SPECIAL ISSUES IN DRAFTING (and Administering) BUY-SELL AGREEMENTS

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Introduction

• Buy-Sell Agreements Should Contemplate (and Be Coordinated with) Estate Planning Documents and Objectives
  ◦ Wills, Trusts and Other Estate Planning Vehicles
  ◦ Family Holding Companies
  ◦ Transfer Tax Planning
  ◦ Confidentiality and Dispute Resolution

• Standard Forms are Often Inadequate
Case Study: Brown Real Properties, LP

- $25M of Income-Producing Real Property, Some Cash
- Actively Managed within the Meaning of IRC Sec. 6166

- 1% General Partner: John Brown Revocable Trust
  25% Limited Partner: John Brown Revocable Trust

- 1% General Partner: Mary Brown Revocable Trust
  25% Limited Partner: Mary Brown Revocable Trust
Brown Real Properties, LP (cont.)

- 10% Limited Partners: Adult children of John and Mary (Anna and Barbara)
- 4% Limited Partner: Adult child of Mary (Charles)
- 10% Limited Partners: Irrevocable exempt trusts for each of Anna, Barbara and their descendants (Anna has lots of pets, but no children at age 40)
- 4% Limited Partner: Irrevocable exempt trust for Charles and his descendants
Brown Family When LP Created

(John is taking the picture ...)
... But there are also *these* Brown family members

*Meet John’s estranged son, David, and his Wife ...*
John’s Estate Plan

- **Pour-Over Will to Revocable Trust**

- **John’s Revocable Trust:**
  - Mary is Successor Trustee
  - Discretionary Bypass Trust for Mary and for John’s descendants
  - Exempt and Non-Exempt QTIPs for Mary
John’s Revocable Trust (cont.)

Upon Mary’s Death (or John’s Death, if John is the Survivor):

- GST exempt assets divided into two shares and added to Irrevocable Exempt Trusts for Anna, Barbara and their respective descendants
- GST Non-Exempt assets divided equally between Anna and Barbara and distributed to them outright
- David, Charles and their respective descendants are specifically disinherited
Mary’s Estate Plan

- Pour-Over Will to Revocable Trust

- Mary’s Revocable Trust:
  - John is Successor Trustee
  - Discretionary Bypass Trust for John and for Mary’s descendants
  - Exempt and Non-Exempt QTIPs for John
Mary’s Revocable Trust (cont.)

- **Upon John’s Death (or Mary’s Death, if Mary is the Survivor):**
  - GST exempt assets divided into three equal shares and added to Irrevocable Exempt Trusts for Anna, Barbara, Charles and their respective descendants
  - GST Non-Exempt assets divided equally between Anna, Barbara and Charles and distributed to them outright
  - David and his descendants are specifically disinherited
John’s and Mary’s Goals

- Maintain Control of the Partnership and Its Business by Family Members
- Protect Family Members from Impulsively Liquidating Their LP Interests for a Quick Buck
- Save (or at Least Defer) Transfer and Other Taxes
John’s and Mary’s Goals (cont.)

- **Protect the Business from:**
  - Estranged Family Members *(David)*
  - Hostile Former Spouses of Family Members
  - Creditors of Family Members
  - Interference from Non-Family Members and Disruptive Family Members
  - Disputes among Family Members
Buy-Sell Agreements: Part I

- Trusts and Entities as Family Business Owners
- Handling Ex-Spouses, Creditors and Involuntary Transferees
- Buying Out Disruptive or Unpleasant Partners
- Rights Arising from Non-Cash and Gratuitous Transfers
Drafting for Trust Owners - Common Considerations -

- Who is the Shareholder/Member/Partner?
  - The Settlor?
  - The Beneficiary?
  - The Trustee?

- What is a “Transfer” by a Trust Owner?
Drafting for Trust Owners - Common Considerations (cont.)

- Whose Death, Incapacity or Divorce Matters?
  - The Settlor?
  - The Beneficiary?
  - The Trustee?
  - A Spouse?
What is a “Permitted Transferee”?

- A Transferee of a Partner’s Interest that Does Not Trigger Buy-Sell Provisions
- Generally Limited to “Family Members”
- Should Include “Family Member Trusts”
What is a “Family Member”?

• Generally Members of a Line of Descent (and Sometimes Ascent)

  • Does the definition of “ancestor,” “descendant” or “issue” match the estate planning documents?
    ...Think about David!

