Farm Buy-Sell Agreements

It is important that each farm have an up-to-date business plan as well as an up-to-date Buy-Sell Agreement in effect that will address the terms and conditions under which an owner's interest will be transferred upon a death, a total and permanent disability, or a termination of the owner's relationship with the farm. Upon the occurrence of any of these triggering events, it is important to carefully determine how an interest will be acquired, whether it be an optional purchase or a mandatory purchase. It is also important to carefully define how the payment for the purchase will take place to avoid an unnecessary and disastrous drain on the farm's cash flow.

There are several issues which must be discussed in structuring a farm Buy-Sell Agreement and each one should be given careful consideration depending on each owner's personal family and estate circumstances. The following sets forth those issues which should be considered in structuring a Buy-Sell Agreement.

A. PURPOSES

1. To provide a buyer in the event of termination of employment of a partner/employee.

2. Protect the partner/employee or his estate from being locked into an interest in a farming operation in which there is no continuing participation.

3. Provide a source of funds with which to pay estate taxes or to generate income for the terminated partner/employee and/or his family.

4. To provide a value for the purposes of estate taxes.

5. Preserve control of the farming operation with the remaining partners.

6. Preclude individual partners from selling their interest in the farm without the consent of the other partners.

B. WHAT TYPE OF AGREEMENT SHOULD BE EMPLOYED?

Redemption vs. Cross Purchase. Should the purchaser be the Company (Redemption) or should the purchaser be the remaining partner or trust created for the family of the remaining partner (cross purchase)? In some cases where the farm family is structured so children of a deceased partner will continue with the farm, it is more appropriate to have a trust created in the will of the deceased partner to acquire the shares. This insures the interest is preserved until such a time that children have proven that they are ready to take on ownership of the farm and also insures that an entire family is not mistakenly cut out of the farm because a surviving sibling has acquired all the interest. All of this depends on how active the children are in the farm. And, this may change from time to time as the children mature. Therefore, the overall plan should be reviewed on a regular basis as family structures change.

(a) If the Company redeems the partnership interest of a terminating partner, the remaining partners' cost basis is unchanged. Gain on all subsequent sales by the remaining partners will be measured by the difference between the original cost for their interest and the sale price. The terminating partner typically would have a capital transaction.

(b) If a cross purchase is used, the remaining partners will have paid for the interest of the terminated partner. Their basis would, therefore, increase upon the purchase of the interest. Any gain on a subsequent sale would be reduced.

If the sale occurs by reason of death, typically there is no gain recognized by the selling partner's estate because the estate benefits from a "Step up" of the deceased's cost (or "basis") to the fair market value as of the date of death.

C. WHEN SHOULD THE AGREEMENT BECOME OPERATIVE?

1. Death. Almost all buy-sell agreements are triggered by death. If a redemption agreement is used, the purchase price may be covered by life insurance on the deceased partner owned by the Company. If a cross purchase is used, the insurance policy on the deceased partner may be owned by the other partners. The proceeds when received are used as full or as a down-payment.

2. Disability. The agreement should also cover total and permanent disability. If a principal is no longer capable of performing his duties, it is quite possible that profits would be reduced. Unfortunately, a disability buy-out is more difficult to fund with insurance than a death buy-out. Disability buy-out insurance, while available, tends to be quite expensive.

   Disability insurance for farmers has traditionally been difficult to obtain because it is a high risk occupation. However, there are certain policies that are available which can provide a valuable benefit.

3. Termination of Employment. If a partner is active in the operation of the farm, consideration should be given to providing for a buy-out upon the termination of employment.

   Consideration should be given to having a buy out only if employment is terminated for certain events. For instance:

   (a) Voluntary Termination. If a partner/employee voluntarily terminates his employment with the Company, this may, depending on the circumstances cause a hardship on the farm and could affect the operation of the business. Termination could be a result of having to relocate for health reasons, job dissatisfaction, a fear of the partner's partnership interest value declining, etc. Therefore, the terms under which a partner/employee will be bought out when he resigns be carefully spelled out. Options available are to provide for vesting schedules, long-term payment provisions, or not having a buy-out mandatory in such an instance.

If someone voluntarily terminates their association with the farm a discount penalty of 20%-40% is common. This reflects that the farm must now replace one of its key employees and also protects the farm from being adversely affected to the extent it cannot make the payments. Such a penalty provides an incentive for the partners to stay together. Also, a long payout may be utilized for a partner who has voluntarily left the farm. In many cases, the discount may be less or no discount at all if there is termination as a result of attaining a pre-arranged retirement date.

It is also common to include a provision that states if a partner voluntarily leaves the farm that the remaining partners may elect to sell the entire operation rather than have to buy out their partner.

(b) Termination for Cause. If a partner is terminated for cause, certain limitations on the buy-out of the partner's interest may be imposed. Generally, employment agreements are entered into with partners which define when a termination is "for cause". It is, of course, difficult to imagine a termination for cause on a closely held farming operation, but it should be addressed.

