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SOME PRACTICAL ASPECTS OF BUSINESS BUY-AND-SELL AGREEMENTS

By

ARTHUR L. BERGER*

The growth of interest in business buy-and-sell agreements is primarily attributable to the spade work of life insurance companies and their representatives. Since the most useful explanatory material exists in the form of insurance company pamphlets, the average attorney’s unfamiliarity with the subject is not surprising. The field, however, is not complex, it is important, and it is one in which the attorney can render substantial guidance to his clients. This article is intended to point up the areas where guidance may be necessary and generally to give the attorney an indication of some of the problems and possible solutions to them.

The term “business buy-and-sell agreement” refers to any agreement which contemplates the sale of an interest in a business at the death of its owner. Generally, it is a reciprocal arrangement among parties all of whom own interests in the business, so that the identification of buyer and seller depends upon the order of death. The business is generally a “closed” one, and the agreement may be between a sole proprietor and his employees, partners, or shareholders, or it may be between a partner and his partnership or shareholders and their corporation. It can be a fixed commitment by one party to sell and the other to buy, or it can be an option. The option can be exercisable by either the seller or the buyer.

The distinctive characteristic of such an agreement from the standpoint of a party whose business interest is being made subject to sale is its testamentary nature, though it may not be testamentary from the standpoint of state law.¹ It represents a disposition of assets at death through what is almost literally an unalterable will. From his standpoint as a prospective purchaser, since in most buy-and-sell agreements all the parties are both prospective purchasers and prospective sellers, the buy-and-sell agreement represents an important business commitment. In view of these facts, the matter must be approached with great care. This is especially true with regard to obtaining the necessary information, and, in addition to the basic information for preparing the agreement, the attorney should have a reasonably complete picture of the personal dispositive plan of each party, the company’s financial history, its prospects, and the personalities of the principal personnel.

From the attorney’s standpoint, the distinctive feature of buy-and-sell agreements is that while they contain all the elements of ordinary agreements of sale, there are the additional elements of the indefinite time of execution and the un-

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¹ Infra p. 19.
certain status of the parties as buyers or sellers. The complexity which these add to the drafting problem is appreciable. Another point to be noted is the mutual reliance of the parties on their attorney for aid in achieving an agreement which will be equitable to all under any contingency. This represents a notable change in the lawyer’s role from litigation specialist to business counselor.

The remainder of the article is divided into sections dealing with questions of policy, Pennsylvania law, and draftsmanship, respectively. The division was an arbitrary one, and it has not been adhered to where it appeared to detract from the natural order of discussion.

**Policy Considerations**

*To Sell or Not To Sell*

In most cases, buy-and-sell arrangements are desirable from the standpoint of the deceased owner as well as from that of the survivors. However, this is not so in every case, and the attorney who points out that an inter vivos arrangement is not the best possible solution to his client's problems has rendered a substantial service, albeit a service which results in his not writing any buy-and-sell agreement at all.

An intelligent decision whether to enter into a buy-and-sell agreement requires knowledge of what will happen if such an arrangement is by-passed. Usually when an attorney is called upon for advice in this field the client either has no will or a simple one in which the problems involved in disposing of his business interest were not seriously considered. It is only if this arrangement does not appear to be satisfactory that the question of entering a buy-and-sell agreement arises.

In the case of a sole proprietorship, the law relating to disposition at death is simple and relatively clear. The executor's initial duty is to dispose of the business as expeditiously as possible. If he chooses to continue the business, he does so at his own risk, though he may escape surcharge for emergency operation where discontinuance would result in considerable loss. For more extended operation during administration, it is possible to obtain court approval, and it may also be possible to incorporate. With court permission, the business can be distributed in kind, though such distribution may be thwarted by the objection of a beneficiary. It is, of course, clear that if the rights of creditors are not involved, the executor can obtain immunity for any action if he obtains proper waivers from

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2 Shinn's Estate, 166 Pa. 121, 30 A. 1026 (1894).
3 Nagle's Estate, 305 Pa. 36, 156 A. 309 (1931).
4 McCormick's Estate, 19 Berks (O. C. Pa.) 108 (1926).
8 Evan's Estate, 30 Dist. (O. C. Pa.) 253 (1921); But cf. Park's Estate, 19 D. & C. (O. C. Pa.) 219 (1933).
the beneficiaries. In the light of this situation, it would appear that where there is a single principal beneficiary, such as a wife, who is willing and able to run the business or where the business can readily be sold without appreciable loss of value, there is no reason for any complicated dispositive arrangement. This will also be true where several principal beneficiaries are involved, so that no one of them has a sufficient interest to take the business in kind, provided that either the business is readily salable or any one of the beneficiaries is willing and able to manage the business and the others are willing to accept shares of stock or interests as limited partners in the business. If these conditions are not satisfied, the discussion of some other arrangement becomes necessary.

With respect to a partnership interest, the situation is analogous. That is, in the absence of a court order or the permission of the beneficiaries, the executor is under a duty to make an expeditious disposition. Here, however, there is an additional factor in the automatic dissolution of the partnership which occurs at the death of a partner. Thus, either the executor or the surviving partners can force a sale of the business. This means that from the standpoint of a deceased partner his partnership interest can be retained for the benefit of his beneficiaries only if the surviving partners are willing to accept one or more of the beneficiaries into the business, either as partners or shareholders. From the standpoint of the survivors, it means that they can continue the business only if they are willing to accept a new associate or to meet the highest price which can be obtained for the business on the open market. Needless to say, in partnership situations the desirability of some sort of unambiguous arrangement is generally quite clear.

In the case of a corporation, the requirement of an immediate cessation of business does not apply, although this may not be so if there is only a single shareholder. In the latter event, the problem is similar to that of the sole proprietorship. Where there are several shareholders, the danger of the destruction of the business which exists in the case of a partnership is no longer present, so that if a shareholder wishes to have his interest retained after his death, no problem is raised. However, whether to retain such a shareholding interest, unless perhaps it represents a controlling interest, is usually somewhat dubious, and this question is discussed below.