  • Are spouses “Family Members”
    ...If so, how is “spouse” defined?
Concept of a “Family Member Trust”

- **Revocable Trust**
  - **A Family Member…**
    - Is the settlor, sole beneficiary and sole Trustee
    - Has unilateral power of revocation and amendment
  - **A Family Member and his or her spouse…**
    - Are joint settlors
    - The Family Member spouse must exercise all rights as a Partner
    - The Family Member spouse has unilateral power to revoke or amend the trust as to Partnership Interest
Concept of a “Family Member Trust” (cont.)

• Irrevocable Trusts
  ▪ Only Family Members are current beneficiaries and first line remainder beneficiaries
    • Should QTIP Trusts for surviving spouses be Family Member Trusts?
  ▪ Trustee is a Family Member or is approved by the other Partners and/or the General Partner
  ▪ Family Members should have the power to remove a Non-Family Member Trustee
What Should Be a “Transfer” by a Revocable Trust?

- **Death of the Settlor**
  - Partnership Interest must pass to a Permitted Transferee
  - If does not pass to a Permitted Transferee, Buy-Sell Provisions Apply
    - Allow a reasonable period of time to determine who will receive the partnership interest
What Should Be a “Transfer” by an *Irrevocable* Trust?

- Change in Beneficiaries
  - May arise due to death of a settlor, a beneficiary or some other event
  - Trust must continue to qualify as a “Family Member Trust” after the event or Buy-Sell Provisions will apply
What Should Be a “Transfer” by *Any Trust*?

- **Change of Trustee**
  - By resignation, removal, death or incapacity

- **Successor Trustee must be**
  - A Family Member or
  - A non-Family Member approved by the other Partners and/or the General Partner

...or Buy-Sell Provisions will apply
Revocable Trust as a General Partner: Death or Incapacity of the Settlor

- Does the Successor Trustee automatically assume the role of General Partner?
- Does the General Partner Interest convert to a Limited Partner Interest?
- Does the Successor Trustee acquire an assignee interest?
- Does the Limited Partnership dissolve if no General Partner is elected by the remaining Partners?

**Best Solution:** Hold GP Interest in an entity
Back to the Brown Family...

John and Mary take your advice and transfer their GP interests to Brown Asset Management, LLC.

John’s and Mary’s Revocable Trusts are 50/50 members of Brown Asset Management, LLC.

John and Mary are both Managers in their individual capacities.
Drafting for Entity Owners

- What makes an entity a “Family Member Entity” so that it is a Permitted Transferee?

- What changes in the entity should be treated as a “Transfer” of the entity’s Partnership Interest?
A “Family Member Entity”

- Family Members Must Hold Interests in
  - Capital
  - Profits
  - Voting Rights

- How Much of an Interest Must Family Members Hold?
  - 100% of all interests?
  - Supermajority of all interests?
  - 100% of voting interests and supermajority of all other interests?
A “Family Member Entity” (cont.)

- Managers/General Partners/Officers/Directors (“Managers”) Must Be
  - Family Members
  - Non-Family Members approved by Limited Partners and/or General Partner

- One Manager is the “Designated Representative” of the Entity
  - Gives and receives all information relevant to the Partnership
  - Has unilateral authority to act for and bind the entity in all Partnership matters
What Should Be a “Transfer” by an Entity?

Change in Ownership

- If a change in ownership causes the entity to cease to be a Family Member, Buy-Sell Provisions apply.
- If change is due to the death of an owner, allow a period of time to determine status before Buy-Sell Provisions apply.
  - *Deceased Owner’s interests could be acquired under the entity’s own Buy-Sell Provisions rather than the deceased Owner’s estate plan.*
What Should Be a “Transfer” by an Entity?
(cont.)

- **Change of Management/Control**
  - By resignation, removal, death, or incapacity
  - By adding a co-Manager
  - Failure to appoint a Designated Representative
How John’s Business Interests are Held after His Unfortunate Death

- **Bypass Trust for Mary and Descendants**
  - Holds John’s 50% interest in Brown Asset Management, LLC (GP)
  - Holds a 15% LP interest

- **QTIP Trust for Mary**
  - Holds a 10% LP interest
  - Holds balance of John’s assets
Fast Forward >>>

The Brown Family 20 Years Later

- On wife # 3, so far, so good
- Family likes him (the spouse) more than her
- Spendthrift
- Mary remarried after John's death
- Unhappy since divorce; angry with entire family
- Want to give their entire estate to Humane Society
Meet Charles Lindquist  
(Mary’s 58 Year Old Son)  
Loves Sports and Sports Bars  *(and Women Who Frequent Them)*  
*Married Three Times*  
Has Run the Family Real Estate Business  
since John’s Unfortunate and Untimely Death
Drafting for Divorce or Death of Non-Family Member Spouse: The “Marital Interest”

