“You don’t have to plan to fail; all you have to do is fail to plan.”
~ Anonymous

Avoiding Mistakes in Buy-Sell Agreements

Virtually every business having more than one owner needs some arrangement for the purchase of an owner’s interest in the business upon death, retirement or incapacity. Unfortunately, buy-sell agreements are often drafted with a less than complete analysis of the client’s needs and the relevant facts. This article will address some of the common mistakes that can be found in buy-sell agreements.

Whether it’s a part of a shareholders agreement, part of an employment agreement which grants stock or stock options to an employee, part of a limited liability company operating agreement or part of a partnership agreement, buy-sell agreements are a fundamental part of the planning for closely held businesses. Typically, the agreement will also deal with other issues, such as business management and voting by the owners.

Buy-sell agreements come in three principal forms. The first is a redemption agreement in which the business entity has the original right and/or obligation to redeem the owner’s interest upon the occurrence of certain triggering events (e.g., death, disability or retirement). The second approach is a cross-purchase in which owners have the right and/or obligation to buy shares upon certain triggering events. The final approach is a hybrid, in which either the business entity or the remaining owners could buy out the interest.

To simplify the wording, this article will refer to the business interest of any owner as “shares.” The business entity will be referred to as the “business” or the “company.”

The analysis of these agreements can easily be divided by the old journalistic technique of:

“WHO, WHAT, WHERE, WHEN, HOW AND WHY?”

WHO are the Parties?

Whether they are shareholders of a corporation, members of an LLC or partners of a partnership, the parties bound by the agreement need to be clearly defined. Among the common mistakes are the following:

Different Deals. Planners often make the mistake of assuming that all owners need to have the same arrangement. This is not necessarily true. For example:

• In order to assure that majority control is retained by majority owners, it may make sense to have a buy-sell agreement only bind the majority owners. For example, assume A & B started the company and each own 30% of the business. Ten other owners own the remaining 40%. If A leaves the business and each of the remaining owners purchases their respective portion of the shares (or the business redeems the shares), B would lose control of the business (i.e., B’s ownership interest would become 42.9%). To avoid this, A & B might have a separate agreement that allows each of them the first option to acquire the other’s shares. In the alternative, the agreement might allow B to acquire a sufficient number of A’s shares to retain control.

A similar pattern might occur if A&B where married and C & D also owned a part of the business. If either A or B died, the agreement might provide that the surviving spouse did not have to sell any part of the deceased spouse’s shares to C or D, but could retain it until the surviving spouse leaves the business.

• In the alternative, it may make sense to only restrict minority owners, so that those who have small numbers of shares are required to sell their shares when they leave. For example, assume a company gives out “That-A-Boy” shares as a reward for superior work. In most cases these shares are a nominal amount, but the other owners probably do not want small numbers of shares scattered among ex-employees (i.e., if the business is to be sold, each of those departed owners would have to be contacted about selling the shares and there might have inflated expectations). The solution? Sign either an employment agreement or buy-sell agreement
when the shares are first issued, requiring the sale of the shares at a determined price when the employee is no longer with the company.

**Include the Business Entity.** The agreement should normally provide that the shares of a departing owner can be sold to either business entity or the remaining owners. Unfortunately, many drafters fail to name the business entity as a party to the agreement. There are a number of reasons that the entity rather than the owners may be the best purchaser of the shares, including:

- Redemption by the entity assures that the remaining owners retain their relative ownership interests in the entity after the purchase. If the agreement only provides for the remaining owners to purchase the interest of a departing owner, and not all owners exercise the ownership option, the relative ownership interests among the surviving owners could significantly change.

However, if the owners have the desire to keep any single member from acquiring majority control, a redemption might violate this principal. For example, assume the ownership of the business is: A owns 40%, B owns 30% and C & D each own 15%. If B died and the company acquired his interest, A would then own 57% of the entity. The solution? Either provide for appropriate restrictions on A’s voting rights (e.g., restricting A’s ability to vote in a majority of the company board of directors), or provide that no member may own a majority of shares and provide that C & D can each acquire sufficient shares to keep A’s ownership below 51%.

- Assume the shareholders to a C corporation are the only parties to the agreement and, thus, are the only parties legally required to acquire the shares. If the shareholders have the corporation purchase the interest of a departing shareholder, the redemption could be treated as a constructive dividend to the remaining shareholders. A constructive dividend can result in both the corporation and the remaining shareholders paying taxes at ordinary income tax rates on the redemption proceeds. Moreover, the departing shareholder must also pay capital gain taxes on the sale. See the later discussion in this article.