Assuming that the ordinary legal processes indicated above do not appear to be satisfactory, each owner of a business interest must usually face the problem of entering a buy-and-sell agreement in the light of two contingencies. One, he may be the first to die and therefore the one whose interest will be sold. Two, he may be the survivor and hence the one who will be buying. As a prospective seller, he must ask himself two questions:

1. Is this business interest one which I would like to have retained for the benefit of my family and other beneficiaries?

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10 Act of March 26, 1915, P.L. 18, part VI, § 29 (59 P.S. § 91); But see infra n. 29.
If it is not, are the terms of this particular proposition sufficiently attractive to justify my entering into it?

As a prospective buyer, the questions are just the opposite:

1. Is this a business interest which I am interested in buying if I survive my associates?

2. If so, is this particular proposition sufficiently attractive to justify my entering into it?

Although the questions are similar, needless to say, the interests to be protected are diametrically opposed. Where the parties occupy the dual status of prospective buyer and seller, the realization of the conflict is likely to lead to an agreement which is fair to all. Where it is reasonably clear who is to be the seller and who the purchaser, as in the case of a prospective sale from a sole proprietor to his employees or an older partner or shareholder to his younger associates, an appreciably greater adversary flavor may enter. From the standpoint of both prospective sellers and buyers, the factors which must be considered in determining the attractiveness of the arrangement which is proposed are the usual ones applicable to any sale, for example the purchase price, terms of payment, security, and the like. In determining whether to consider the sale initially or to retain the interest, however, there are other factors which tend to vary somewhat depending on the form of business involved.

In the case of a sole proprietorship, the main problem often concerns obtaining satisfactory management for the business after the death of the owner. In many cases, the earning record of the business may make it more attractive than any investment that could be purchased with the proceeds of the sale. Although a sale to employees may still turn out to be the most practical plan, the possibility of retention should at least be carefully explored. In this connection, the possibility of placing the business in trust, with either an employee, a corporate fiduciary, or both, as trustees, should not be overlooked. A recurring situation is that of the son who is in a business which will have to be the main support of his mother. One way in which this problem is sometimes solved is merely to put a charge on the business in favor of the mother. From a practical as well as a drafting standpoint this is much less satisfactory than either a trust of the business, with the son as trustee and remainderman, or a straight buy-and-sell agreement with the proceeds payable in installments. Even where obtaining the maximum return from the business indicates retention, there may be factors which lead to a sale. Among these, two are noteworthy. First, the business may not be a great part of the owner’s estate and may not be the prospective source of his wife’s support, and second, there may be strong feelings of moral duty toward the employees which dictate allowing them to obtain control. The latter reason may become more persuasive when viewed in the light of the considerable increase in efficiency and loyalty which is likely to be the result during the lifetime of the owner. From the standpoint of the employee-
purchasers, the only hitch is likely to be the working out of a feasible method of financing the purchase. There may be some question about the ability of the employees to carry on successfully without the owner, but it is a rare employee who is fazed by this prospect.

In the case of a partnership, finding competent management is generally no problem, since it exists in the persons of the surviving partners. In fact, it is this which gives rise to the main difficulty. A partner may be very satisfied with the state of the business, and contemplate with some satisfaction the possibility of one of his beneficiaries as a partner or a shareholder after his death, but he is likely to face the reverse possibility, of having a beneficiary of his partner as an associate, with a shudder. It is possible, of course, that a particular son or son-in-law is one whom the other partners would be willing to accept. In such a case, what is probably called for is an agreement for the admission of the new partner at the death of the old, which, though unenforceable specifically, is likely to carry sufficient moral suasion to insure compliance. There may be other situations, particularly where relatively large amounts of capital are invested in a stable business, which lend themselves to arrangements for continuing the interest of a deceased partner after his death, and these possibilities should not be ignored. But in the usual case, each partner's desire to run the business with people of his own choosing is likely to be so much greater than his inclination toward having his own interest continued in the family that the possibility of an arrangement for a mutual retention of interests will receive short consideration in his own mind. The question then becomes one simply of whether a present buy-and-sell agreement is preferable to the normal processes of partnership dissolution. In such a dissolution, the surviving partners have a decided advantage. Although they have a duty to meet the highest price offered by an outsider, their position is analogous to that of a mortgagee at a foreclosure sale, with the probability of their being able to make a bargain purchase being quite high. Despite this, there are several reasons why a buy-and-sell agreement will usually turn out to be an attractive arrangement. First is the simple fact that no one knows who will be the survivor, and the only way a partner can be certain that his estate will receive a fair price for his partnership interest is to enter into a fixed commitment beforehand. Second is the less objective but equally compelling fact that each of the partners will probably feel at least some responsibility for the families of the others, and a buy-and-sell agreement is probably the most satisfactory way in which this obligation can be discharged. Where a given partner controls a substantial majority of the firm's assets, the situation tends to approach that of the sole proprietor who is considering selling out to employees.

While the holder of a partnership interest may have some inclination towards wanting its retention, there is little chance of this in the case of a shareholder. The reasons for this are the lack of control exerted by a minority corporate interest, in-

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cluding the inability to force dissolution, the traditionally meager dividend policies of closed corporations, and the extreme unmarketability of such interests. It is these factors which tend to reduce the attractiveness of an inter vivos buy-and-sell agreement from the standpoint of the shareholder in his role of prospective purchaser, his analysis probably being that the existence of a minority shareholder will not substantially affect his control and that, in any case, the purchase of the shares from the beneficiaries of the deceased will not be difficult. As with the partnership, it is such factors as the possibility that he may be the first to die, and the consequent desire that his estate have a ready market for its shares, and the feeling of a community of interest with the other shareholders, that are likely to lead to the decision to enter into an inter vivos commitment. Although this is the typical situation, there may be other reasons which will intensify or decrease the desire to buy or sell. As a potential seller, the shareholder may be influenced by such things as the existence of a consistent dividend paying record during his lifetime, the fact that he has other assets which can support his family, or a confirmed belief in the future of the business. As a potential buyer, he may be influenced by the psychological problem inherent in a majority-minority stockholder situation, the inevitable pressure for the payment of larger dividends, and the fact that part of his own efforts will result in appreciation of the stock of persons who are not involved directly in the business operation. Here, again, if the shareholder controls the corporation, the analysis is akin to the employer-employee one. One other possibility which might be pointed out is a recapitalization of the corporation which will give the estate of the deceased shareholder a preferred stock interest in exchange for his common shares, a solution which will sometimes satisfy the requirements of both parties.

