a price set in the agreement
- 2) **Fixed Formula** – shares are purchased/redeemed at a price determined by a formula contained in the agreement
- 3) **Appraiser-Driven** – a combination of up to three appraisers determines the price at which the buy-sell agreement will be executed

## ... The Buy-Sell Agreement – Fixed-Price Agreements

- **Advantages**

- Easy to understand
- Easy to execute
- Low cost to put into place

- **Disadvantages**

- Proper price only in one instance (maybe)
- Determination of the fixed price (independent appraiser or “back of the envelope”)
- Relevance on a go-forward basis given economic climate, growth of the business and a host of other factors impacting the valuation of a closely-held company

## ... The Buy-Sell Agreement – Formula Agreements

### Advantages

- Can be incorporated into agreement so as to be easy to understand
- Easy to execute
- Reduces (not eliminates) opportunity for manipulation

### Disadvantages

- How was the formula determined (independent appraiser or “back of the envelope”)
- Relevance on a go-forward basis given economic climate, growth of the company and a host of other factors impacting the valuation of a closely-held business – needs to be revisited annually

## ... The Buy-Sell Agreement – Appraiser-Driven Agreements

### Advantages

- Will be reflective of current value of the company given current market and economic environment
- Eliminates arbitrary valuations when appraiser is independent
- Credible results

### Disadvantages

- Time-table and cost
- Consistency in approach and methodology between differing appraisers could impact effectiveness of the buy-sell agreement
- Requires management input, thought and discussion

## ... The Buy-Sell Agreement – Summary of Required Elements

### **Purchase obligation on death**

- Should be mandatory purchase by the corporation or the remaining shareholders
- Price will be determined under a formula set forth in the agreement
- If local law prohibits corporation purchase, shareholders should be obligated to purchase

### **Option upon voluntary transfer**

- Shareholder desires to transfer his shares, he should be required to offer it to the corporation or remaining shareholders
- Price should be the same formula price
- Prevents outsiders from becoming shareholders
- Can be mandatory



## ... The Buy-Sell Agreement – Summary of Required Elements

### Option upon involuntary transfer

- Addresses involuntary transfers where the shareholder becomes insolvent or bankrupt and his shares pass to a trustee in bankruptcy
- Also applies if the shareholder becomes incompetent and a guardian is appointed
- Shares become subject to the same options in favor of the corporation or the remaining shareholders

### Purchase obligations upon termination of employment

- Mandatory purchase by the corporation or the remaining shareholders
- Mandatory sale by the shareholder on the termination of his employment with the corporation
- Can be an option rather than an obligation
- Price is determined by the same formula price (generally)

## ... The Buy-Sell Agreement – Summary of Required Elements

### Option upon permanent disability

- Agreement should address the purchase event of an owner with a serious illness for a substantial period of time
- Should have a purchase option in favor of the corporation or remaining shareholders upon the disability of the shareholder
- Should be mandatory
- Important to define disability
- Consider tying into regular disability policies

### Purchase price

- Formula price should be described in detail
- Set forth formula in an attached exhibit since the formula provisions are complicated
- Consider a “Certificate of Value” that calculates value annually to ensure formula is still representative

## ... The Buy-Sell Agreement – Summary of Required Elements

### Payment of the purchase price

- Agreement must provide for the mode of payment of the purchase price of the shares purchased
- Payment of life insurance proceeds, if any, should be used to pay down the purchase obligation
- Balance due, after the payout of the insurance proceeds can be paid out in cash and/or a promissory installment note
- Note should be attached as an exhibit
- Note should specify the payment amounts, due dates (i.e.; monthly, quarterly or annual) and the applicable interest rate

### Closing

- Specify the dates of closing
- Make sure the redemption takes place after the purchase of shares by the remaining shareholders
- Avoid dividend treatment

## ... The Buy-Sell Agreement – Summary of Required Elements

### Legend on certificate

- Prevents transfer of shares to bona fide purchasers free of the terms of the agreement
- Most states require a copy of the agreement be filed in the office of the corporation to be binding

### Termination or Amendment

- Need to enumerate the events which terminate the agreement
- Bankruptcy of corporation; dissolution; written agreement of owners
- Provide for the purchase of any insurance policies by a shareholder of any policies owned by the other shareholders or by the corporation if the agreement is terminated

# ... The Buy-Sell Agreement – Summary of Required Elements

## Insurance

- List policies in an attached exhibit
- In the case of the corporation, it should not be obligated to continue policies in force if there is a need for working capital or a deficit in earned surplus
- Individual shareholders should be obligated; unless all parties to the agreement consent to change
- Key-man insurance is also a consideration to replace the talents of a deceased shareholder