- Any interest in the Partnership of a Non-Family Member Spouse, Whenever or However Acquired
  - During life or upon death or divorce
  - Prior to marriage or during marriage
  - By voluntary permitted transfer
  - By other voluntary transfer
  - By operation of law
    - Community or other marital property
    - Inheritance rights
    - Contract to make a will
Drafting for Divorce or Death of Non-Family Member Spouse

Disposition of a “Marital Interest”

- Marital Interest must be allocated to Family Member spouse (or other Permitted Transferee) within a stated time frame or Buy-Sell Provisions apply
- Same rule if Non-Family Member spouse dies and does not leave Marital Interest to Family Members
- General Partner can determine the scope of the “Marital Interest” if unclear
- Should spouses sign a Consent and Waiver?
Fiduciary Duties and a Marital Interest in Divorce

- **Valuation and Terms Must Be Reasonable**
  - Any discount or onerous terms will likely be factored into division of marital property *against* the Family Member spouse
  - Price and terms might not be enforced if deemed a forfeiture or a breach of spousal fiduciary duties
Fiduciary Duties and a Marital Interest in Divorce (cont.)

- Courts Can Be Very Protective of the “Out Spouse” in these Situations

- Family Collusion against the “Out Spouse” is Expected, if Not Presumed
Meet Anna Brown-Smith, Age 52
(...but you will wish you hadn’t)

Argumentative, Opinionated and Drinks Too Much
Can Totally Disappear for Long Periods of Time
Ungrateful when Business is Going Well
 Entirely Charles’s Fault if Business Hits Tough Times
Sued for Libel for Lawn Signs Disparaging Her Neighbor
Wants to Trade a Portion of Her Partnership Interest
with a “Friend” for a 40 Foot Cruising Sailboat
Buying Out Problem Partners

- Focus is Protecting Business from Disruptive Partners (*even Family Members or prior approved transferees*)
- Generally Requires a Supermajority Vote
- Should **Not** Require any Reason (*leads to litigation over whether reason exists*)
- Price and Terms Should Be Consistent with Other Mandatory Sales
Creditor Protection

• Focus is Protecting Business from Partners’ Creditors

• Valuation and Terms Must be Reasonable
  ◦ Price and terms might not be enforced if deemed a forfeiture
  ◦ Best if same price and terms apply in other contexts

• Fraudulent Conveyance Issues Possible if Not for Full Consideration
Uniform Voidable Transactions Act

- Applies Rules to Current and Future Creditors if Purpose is to Hinder, Delay or Defraud

- Comment 8 on Intent, reads in part:

  “A transaction that does not place an asset entirely beyond the reach of creditors can nevertheless ‘hinder, delay or defraud’ if it makes the asset more difficult for the creditors to reach. Simple exchange by a debtor of an asset for a less liquid asset, or disposition of liquid assets while retaining illiquid assets, may be voidable for that reason.”

- Could the Conversion of a Partnership Interest into an Installment Note with Deferred Payment Terms be a Voidable Transaction?
  - Is the debtor the transferor? Is the note really less liquid or marketable than the Partnership Interest?
Right of First Refusal: Transfers for Non-Cash Consideration

- Many Agreements Fail to Address Proposed Transfers that Involve *Non-Cash Consideration* (such as a 40 foot cruising sailboat)

- Should Provide the Option to Purchase for Offered Consideration/Offered Terms OR for Price and Terms as Set Forth in the Buy-Sell Provisions
Right of First Refusal: Gratuitous Transfers

- Many Agreements Fail to Adequately Address Proposed Transfers that Involve NO Consideration *(Gifts/Donations)*
- Should Provide the Option to Purchase for the Price and Terms Set Forth in the Buy-Sell Provisions
Buy-Sell Agreements: Part II

- Valuation Issues
- Post-Mortem Administration
- Dispute Resolution and Confidentiality
- Charitable Vehicles as Business Owners
Meet Mary’s New Husband
Sean O’Malley

Likable Irishman Mary Met while Traveling
Naturalized U.S. Citizen, Not Wealthy, Age Appropriate
No Children, Loves Mary Dearly, So-So Health

(a.k.a. The Perfect Spouse for Estate Planning)
Mary’s New Estate Plan

- **Intervivos QTIP for Sean**
  - Goal is to defer estate tax, secure Sean’s applicable exclusion and GST tax exemption
  - Funded with a 20% LP interest
  - Augmented at Mary’s death with assets from her trust in excess of her Applicable Exclusion
  - Upon Sean’s death, distributed in accordance with Mary’s own plan
    - *Limited to Sean’s applicable exclusion if Mary is the Survivor, with the balance held in a continuing QTIP for Mary’s benefit*
Mary’s New Estate Plan  
(cont.)