Whatever the form of the business, the result of this analysis will in most cases be a decision that a buy-and-sell agreement is desirable. It may be, however, that one or more additional factors may cause some hesitation about entering into an immediate commitment. Among these might be the following. The business may be comparatively new, so that the desirability of retention is not clear. In the case of a sole proprietorship, the owner may not yet have complete confidence in the employees' ability to meet the necessary financial commitments. There may be children in the picture who are not yet old enough to permit a determination as to the likelihood of their going into the business. Finally, there may be a vague feeling that it would be better to wait until a death has occurred before having any fixed commitments. In any of these cases, several alternatives exist in the form of option arrangements. One is to give the estate of a deceased an option to sell to the survivors. This is advantageous to the deceased because it puts a floor under the price of his interest. Another possibility is to give an option to purchase to the survivors. This has the effect of putting a ceiling on the price they will have to pay. Although it is very advantageous for the survivors, it is correspondingly less so to the estate of the decedent, and, considering the human values that may be involved, should be seriously considered before being recommended. Another possi-
bility is to make the agreement mandatory but to give the deceased a right to bequeath his interest to certain designated legatees, his spouse and lineals in the usual case, by specific bequest. This allows a little more flexibility, though from the standpoint of the survivors it may result in just what they want to avoid.

Valuation

Although the valuation of business interests is something less than a science, the subject is of prime importance, since the method used will determine the purchase price. What makes the problem especially difficult is the absence of an adversary transaction to help in determining what would be the verdict of the market place, which is what is being sought. The quest is not made easier by the fact that the purchase may not occur for ten or fifteen years. All that can be done is to try to fix the value as carefully and fairly as possible, keeping in mind that what is being dealt with is often the principal asset of the various parties' estates.

One general observation is that there tends to be an under-estimation of the values involved. One reason is probably that buy-and-sell agreements are sometimes "sold" on the basis that the values fixed by them will be binding for federal estate tax purposes. Until federal estate tax rates reach 100%, this is a losing proposition. Where a client appears to be primarily tax motivated, he should be told gently but firmly, first, that if he is dealing with unrelated business associates his duty to his beneficiaries is to set as fair a price as possible and, second, that if he is dealing with some one in his family, such as a son, the chances are that the agreement will not have the binding effect which he might like it to have. Generally, the law concerning the effect of buy-and-sell agreements on estate tax valuations is far from clear. If the agreement is with a close relative, if it gives the seller an "out" by permitting a sale of the interest during his lifetime without first offering it to the other parties, or if it does not require the estate of the deceased to make the sale, either by its own terms or at the option of the survivors, it will have little persuasiveness in valuation. If the agreement is with non-relatives and provides for a binding obligation to sell at death, with appropriate inter vivos restrictions, it will probably be given consideration in the valuing process. Also, it will be helpful in avoiding inflated figures and in promoting an expeditious settlement, but to give any assurance that it will "do the trick" is not warranted.

In general, there are three methods by which the business, and consequently the interests in it which are subject to sale, may be valued: (1) by the partners during their lives; (2) by an appraisal at death; or (3) by the application of a formula at death. Where the partners do the valuing, there is generally a schedule

12 Accord: Claire G. Hoffman, 2 T. C. 1160 (1943).
13 Matthew's Estate, 3 T. C. 525 (1944).
14 Krauss v. U. S., 140 F.2d 510 (5th Cir. 1944).
15 Kline v. Commissioner, 130 F.2d 742 (3rd Cir. 1942).
16 Commissioner v. McCann, 146 F.2d 385 (2nd Cir. 1944).
placed at the end of the agreement into which can be entered at the beginning of each year the value which is to prevail for the year. This has the obvious advantages of being certain, simple, and a value which the partners have agreed upon. It has the disadvantages, however, of raising a yearly problem which the partners may ignore, that the partners may not be the best qualified persons to make the appraisal, and that the attitude of each partner may vary with such extraneous circumstances as the state of his health. An appraisal at death has the advantages of being current and probably realistic. On the other hand, problems of personal reeling may arise, it involves some delay and expense, and competent appraisers may be difficult to find.

Probably the most generally satisfactory method of valuation is through use of a formula. It supplies a current automatic value without the necessity for participation by either the parties or outsiders, and while the results may be arbitrary the parties are likely to find it a convenient vehicle for solving what could otherwise be a troublesome problem. This is a point at which it is desirable to request the services of the accountant for the business. The problem is usually one of the weight to be given to such good will as may exist. If it is decided not to consider good will, the use of asset values, either book or appraisal, is likely. Where consideration is to be given to good will, its extent is probably most easily measured by a formula which involves capitalizing the earnings of the business for a predetermined number of years prior to the purchase at a predetermined rate. Ten percent is a rate that is frequently used, but where the business is at all sizable, this is a matter to which considerable attention should be given. Where a more rough and ready method is desired, it is sometimes possible to use asset values and to add a fixed sum or a fixed percentage for good will. One final note of caution is the necessity for a careful perusal of the financial statements of the business to determine the extent to which the expected operation of the formula will be affected by accounting practices. The necessity for making allowances for salaries for the proprietor or partners where a capitalization of earnings method is used should not be overlooked. Where insurance is used to fund the agreement, the question of the inclusion of the cash values or proceeds at death must be answered, and this is discussed below.