(c) Retirement. The agreement should also define when a partner will be considered as having terminated employment as a result of "retirement", i.e., notice requirements, etc.

The primary events of termination that should be covered are death, disability and if someone decides they no longer wish to farm. Each of these situations can cause unexpected problems. Therefore, the terms under which each of these situations will be handled should be agreed upon while the parties are in agreement.

D. MANDATORY SALE VS. OPTION

With respect to the methods set forth above, should the purchase and sale be compulsory?

1. Most agreements provide that upon the occurrence of an event that triggers a redemption or sale, the partner, or his estate, is required to sell and the farm (if a redemption) or the remaining partners (if a cross purchase) are required to purchase the shares of the terminated or deceased partner.

2. Some agreements are in the form of a "Put". This means that upon an event that would trigger a redemption or sale the terminating partner may require the Company or the other partners to buy the partnership interest of the terminating partner. The terminating partner is not required to sell.

3. The Company or the remaining partners could have an option or a "Call". This is the reverse of a Put. In other words, the remaining partners or the Company have the right to acquire the partnership interest of the terminated partner, but they are not required to acquire the partnership interest.

Many times the determination of whether a sale is mandatory or not depends on whether the purpose of the plan is for passing the interest in the farm to the next generation. In those cases, it may be advisable to allow a transfer to "Permitted Transferees". That is, family members who are active in the operation of the farm, trusts for family members or certain selected individuals who have shown a commitment to the farming operation for a period of years. In these cases, the remaining owners may not be given the first opportunity to acquire the terminated owner's interest.

E. RESTRICTION ON TRANSFER

Every buy-sell agreement should prohibit transfer by any partner other than in accordance with the terms of the buy-sell agreement or with the consent of the other partners. As discussed above, transfers to selected "Permitted Transferees" may be allowed either during life or at death.

F. VALUATION

This is the most difficult issue in any buy-sell agreement, especially in a farming operation. Dairy and produce prices fluctuate regularly and land and machinery values are difficult to exactly determine without an appraisal. If the event triggered is by death, the value could be the value established in the Federal Estate Tax Return. This is done by appraisal.

What is common is to have the value determined by the agreement of the parties on an annual basis. If there is a triggering event within the twelve (12) succeeding months, the agreed upon value governs. However, if the parties fail to meet to agree on a new valuation within twelve (12) months of a triggering event, the price will be determined by appraisal. This presents a price and value from becoming stale.

G. FACTORS TO BE CONSIDERED IN DETERMINING THE VALUES OF CLOSELY HELD COMPANY INTERESTS.

1. The nature of the business and the history of the enterprise.

2. The economic outlook in general, the condition and outlook of the specific industry in particular, and the overall optimism or pessimism of the investing public.

3. The book value of the partnership interest and the financial condition of the business.

4. Prospective earning capacity.

5. The Farm's net worth.

6. Whether or not the farm has goodwill or going concern or other tangible value.

7. The Farm's position in the industry and its management, including loss of management from a death of the key manager.

8. The market price of farms in the same geographic area.

9. The value of the land, buildings, cattle and machinery.

H. TERMS OF PAYMENT

1. Death buy-out. If a death buy-out is contemplated, the purchase price may be totally or partially funded by life insurance. If a redemption is used, the Company would be the owner and beneficiary of the policy. If the purchase price, all or partially, is funded by life insurance, the balance could be paid in cash or by installment note.

2. Installment Payment. In all situations, the purchase price could be paid by a combination of a cash down payment and an installment note. The note could be for a stated number of years at a reasonable rate of interest. The note could be for a stated monthly or annual amount. If this form of note is used, the term of the note becomes the variable; however, the Companies are in an excellent position to budget without surprise. The length of the pay-out can be different for each triggering event. The pay-out should balance the needs of the partner (and his family) and the operating capital requirements of the Company.

I. RIGHT OF FIRST REFUSAL

It is appropriate to have a provision in the agreement that prohibits a partner from selling his partnership interest without first granting the remaining partner an opportunity to acquire the partnership interest. Therefore, if one of the partners wishes to sell his shares, he would notify the other partners of his intention to do so and the other partners are given a reasonable period of time to acquire the terminating partner's interest in the Company. The purchase price in such an event is generally the lesser of the offer from a third party or the value as determined pursuant to the buy-sell agreement.

J. SECURITY

In the event of a sale, the selling partner may receive installment notes. These notes could be secured by a pledge of the partnership interest which was sold, by personal guarantees or by the farm issuing a security interest in its assets.

Care should be taken to balance the interest of the terminated partner or his estate and the needs of the farm. A standard security interest in farm assets may result in the farm's inability to secure bank financing if it is subsequently needed. Therefore, the terminated owner's interest is generally subordinated to third party creditors.

At the same time, care should be taken to insure that the selling partner is adequately protected in the event the farm is subsequently sold by the remaining partners. The agreement may provide that upon the occurrence of a subsequent sale, the balance of the purchase price is immediately due and payable.

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