- Applicable Exclusion Amount Distributed to Descendants at Mary’s Death if Sean is Survivor
  - GST exempt assets divided into three equal shares and added to Irrevocable Exempt Trusts for Anna, Barbara, Charles and their respective descendants
  - GST Non-Exempt assets divided equally between Anna, Barbara and Charles and distributed to them outright
Buy-Sell Provisions and QTIP Trust

- Is the QTIP Trust Mary Created for Sean a Permitted Transferee?

- Could Events Occur during Sean’s Lifetime (or during Mary’s Overlife) that Result in a Required Sale of LP Interests in the QTIP?
Buy-Sell Provisions and QTIP Trust (cont.)

- Could the QTIP Trust be Required to Sell the LP Interest for Less than Full and Adequate Consideration in Money or Money’s Worth as Determined for Federal Transfer Tax Purposes?

- Could the Terms of the Buy-Out Create a Transfer of Sean’s (or Mary’s) Income Interest under IRC Sec. 2519?
Buy-Sell Provisions Not Likely to Control Transfer Tax Value

- Requirement to Sell for Less than
  - Final federal estate tax value at death
  - Full and adequate consideration during the lifetime of the surviving spouse

  .... *Will Reduce the Marital Deduction*

- Beware of Circular Calculation
Buy-Sell Provisions Not Likely to Control Transfer Tax Value
(cont.)

- Simply Referring to Final Estate Tax Values Insufficient if Purchase Is Not Effective as of Date of Death

- Can have special Buy-Sell Provisions dealing only with LP Interests passing under the marital deduction
Buy-Sell Provisions Not Likely to Control Transfer Tax Value (cont.)

- Consider requiring an Independent Trustee for the QTIP to secure its own appraisal and negotiate the purchase price

- Consider requiring the reporting of any purchase to the IRS for estate or gift tax purposes and a purchase price adjustment if necessary
Who Pays Transfer Tax if Marital Deduction Reduced or Sec. 2519 Triggered?

- State Apportionment Statutes Will Not Likely Allocate Tax to the Buyer (not a “Beneficiary”)
- Consider Adding Requirement to the Buy-Sell Provisions that Buyer Incurs any Transfer Tax
  - Creates a net gift for lifetime transfers (and a “reverse” circular tax computation)
  - *Not* a complete solution for Sec. 2519 tax on entire QTIP
    - Already a net gift calculation
    - QTIP assets are still included in the spouse’s estate
Reducing Sec. 2519 Risk: Provide Spouse a Limited Power of Appointment

- Creates Incomplete Gift Argument
- Can Be Very Restrictive as to Permissible Appointees
- Can Require Consent of a Non-Adverse Party
- Could Be Limited to QTIP Assets Treated as Gifted under Sec. 2519
Reducing Sec. 2519 Risk: Provide Surviving Spouse a Limited Power of Appointment (cont.)

- “Bargain sale” Portion is Still a Completed Gift to Buyers

- Inclusion of Sec. 2519 QTIP Assets in Surviving Spouse’s Estate
  - Under Secs. 2036/2038, not 2207A
  - Tax apportionment and recovery rules are different
  - Consider applying 2207A rules in all circumstances
Buy-Sell Agreements and Post-Mortem Administration

- Concern for Valuation Inconsistencies
- Can Transfers be Prohibited until Audit is Over? Challenges Include:
  - Uncertain time frame to conclude audit
  - Death of more than one partner in close succession (multiple audits)
  - Involuntary transfers
  - Transfers for consideration v. gift transfers
Buy-Sell Agreements and IRC Sec. 6166

- Requirements for Sec. 6166 Estate Tax Deferral
  - Interest(s) in *active* trade(s) or business(es) are more than 35% of Decedent’s gross estate
  - Decedent held at least a 20% interest in each active trade or business
  - Each active trade or business has 45 or fewer owners
Buy-Sell Agreements and IRC Sec. 6166 (cont.)

- **IRS May Accelerate the Deferred Estate Tax if:**
  
  - Distribution, sale, exchange or other disposition of 50% or more of the value of the decedent’s interest in the closely held trade or business
  
  - Withdrawal of 50% or more of the value of the closely held business
  
  - IRS is more likely to accelerate on transfers to non-family members
Section 6166 and Mary’s Estate Plan

• **If Mary Predeceases Sean**
  
  ◦ Only 16% of LP is in Mary’s taxable estate (John’s LP Interests in QTIP + Mary’s own LP Interests not gifted to Sean’s QTIP)
    
    • *But all tax is deferred anyway by the QTIP for Sean if it qualifies for the marital deduction*
  
  ◦ Must allocate an LLC interest (GP) to the QTIP for Sean’s estate to qualify as holding an “active business” interest
Section 6166 and Mary’s Estate Plan (cont.)