To make the picture complete, it might be pointed out that the choice of method is likely to depend to some extent on such considerations as whether or not the agreement is being funded by insurance, the terms of payment, the general estate situations of the various participants, including the estate tax brackets into which they fall, their desire to have commitments which they themselves can meet relatively easily, and the existence of deferred compensation arrangements which may be substituted for the recognition of good will.\textsuperscript{17}

\textsuperscript{17} Infra p.56.
Assuming that the decision to enter into a buy-and-sell agreement has been made, the question naturally arises as to how the purchase price is to be paid. It is here that the subject of insurance first arises, and it is a subject whose relationship to the overall transaction is not always clearly understood. What must be kept in mind is that what is occurring is simply the sale of a business. In the ordinary sale, the seller will have satisfied himself as to the ability of the purchaser to make the necessary financial commitment or to furnish adequate security, and the matter will be wound up soon after the execution of the contract to sell. Here, the actual transfer may not occur for a period of many years, and then only at the death of one of the parties. This raises problems which must be faced. From the standpoint of a potential seller, his business interest is likely to represent a substantial portion of his estate, and one he may want to be certain can be turned into cash relatively quickly at his death. If the immediate need for cash does not appear serious, an installment payment arrangement may be satisfactory. Even here, the difficulty of ascertaining the ability of the parties to furnish adequate security can easily be appreciated. From the standpoint of the potential buyer, the problem is perhaps not as serious, but even he may be weighed down by the possible deflation of the business as a result of the death of one of the principals and by the increased difficulty of meeting his purchase commitment which would result. He must also keep in mind that making of the payments will be made more difficult because the funds will be available only after payment of income taxes on them by himself. An obvious answer to the seller's problem is to require the potential purchaser to take out insurance on the seller's life in an amount approximately equal to the anticipated purchase price. From the standpoint of prudent business planning, the taking out of such insurance represents an equally obvious answer to the problem of the potential buyer. Since in the usual case each party occupies both roles, each is in the position of having a sound reason for wanting the other parties to take out insurance on his life and for himself to take out insurance on theirs. It is clear that none of the parties is in a position to ask the others to furnish security in the form of insurance for their potential purchases unless he is willing to furnish similar security for his own. Where there is some reluctance to do the latter, the question becomes one of balancing the inclination to have security against the disinclination to furnish it.

In answering the insurance problem, the question often resolves itself into whether the premium which each party is considering spending for insurance to fund the potential purchases from his associates might not better be spent on personal insurance on his own life. The argument made is that, assuming that equal amounts of insurance can be purchased in both cases, if the owner purchases insurance on the life of an associate and the associate does just the reverse, at the death of each his estate will receive only the amount which has been determined as the purchase price for his business interest. If each instead purchases in-
surance on his own life, the estate will receive the insurance proceeds in addition to having a fixed commitment by the associates to purchase the business. It is recognized that this eliminates the security for the purchase price, but the larger total amount received by the estate is said to justify the sacrifice. While this reasoning is correct, it does not tell the whole story.

First, business insurance of this type is not in any way intended as a substitute for the ordinary personal insurance protection which most people feel they should carry for themselves and their families. Assuming that each party does in fact have an adequate personal insurance program, the argument against the use of business insurance loses its weight. On the other hand, a party who does not have an adequate program may be correct in feeling that any contemplated expenditure, whether for the purchase of business insurance or a new automobile, should be deferred until his personal insurance needs have been met. It is clear, however, that the need for personal insurance and the need for business insurance are not interchangeable. Second, the argument overlooks the fact that for the party who is the survivor the problem of raising a sufficient amount to meet his purchase commitment may well result in a less advantageous position for his estate than if he had followed the dictates of ordinary business prudence. In addition, there are other reasons pointing toward the use of an insurance funding arrangement. Among these are the facts that the cash values of the policies purchased by a deceased on the lives of his associates will to some extent offset any deficiency in his personal insurance program, the existence of the funding arrangement will probably mean a larger purchase price, and the fact that only the business interest or insurance, not both, will be includible in the estate of a deceased will result in some estate tax saving. Altogether, the decision not to use an insurance funding arrangement should be made only after careful consideration.

There are several other matters related to the funding problem which may arise. Where it is clear who is to be the seller and who the purchaser, such as where employees are buying from a sole proprietor or one of several partners or shareholders is appreciably older than the others, it is obviously necessary only for the prospective purchasers to make funding arrangements. One difficulty that sometimes arises in the proprietorship situation is that while the employees are perfectly willing to enter into the agreement they are not so willing, or not able, to make the necessary year-to-year insurance premium payments. The result of this may be the necessity for pay raises in an amount sufficient to cover the premiums. While this will undoubtedly have a salutary effect morale-wise, it must be recognized for what it is, a method by which the employer is essentially using his own money to buy the business for his employees. This is one situation where a party whose main interest is his own economic well-being might justifiably decide to use the money involved for personal insurance and take a chance on the ability of the employees to raise the purchase price. Where more than two shareholders or partners are involved, it is important to note that al-
though the agreement may be fully funded at the outset, the death of any one results in underfunding. If, for example, there are three partners in a business which has been valued at $99,000, and on the basis of this insurance in that amount has been procured, the death of any one results in a $33,000 payment to his estate. Although the business is still worth the same amount, there is now only $66,000 in insurance outstanding to fund any future purchase. This points up the necessity for reviewing the whole arrangement from every standpoint at the death of each participant in the agreement in those situations where more than two parties are involved. Where the buy-and-sell agreement contains options to purchase or sell rather than providing for a mandatory sale, there may be some question as to the place of insurance in the scheme. While the necessity for insurance decreases as less of a fixed commitment is entered into, there may still be wise to provide for it. This is especially so where the option is with the seller to force a sale rather than with the buyer to make a purchase.