- Loss of Basis. If a corporation owns the insurance policy and an owner dies, the corporate redemption does not provide any tax basis adjustment to the remaining owners. If the remaining owners own the policy on the deceased owner, they would receive an increase in their income tax basis. For example, assume three equal owners intend to insure each of their lives for $1.0 million to fund a buy-sell agreement. Owner A dies. If the corporation owns the insurance and carries out the redemption, the remaining shareholders receive no step-up in the tax basis in their stock. The remaining owners each own 50% of the business.

- However, if the remaining owners owned the insurance and used it to acquire the deceased shareholder’s shares, each owner would receive a $500,000 increase in the basis in their stock - even though they own exactly the same percentage of stock as they would have if the corporation had redeemed the stock. Assuming an effective state and federal capital gain tax rate of 25%, each shareholder could save up to $125,000 in capital gains taxes when they sold the stock.

- When there are multiple owners, the use of a cross-purchase buy-sell means that each owner might have to own an insurance policy on each other owner. To avoid this issue, the owners could create a partnership or LLC to own a single life insurance policy on each owner’s life and use the partnership as the funding vehicle. However, the buy-sell agreement, partnership agreement or operating agreement should provide how an owner who departs the business is required to give up his or her interest in the insurance partnership or LLC.

**After-Acquired Shares.** In many cases the agreement is drafted to govern all owners, but the agreement fails to address future owners. The best approach could involve one or more of the following:

- Provide in any documents filed with the government (e.g., articles of organization) that future owners must sign a copy of the company’s buy-sell agreement to become owners in the business.
- If the owners are given any evidence of their ownership (e.g., a stock certificate) make sure the title document reflects the existence of the restrictions on ownership.
- The agreement should also specifically say that it restricts not only the owner’s existing shares, but also any after acquired shares (e.g., future shares issued pursuant to stock options).
- The business owners are also well advised to provide that any permitted transfer of shares (e.g., to a trust for an owner’s family) requires that the new owner agree (as a condition of the transfer) to be bound by the terms of the buy-sell agreement.
- Make sure the agreement applies to a ex-spouse who acquires shares as a result of divorce. The agreement may provide only employees and company officers can own shares. As soon as the divorcing spouse receives the shares (and is not an employee), the remaining owners may have the right to acquire the shares.
WHAT is the Buy-Sell Agreement Designed to Do?

The normal purpose of a buy-sell agreement is to create rights and obligations among the owners that do not exist in the applicable statutes or case law. Among these purposes are:

**Controlling Ownership.** Typically, buy-sell agreements are designed to maintain control and ownership among existing owners. Among the considerations in this area are:

- Because S-Corporations are limited in the types of authorized shareholders (e.g. only certain kinds of trusts qualify as S-Corporation shareholders) the agreement should restrict the ability of any shareholder to transfer his or her stock to an entity or person which is not a qualified S-Corporation shareholder. If such a restriction does not exist, one shareholder could transfer ownership to a non-qualified shareholder and terminate the S-Election for the entire S corporation.

- Most buy-sell agreement include rights of first refusal which restrict the ability of an owner to transfer ownership without first offering it back to the other members on comparable terms and conditions. In many cases, some types of transfers are permitted, such as transfers to estate planning entities, like family partnerships and trusts. However, the agreement should assure that such permitted transferees are also required to sign the agreement.

- One common mistake is failing to create sufficient notice of the terms of the restrictive buy-sell agreement. With a stock certificate, the language can be placed on the back of the certificate, placing all future owners on notice of the agreement’s existence. If may be advantageous to place similar language in the recorded articles of organization of an LLC or the limited partnership certificate of a limited partnership.

- A minority owner may want to make sure his or her percentage ownership interest in the business is not diluted by future stock sales by the company. The agreement may provide for pre-emptive rights to all owners, or adopt a mechanism by which new shares are made available (e.g., a super-majority of 80% of the owners must vote in favor of the new issuance).

- What happens if the remaining parties believe the price offered by the third party is excessive? The agreement might provide that the remaining owners have the right to obtain an independent appraisal and use either the third party offer price or the appraisal as the purchase price for the shares.

- What happens if the third party is offering all cash, but neither the company nor the remaining shareholders have the cash to match the offer? The agreement might provide that the company or the remaining owners could purchase the departing owner’s shares on either the terms of the third party offer or upon terms spelled out in the document (e.g., “20% down, with the balance paid in equal monthly payments at prime rate over five years”).

Creating a Market for Shares. An interest in most closely held businesses is not readily marketable. One of the principal purposes of a buy-sell agreement is to create a market for an owner’s shares. However, as discussed in this article, in order to obtain that market, the owner may be required to give up other rights (e.g., the ability to solicit customers of the business).

**Contemplation of Divorce and Constructive Dividends.** In many cases, a couple have either owned a business corporation together, or part of the stock is transferred as a result of the divorce. Having an ex-spouse as a partner is not usually a good idea and often the spouse most active in the business wants to buy out the interest of the ex-spouse.