- If Sean Predeceases Mary
  - Mary’s estate may no longer qualify for Sec. 6166
  - Mary might want to purchase some LP interests from the children or their trusts to meet 20% requirement

Take Away: Buy-Sell Provisions Can Alter Sec. 6166 Mathematics (positively or negatively depending upon the facts)
Dispute Resolution

- Considerations in Family Dispute Resolution
  - Time
  - Cost
  - Privacy
  - Preservation of Family Relationships

- Choice of Venue
  - Location of Business or Beneficiaries?
Dispute Resolution Provisions

- Confidentiality
- Small Claims Preservation
- Mandatory Mediation
- Mandatory Arbitration
  - Limited discovery?
  - Non-appealable?
Dispute Resolution Provisions (cont.)

• **How Are Costs Shared?**
  ◦ Agreed allocation?
  ◦ Party who prevailed pays nothing?
  ◦ Party determined to have prevailed on the most points pays nothing?
  ◦ Arbitrator/mediator decides on appropriate allocation among parties?
Valuation Disputes

- Agreed Price/Book Value/Other Fixed or Objectively Determinable Value
  - Fewest avenues for dispute *but*...
    - Unlikely to fix value for transfer tax purposes
    - May be a forfeiture v. ex-spouses and creditors if too low
    - Maybe best solution for small fractional interests
Valuation Disputes (cont.)

• **New Appraised Value**
  ◦ Fairest but most expensive approach
  ◦ Appraisers can have different opinions

• **Previous Appraised Value**
  ◦ Possibly appropriate for small interests or multiple sales of similar interests that are close in time
  ◦ Could allow buyer or seller opportunity to secure new appraisal at their own expense (to be shared if new appraisal favors that party)
Anticipating Disputes over Appraiser Selection

- Agreement Names Appraiser
  *Might not be available*
  *Might no longer be as good as they once were (changes in personnel)*

- Each Party Provides a List of Appraisers in Order of Preference, Pick Highest Ranking Appraiser

- Two Appraisers Pick a Third
  *What appraiser wants to do that?*
Anticipating Disputes over Appraiser Selection (cont.)

- **Average of Two (or More) Appraisals**

  *So both must be outrageous in case one of them is?*

  *Also a very expensive option*

  *Will this apply to both valuation of assets in the business or just the business/business interest?*

  *Might be appropriate for very large valuations*
Anticipating Disputes over Appraiser Selection (cont.)

- Pick an Appraiser by Lot
- Majority of Limited Partners and/or General Partner Selects the Appraiser
- Appraisal Committee Consisting of Insiders and Outsiders Pick Appraiser
Other Valuation Disputes

- Disputes over Methodology to be Applied
  - Net asset value
  - Discounted cash flow model
  - Other?
  - Might differ based upon relative size of interest
Other Valuation Disputes (cont.)

- Disputes over Appropriate (or any) LOM/LOC/BIG Discounts
  - Could agree applies in accordance with transfer tax valuation principles
  - Should principles of Chapter 14 (particularly Section 2704) be applied consistently, regardless of the relationship of buyers and sellers?
Other Valuation Disputes (cont.)

- Disputes over Communication with Appraisers
  - Could appoint two designated representatives (for Buyers, collectively and Sellers, collectively)
    - Receive all information
    - Communicate directly with appraiser
  - Could permit all points of view to be communicated to appraiser in writing
Meet Barbara Brown-Davis, Age 55
(and her furry family members)

Content, Happily Married for 30 Years, No Children
Owns 6 Rescue Dogs and 1 Rescue Cat
Entire Estate to Support Animal Welfare Charities
Also Considering Lifetime Charitable Gifts
Addressing Ownership by Charitable Vehicles

Most Common Vehicles

- Bequests to Charities
- QTIP Trust with Charitable Remainder
- Lifetime Gifts to Charities
- Private Foundations
- Donor Advised Funds
- Charitable Remainder Trusts
- Charitable Lead Trusts
Addressing Ownership by Charitable Vehicles (cont.)

Special Issues

- Involvement of charities (and their lawyers) to protect the charities’ interests
- Involvement of Attorney General to protect the people’s interests
- Direct and indirect self-dealing
- Excess business holdings
- Income tax charitable deductions
- Estate and gift tax charitable deductions
SPECIAL ISSUES IN DRAFTING (and Administering) BUY-SELL AGREEMENTS

QUESTIONS?