**Considerations Under Pennsylvania Law**

*Problems of Testamentary Disposition*

Since the buy-and-sell agreement is an instrument under which a sizable portion of a decedent's estate will pass at his death, questions as to the possible testamentary nature of the instrument must be considered. These fall under two headings. First, is the instrument itself a testamentary document which must be executed in accordance with the requirements of the *Wills Act*? Second, will the business interest being sold be part of the decedent's estate for administrative purposes? Although the question might have been argued at one time, it now seems clear that the instrument is not ordinarily testamentary, and its validity is to be determined solely on the basis of the ordinary laws of contracts.

The includibility of the business interest in the estate is a question of interpretation of the instrument, some buy-and-sell agreements providing for an automatic passage of title at death while others anticipate a transfer by the executor after payment of the purchase price. The latter case presents no problem, the procedure being simply to include both the business interest and the purchase price as assets and to include the claim of the purchaser against the estate as a liability. On the other hand, the use of an automatic vesting provision is likely to raise questions as to the purchaser's source of title, especially where real estate is involved, and, despite the theoretical non-includibility, quitclaim deeds and other instruments from the executor will nearly always be necessary. For this reason, and because of the lack of security it affords the estate, the use of an automatic vesting provision probably should not be recommended. Another source of confusion in connection with automatic vesting is that such provisions are often combined

18 Act of April 24, 1947, P.L. 89, § 1 et seq. (20 P.S. § 180.1 et seq.).
19 In re Eisenlohr's Estate (No. 2), 258 Pa. 438, 102 A. 117 (1917).
with provisions for payment of the purchase price to a designated beneficiary of the deceased rather than his estate. This leaves the estate with neither the business interest nor purchase price. Although there appear to be no Pennsylvania cases on point, it is probably safe to say that such a device will receive little protection from the claims of either creditors of the deceased or his spouse.

**Corporate Ability to Purchase Own Shares**

As is discussed more fully below, a frequent method of accomplishing the purchase of corporate shares is by means of an agreement among the shareholders and the corporation itself in which the corporation becomes the purchaser at death rather than the individual shareholders. The power of a corporation to enter into such an arrangement is clear, but it is subject to two limitations which must be noted. First, the purchase cannot be made at any time when the net assets of the corporation are less than its stated capital, or if the purchase would reduce the net assets below that figure. This requires essentially that the purchase be made out of surplus, whether earned, paid-in, or capital. Since the financial situation at an unascertained time in the future cannot be predicted, it becomes necessary to limit the obligation to the extent of requiring only such purchases as may be legally permissible under state law. The effect of this limitation can be overcome by a supplementary provision in which the participating shareholders, assuming they represent a majority of the voting stock of the corporation, agree to vote in favor of a reduction of stated capital to create the necessary surplus, a procedure which seems permissible, or in which they agree to purchase in their individual capacities any shares which are not purchased by the corporation.

The second limitation concerns the fiduciary duties which the directors of a corporation owe to the corporation and which the majority shareholders owe to the minority. Where there are nonparticipating shareholders, these impose a heavy obligation on the participants to make certain that the arrangement is a fair one to the corporation in every respect. Although the authority to enter into such an agreement might theoretically come from the board of directors, it is desirable to attempt to secure as nearly unanimous shareholder approval as possible.

**By-Law and Restraint on Alienation Problems**

Where the corporation is to be the purchaser of the shares, a frequent practice is to spell out the purchase arrangement in the corporate by-laws and to dispense with a separate agreement. Even where an agreement is entered into, the by-laws are sometimes used to supply a supplementary inter vivos restraint on alienation. In either event, the question arises as to the binding nature of the

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25 Act of May 23, 1949, P.L. 1773 § 4 (15 P.S. § 2852-401 (pocket part)).
by-laws. Since by-laws are intended to govern the internal affairs of the corporation, there might be some legitimate question as to the propriety of provisions attempting to govern the relationships between the corporation and its shareholders or among the shareholders themselves. This question appears, however, to have been settled by holdings to the effect that, whatever their validity as by-laws may be, such provision constitutes enforceable contracts between the shareholders and the corporation or among the shareholders themselves, as the case may be. Since by-laws may usually be changed by either the board of directors or a specified proportion of the shareholders, while a contract can only be changed with the consent of all the parties, these holdings raise interesting possibilities with regard to such things as the ability of the by-laws to bind persons who became shareholders before they were adopted or the ability of a majority of the shareholders, say, to change what the minority thought were binding contractual arrangements. In the light of these possibilities, it would appear to be discreet to avoid the use of by-laws to make what are essentially contractual arrangements. Because of the strong common law policy involved, the existence of any restraint, whether in by-laws or in a separate agreement, might be expected to raise difficulty. This appears not to be the case, at least where the restraints involved are reasonable in relation to the purpose intended to be accomplished. Any attempt to impose an absolute restraint, however, should be approached with caution.

**Drafting Considerations**

**Mechanics**

While not a matter of substantive importance, the instruments in which the terms of the buy-and-sell agreement are spelled out might be noted. In the case of a sole proprietorship, all that is needed is an agreement of sale between the parties. With a partnership, the terms of the buy-and-sell agreement are sometimes included as part of the partnership agreement itself, especially when the decision to enter into the arrangement is made at the time the partnership is formed. Although this may be satisfactory where there are only two partners and no insurance funding arrangement, when the partnership is larger or insurance is used, the buy-and-sell portion will generally dominate the agreement and necessitate subdivisions comparable to those in the *Internal Revenue Code*. Because of this, a separate agreement, scrupulously compared with the partnership agreement itself for possible inconsistency, is probably advisable. If shareholders are entering into an agreement among themselves, a single instrument providing for the purchase and sale is sufficient. If the corporation is to be the purchaser, all of the sellers can enter into a single agreement with it. Although the terms of the agreement, or an inter vivos restraint on alienation in connection with it, can be in-

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28 Accord: Fitzsimmons v. Lindsay, 205 Pa. 79, 54 A. 488 (1903).
cluded in the corporate by-laws, the dangers involved in this have been pointed out above.