## Use of escrow accounts

- Can make the stock purchase agreement self-executing
- To ensure that upon an event of sale and purchase that the provisions are performed, an escrow agent can be used whose instructions for disposition are based on the documents he or she holds
- A responsible financial institution such as a bank or trust company can be used

# ... The Buy-Sell Agreement – Summary of Required Elements

## Other Valuation Provisions

- Effective date of the valuation
- “Drag Along” and “Tag Along” provisions in the event of an outside sale
- “Haircut” provisions for certain Events of Transfer
- “Air bag” clause to limit redemption payments based on actual cash flow

## Spousal Acknowledgement

- Community property states – a must!
- Good idea for other states as well



## ... The Buy-Sell Agreement – Covenant Not-To-Compete

- A non-compete clause (or covenant not to compete) is a term used in contract drafting, and it refers to an agreement under which one party, usually a shareholder, agrees to not pursue a similar profession or trade in competition against another party, usually the company.
- Companies require shareholders to sign non-compete agreements in order to maintain a competitive edge in the market. These agreements seek to prevent the shareholder's abuse of confidential information and trade secrets obtained from his position with the company.
- Non-compete clauses typically are comprised of three elements:
  - 1) The **time frame** during which the shareholder is restricted
  - 2) The **geographical area** in which the shareholder is restricted
  - 3) The **conduct/employment** with respect to which the shareholder is restricted

## ... The Buy-Sell Agreement – Covenant Not-To-Compete

- When the shareholders or key employees of the company have significant knowledge about clients, operations or other matters, a non-compete agreement is essential to protect the interests of the company and its remaining shareholders.
- Non-compete agreements with shareholders could include specified payments over the non-competition period, which could increase the enforceability of the non-compete agreement.

## ... The Buy-Sell Agreement – Covenant Not-To-Compete

The validity of these provisions is generally determined by state courts

- In a few states, non-compete agreements are unenforceable
- Courts in most states, however, do enforce non-compete agreements to at least some degree
- New York State law “disfavors non-compete agreements as an unreasonable restraint of trade” but will generally enforce a non-compete if the restriction is reasonable

Although courts determine reasonableness on a case-by-case basis, a non-compete can be reasonable only if it:

- Is no greater than required to protect an employer’s legitimate protectable interests;
- Does not impose undue hardship on the employee;
- Does not cause injury to the public; and
- Is reasonable in duration and geographic scope

## ... The Buy-Sell Agreement Covenant Not-To-Compete – New Regulations

- On July 9, 2021, President Biden issued an executive order directing the Federal Trade Commission (FTC) “to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility”
- On January 19, 2023, the FTC released proposed regulations declaring most non-compete clauses, and other clauses which have the effect of prohibiting competition, an unfair method of competition”
- On April 23, 2024, the FTC issued a final rule on non-compete clauses which will become effective 120 days after publication in the Federal Register
- The final rule, issued under Title 16 of the Code of Federal Regulations (CFR), Part 910, bans non-compete clauses with employees
- As a result, existing non-compete agreements must be rescinded, and new agreements cannot be entered into

## ... The Buy-Sell Agreement Covenant Not-To-Compete – New Regulations

Two important exceptions to the ban on covenants not-to-compete were included in the final rule:

- First, existing non-competes for senior executives can remain in place; but employers are banned from entering into any new non-compete agreements with senior executives (§910.2)
- Second, the ban on non-compete clauses does not apply to agreements entered into by a person “pursuant to a bona fide sale of a business entity, of the person’s ownership interest in a business entity, or of all of substantially all of a business entity’s operating assets.” (§910.3)

## ... The Buy-Sell Agreement Covenant Not-To-Compete – New Regulations

- “Non-compete clause” is defined as a term or condition of employment that prohibits a worker from, penalizes a worker for, or functions to prevent a worker from: (i) seeking or accepting work in the U.S. with a different person, where such work would begin after the conclusion of the employment that includes the term or condition; or (ii) operating a business in the U.S. after the conclusion of the employment that includes the term or condition
- “Senior executive” is defined as a worker who was in a policy-making position and received total annual compensation for their employment of at least \$151,164
- Business owners should consult with their corporate counsel to ensure that the required notice to rescind existing non-compete agreements with employees is made and to determine the enforceability of any existing agreements with senior executives



## ... Corporate Governance

- Corporate governance can take different forms including a Board of Directors, Executive Committee, Management Committee, etc.
- Whatever the structure, the company's governance will play an active role in major decisions affecting the company, including carrying out the company's buy/sell agreement.
- Corporate governance needs to be incorporated in other corporate documents outside the buy/sell agreement (corporate bylaws, personnel manual, operations manual, etc.)

# Questions



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