In drafting the instrument, the most important point to keep in mind is that what is involved is essentially the sale of an interest in a business. This means that the buyer and the seller must be identified and the interest being sold carefully defined. In the case of a sole proprietorship, for example, this requires a careful enumeration of the assets to be included and some reference to the treatment of liabilities. In the case of stock interests, it requires some reference to the treatment of shares acquired after the execution of the agreement. The method of determining the purchase price must be carefully indicated, and this should include reference to such matters as the effect of the failure of the parties to make such periodic determinations as may be required, the method by which arbitrators are to be chosen, and a check of any formula which is to be used for possible ambiguity. An important point is the time when title is to pass, the papers to be executed to pass title, and the treatment of any income earned between the death of the seller and the time passage occurs. Although it appears title may be made to vest immediately at death, the inadvisability of this has been mentioned above. The method of paying the purchase price, the security to be given for the unpaid portion, and the remedies in the event of default should also be noted.

In addition to the provisions which ordinarily appear in a sales agreement, there are others which are peculiar to buy-and-sell agreements. Many of these relate to any insurance which may be used to fund the purchase. Among the matters which should be covered are the amounts of insurance, the type, whether term or ordinary life, the treatment of refunds, the method of insuring that premiums will be paid, ownership of the policies, the right to encumber the policies, and beneficiary designations. Where the agreement is optional rather than mandatory, the exact time and manner of exercising the option must be indicated, together with the effect of failures to exercise.

Form of Purchase

The identity of the purchaser is clear in the case of a sole proprietorship, a two-man partnership, or a corporation with a single shareholder. In the case of a partnership with more than two partners or a corporation with more than one shareholder, a choice is presented, since the purchase may be made by the partnership or corporate entity as well as the individual surviving shareholders or partners. The choice is a difficult one, especially where insurance is involved, and no single rule can be given which will govern all cases.

The considerations involved in making the choice are of three types—practical, insurance and tax. The practical problem is to use the form which will be the more understandable to the parties and administratively feasible. Generally, the advantage as to both understandability and simplicity lies with having the purchase made by the business entity, and it increases with the number of share-
holders or partners involved. With a corporate business, an additional factor is that the corporation is likely to be in a better financial position to make the purchase than any of the shareholders. The principal practical deterrent here occurs where not all of the shareholders are participating in the buy-and-sell arrangement. In this case, a corporate purchase has the effect of diluting the proportionate share ownership of the participants. Where a partnership is to be the purchaser, what is usually required is an agreement among the partners, in their individual as well as their partnership capacities, that the partnership will continue in the event of the death of any of them and that the interest of the deceased partner will be purchased by the continuing partnership on specified terms. Since the Uniform Partnership Act provides for dissolution of a partnership at the death of any partner, without apparent regard to the intent of the parties, the analysis of this is not clear. What is probably involved is an agreement that the surviving partners will enter into a new partnership which, though not specifically enforceable, is contractually valid.

If the buy-and-sell agreement is not funded by insurance, the practical considerations mentioned above may be determinative. There are one or two tax aspects in the picture, however, which should be considered before a final decision is reached. If a corporate business is owned by close relatives, the sale to the corporation may give rise to dividend problems, though this is not too likely and in some cases the matter will have been taken care of by recent legislation. A purchase by the corporation also has the disadvantage of not allowing the surviving shareholders to add the amount of the purchase price to the basis for gain or loss of the shares held by them. Since this is important only in case of a sale of the shares during the lifetime of the owner, it will probably not be a weighty factor in most cases. The same loss of basis problem may exist where the purchase is made by a partnership, though this is not so clear under present law.

Where a partnership is on a fiscal year, an additional tax problem arises from the fact that the death of a partner can cause the inclusion of more than twelve months income in the tax returns of all concerned for the year of death. This probably can be avoided by a provision requiring the retention of the estate of the deceased as a partner until the end of the fiscal year in question. However, it does not affect the form of purchase.

The insurance problem is one of convenience as well as achieving maximum use of the policies which have been taken out to fund the purchase. It can be illustrated by the case of a business which has three partners or shareholders and a value of $75,000. If the individuals are designated as the purchasers, the proce-
dure will be for each to purchase $12,500 of insurance on the lives of his asso-
ciates. This will necessitate the writing of six insurance policies, an inconvenience
which becomes considerable where there are four or five partners, which re-
quires the writing of twelve or twenty policies, respectively. At the death of the
first partner or shareholder, the survivors will each use the proceeds of the $12,500
policy each holds on the life of the deceased to buy one-half of the deceased’s in-
terest in the business, and there will be no problem. At that point, however, each
survivor has a commitment to purchase the $37,500 half-interest of the other
but only a $12,500 policy with which to meet it.

If the second purchase is to be as well funded as the first, each must there-
fore purchase an additional $25,000 policy on the life of the other. At the same
time, the estate of the deceased holds as an asset the $25,000 in insurance which
the deceased had purchased to fund his own prospective purchases. The advantage
of the purchase by the business entity is that these policies would be owned by the
entity and available to fund this second purchase, rather than lying dormant in the
estate of the decedent. This would reduce the amount of new insurance to be pur-
chased from a total of $50,000 to a total of $25,000. From an insurance stand-
point, this represents the primary advantage of a purchase by the business over a
purchase by the individuals. It might be suggested that the estate could sell, for
its then cash value, the policy on the life of each survivor to the other, but the
operation of the “transferee for value” doctrine, which is explained below, pre-
vents this. The only practical disposition of the policies is for the estate to sell
each to the survivor whose life is insured by it for use as personal insurance. Al-
though a purchase by the business presents certain valuation and premium pay-
ment problems relating to the insurance, which are discussed below, these are
generally not considered serious enough to offset the advantages which have been
mentioned.

The tax factors involved in choosing the form of purchase relate principally
to any insurance which is used to fund the agreement. Preliminarily, it should be
mentioned that under no form can the premium on the policies be made de-
ductible for income tax purposes.34 However, where the insurance is purchased
by a corporation the premium cost at least avoids taxation in the individual re-
turns of the shareholders, and where the shareholders are in a higher bracket
than the corporation, this may create strong pressure for a corporate purchase.
The problem of achieving an increase in income tax basis equal to the purchase
price paid for the interest has been mentioned above and the fact pointed out that
it is not serious where it appears that the owners of the various interests will prob-
ably retain them until their deaths.

A second tax problem concerns the possible inclusion in the estate of a
decedent of the value of both his business interest and the insurance which is to

34 Int. Rev. Code § 24(a) (1) and (4).
form part of the purchase price for it. In this connection, a strong warning is apropos. Under no circumstances should the parties take out insurance on their own lives and provide that such insurance is to act as an offset against the purchase price. Such a provision will very likely result in both business interests and insurance being included for federal estate tax purposes. On the other hand, it is reasonably clear that the rules governing indirect payment of premiums will not be applied where the ordinary rule of each party purchasing insurance on the lives of the others is followed. At the death of a party, only the business interest or the insurance (it is not clear which) will be includible. If a corporation is the purchaser, only the value of the shares will be includible, though the insurance proceeds may be reflected in that value, depending upon the weight given the buy-and-sell agreement for valuation purposes. In the case of a purchase by a partnership entity, the single precedent against double inclusion was decided under prior law, and no present assurance can be given.

A final tax problem concerns the so-called "transferee for value" doctrine. Ordinarily, the proceeds of life insurance are not subject to income tax. However, where a policy has been transferred during the lifetime of the insured, other than as a gift or as part of a tax-free transaction, the proceeds do become subject to ordinary income tax to the extent of the difference between them and the total premiums paid. It is this fact which in the example above prevented each survivor from purchasing from the estate of the deceased the insurance policy on the life of the other. A corporate purchase eliminates this problem and makes the entire amount of insurance available to purchase the interest of each participant at his death. Again, however, although a partnership purchase will also make the entire amount of insurance available, the possible application of the transfer for value doctrine cannot be categorically dismissed under the present state of the law.

If the discussion of the form of purchase has seemed inconclusive, it is mainly because the answer in any given case is likely to be determined by any one of the factors which has been mentioned. Generalizing, however, it is likely that in most cases practical and insurance considerations will point toward a purchase by the business, while tax considerations, except for the yearly tax savings available through payment of the insurance premiums by a corporation, will point the other way. With a corporation, the tax situation is likely not to be sufficiently serious to justify setting aside a corporate purchase without some hesitation. With a partnership, however, a business purchase should not be undertaken unless the partners

86 Ray E. Tompkins Estate, 13 T. C. 1054 (1949) (insurance); G. C. Ealy Estate, P-H Memo decisions ¶ 51,137 (T. C. 1951) (business interest).
87 Newell v. Commissioner, 66 F.2d 102 (7th Cir. 1933).
89 Int. Rev. Code § 22 (b) (1).
90 Int. Rev. Code § 22 (b) (2).
realize that some risk is involved. Among the facts which might justify a partnership purchase would be the youth of the partners, the relatively small sizes of the business and the insurance, the likelihood that the business was one in which the partners would remain for a considerable period of time, and the fact that the partners were not yet in appreciably high federal estate tax brackets.

Insurance Problems

In addition to the matters relating to insurance mentioned above, several others should be alluded to. It is frequently desired that the beneficiary of each policy be named by the party on whose life it has been issued, the object being to insure receipt by the beneficiary and to make available the settlement options. This is a practice which is generally frowned upon by the insurance companies for a variety of reasons connected with the administration of the estate of the deceased and because it raises a possible question as to the basis of the business interest held by the survivors. However, the trend appears to be toward insuring the availability of the settlement options through having the beneficiary of each party named secondarily in the policy and having the survivors execute waivers after his death. This is a matter which varies from company to company but which merits consideration.

Rarely does the amount of insurance exactly equal the purchase price, and provision for the difference must be made in the buy-and-sell agreement. Where the insurance is insufficient, this involves spelling out the method of payment of the excess and the security that is to be given. Where the amount of insurance is greater, the excess should theoretically be retained by the survivors. However, there is a tendency to set the amount of the insurance as a minimum purchase price. The only disadvantage of this is a possible increase in the value of the business interest for tax purposes. The problem of uninsurables is one for which there is no satisfactory answer other than to attempt to approximate the insurance principal through self-funding.

Where the parties are of different ages and the purchases are to be made by the individuals, the inquiry is sometimes made as to the justification for the difference in the premium payments required of the various participants. The answer to this is that while each may be funding the same size purchase, because of the differences in age each is funding it over a different period of time. Where the purchase is by the business, however, the same point is often overlooked, as is the effect of the ownership of the policies upon the valuation of the business. It is clear that since the policies on the lives of the survivors were purchased from earnings of the business, their cash values should be added to whatever value is arrived at under the method of valuation adopted. In addition, some account must be taken of the policy on the life of the deceased, since it also was purchased from earnings. Where the deceased was appreciably older or had an appreciably greater

41 Legallet v. Commissioner, 41 B.T.A. 294 (1940).
share in the business than the other parties, the failure to take this policy into account may result in a considerable inequity to him. Theoretically it might be necessary to add the entire proceeds at death to the values previously arrived at, but a more practical method which achieves substantial equity is merely to add the cash value of the policy immediately before death.

**Use of a Trustee**

The use of a corporate fiduciary to supervise the transfer of both business interest and purchase price is frequently warranted, especially where there is any hint that either party or his family may have any reluctance to live up to his commitment. Although the fiduciary is usually called a trustee, his actual function is likely to be more akin to that of escrow agent for the insurance proceeds under an agreement which imposes a duty upon him to turn the proceeds over to the beneficiaries or estate of the deceased upon satisfactory proof that transfer of the business interest has occurred. Since the survivors are likely to have physical possession of the business by virtue of their connection with it, the arrangement is primarily for the protection of the beneficiaries of the deceased where it is not desired to have them receive the insurance proceeds directly. Where additional protection is desired during the lifetime of the parties, the trustee is sometimes made the owner of the policies, thus creating an actual trust, and a requirement may be imposed that all premium payments be made through it. Where a corporation is involved, all the parties may endorse their shares over to it in blank. Such an arrangement can of course become cumbersome, and what is appropriate in each case will depend upon a careful and conservative appraisal of the facts. It has been suggested that ownership of the policies by the trust under an arrangement in which the survivors purchase not cash surrender values but rather interests in the trust from the estate of the deceased may be a method of obtaining the use of all the insurance for future purchases without running any transfer for value risk. Although the reasoning seems correct, there appear to be no cases on the point.

**Restraints on Alienation**

In order to assure both the accomplishment of its purpose and recognition as a factor in estate tax valuation, the buy-and-sell agreement should generally contain a restriction on the alienation of the various business interests during the lives of the owners. In the case of an agreement involving corporate stock or one between a sole proprietor and his employees, the usual provision is to grant the prospective buyers a right of first refusal with respect to any contemplated sale, though the sole proprietorship agreement must be carefully worded to avoid interference with the normal operations of the business or the right of the owner to discontinue the business completely. Since the usual partnership agreement

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contains a prohibition against alienation by a partner, the option provision generally
covers withdrawal from the business rather than a prospective sale. In the case of
a partnership, a fixed or formula price takes the place of a price based on a first
refusal. Where it is desired to restrict the interest somewhat more tightly, the
same method may be used in the case of a proprietorship or a stock interest.

Although encumbrances present a somewhat different problem, it is a related
one, and for simplicity in drafting it is often desirable to treat them in the same
manner as sales. Where, as is rarely the case, an option to sell at death is pro-
vided, there is no reason for any inter vivos restraint. An escape which corporate
shareholders sometimes allow themselves is the right to make gifts or bequests
of their shares to designated relatives, generally spouses and lineals, although
this is more frequently found where there is a simple restraint on alienation con-
tained in the by-laws, without a buy-and-sell agreement. Although such a clause
is valid, it may appear to be inconsistent with the purpose of the agreement.

Professional Partnerships and Deferred Compensation Arrangements

Agreements covering the death of a partner are quite frequent in medical,
engineering, legal and similar professional partnerships, but the nature of them is
not always fully understood. The tangible property used in such partnerships is
generally quite small. The only other asset is likely to be accounts receivable, and
these are likely to vary from relatively small amounts in the case of a medical
partnership to relatively large ones in the case of an engineering partnership. In
addition, there will be some work upon which a start has been made but which
has not yet reached a point to justify billing. Toward all of these items a con-
tribution was made by the deceased partner, and his estate should receive some
recognition for each of them. Except with regard to tangible assets, this recogni-
tion is different from the type which is given in a buy-and-sell agreement, it rep-
resenting payment for personal services rather than a purchase of a capital account.
This is usually provided for in the partnership agreement by an arrangement under
which the estate of the deceased receives separately enumerated amounts on ac-
count of tangible assets, accounts receivable, and work in progress which has not
yet been billed. The latter is usually taken care of by a lump sum estimate of what
constitutes the normal value of such work or by an estimate of what percentage
of the profits of the year following death may be said to be attributable to work
in progress. Except for the payment paid for tangible assets, the effect of such an
arrangement is to permit the partnership to make deductions for the payment made
and to require the inclusion of such payments in the income tax return of the de-
ceased’s estate or his beneficiary.43 Because of the tax-shifting effect of such ar-
rangement, the possibility of using comparable deferred compensation agreements
as partial substitutes for the recognition of good will in the the case of corpora-

43 Carol F. Hall, 19 T. C. 57 (1952).
tions or nonprofessional partnerships should not be overlooked. In the case of a corporation, it is, of course, quite customary to provide for post-death payments to the beneficiaries of a deceased officer or employee. In the case of a mercantile or manufacturing partnership, there may be reasonable ground for giving the beneficiary an interest in the profits of the business for a reasonable period of time following the death of a partner, in addition to the purchase of his partnership account which may be provided for.

In the case of a professional partnership, the cases appear to hold uniformly that good will is not a factor to be considered in valuation. In many cases, however, the partners themselves undoubtedly feel that a good will factor does exist, and the result is likely to be provisions for payment to the estate of a deceased in excess of those provided for above. Where this is done, in addition to being includible in the estate for estate tax purposes, such payments are not deductible by the survivors for income tax purposes. There may be a temptation to include such payments for good will among the ones for services mentioned above, but this raises the danger of losing the deduction for even the personal service portion of the payments. The best that can be accomplished is probably to make the personal service portion as large as is reasonable and to frankly admit that the remainder is paid on account of good will.

Because of the misunderstanding as to the nature of a professional partnership agreement, the insurance aspect of the situation is sometimes not clear. With regard to the personal service aspect of the situation, the problem is roughly comparable to that of “key man” insurance. If the partners feel that the death of any one of them may result in such an immediate contraction of the business as, together with the commitment to the estate of the deceased, may result in an immediate though short term decrease in their own earnings, insurance on the lives of each is probably desirable. With regard to the good will aspect, since such good will is, even conceding its existence, probably not salable, the partners would probably be just as well off if each purchased personal insurance rather than attempting to fund a cross-purchase arrangement in the manner of a mercantile or manufacturing business. The number of professional partnerships which contain provisions for the purchase of good will at death by insurance probably testifies more to the psychological attraction of such a plan than to any economic or tax advantages it may possess.

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44 Coates v. Commissioner, 7 T. C. 125 (1946).