A divorce decree may declare that the shares must be purchased. However, if the active business owner has a legal obligation to acquire the stock of the ex-spouse (e.g., pursuant to a divorce decree), but has the corporation redeem the interest, the business owner, not the ex-spouse may be taxable on the redemption. In general, the treatment of a stock redemption as a sale by the business owner is highly disadvantageous to the business owner:

- If the business is a C corporation, the business owner will generally continue to hold significant interests in the corporation after the redemption, making it extremely hard to qualify for capital gains treatment. The resulting treatment of the distribution as a constructive dividend means the business owner may be taxed at federal ordinary income tax rates (as high as 38.6% in 2002), while the ex-spouse could have received capital gains treatment at a rate as low as 10%.

- The business owner may be taxed on 100% of the redemption cost, while the ex-spouse receives 100% of the funds. Thus, the business owner must pay the tax cost of the redemption with other funds.

- In many cases, the business cannot afford to redeem the ex-spouse's stock in one cash payment and will use the installment method to pay the redemption over time. However, if the transaction is treated as a deemed distribution to the business owner, the installment method may be lost, because the transaction may be treated as a taxable dividend.
Withdrawal. In some cases, state statutes permit a business owner to withdraw from the business. For example, Georgia law 4 allows an LLC member to withdraw from an LLC upon thirty days notice, unless such right is denied by the articles of organization or operating agreement.

Most companies cannot afford to have a member withdraw his or her capital from the business. The business may not survive the withdrawal, particularly if the owner holds a significant ownership interest or takes a significant portion of the business upon withdrawal. Therefore, even if permitted by statute, most buy-sell agreements restrict the right of any owner to withdraw from the business. Exceptions may be provided for retirement or incapacity of an owner. In these cases, the owner may receive payment for his or her business interest over several years to minimize the impact on the business’s cash flow.

Capital Contributions. When most business owners create a new business entity, they have in mind the expected capital cost they are willing to invest in the business. Business owners do not want an open-ended liability to be a drain on their personal or business resources. However, the capital expectation may be understated. Therefore, agreements should provide a mechanism by which additional capital contributions may be made. These approaches may include one of the following:

• A provision that no capital contributions can be made unless all owners agree.
• A process by which each of the owners has the opportunity to make capital contributions equal to their existing ownership interest.

The concept is to allow each member to retain his or her proportionate ownership. However, if one member chooses not to make additional capital contributions, his or her ownership interest in the business may be diluted as a result of the contributions of those owners who are more willing (or able) to make contributions.

• A provision which requires all owners to make future contributions to the business in direct proportion to their existing ownership interest.

The divorce agreement should provide that if the couple’s approach is not recognized by the IRS, the party who is not taxed has an obligation to buy the stock or guaranty the company’s obligation to purchase the stock.

What is the answer? Careful drafting is critical, including:

• The divorce agreement should clearly state how the parties intend to treat any redemption for income tax purposes.
• The divorce agreement should provide that if the couple’s approach is not recognized by the IRS, the party who is not taxed has an obligation to assume part or all of the tax cost.
• Under no condition should the remaining business owner have any personal legal obligation to buy the stock or guaranty the company's obligation to purchase the stock.

State Income Taxes. In the last several years a number of states have recognized that "flow through" entities doing business in their state, but having out-of-state owners have not been paying local income taxes. A number of states now require that S corporations, LLCs and partnerships either pay the state income taxes or receive assurance that such payment will be made by the owners. 5 For example, see Georgia Dept. of Revenue v. Sledge, 6 in which the court noted that partners of a partnership doing business in Georgia were subject to Georgia income taxes on the partner’s share of the partnership income, even when the partner had no direct business relationship with Georgia.

Some states 7 provide that for state purposes, the S election for a corporation is recognized only if all resident and non-resident shareholders pay state income taxes on their portion of the S corporation’s earnings. To avoid losing the benefit of the election, the agreement should require that each S corporation shareholder pay the applicable state income tax and if the payment is not made, allow the corporation to withhold the tax from the distributions to the non-resident and pay it on the non-resident’s behalf.

In the alternative, the state 8 may provide that non-resident members of a flow-through tax entity doing business in the state are taxable on their pro-rata share of the net profits of the business entity. If non-residents are to be owners of a flow-through entity and the state income tax is significant, there may be incentives to create family limited partnerships in states without such an income tax burden.

Other Tax Issues. There are a number of tax issues which the agreement should address, including:

• In flow-through entities (e.g., partnerships and LLCs) owners can create a negative basis in their shares by taking losses in excess of their capital contributions to the business. 9 When they leave the business, the negative capital account will normally create taxable income to the departing owner. For example, assume an LLC member has his interest in the LLC acquired for $10,000 when his basis in the partnership is a negative $20,000. As a part of the acquisition, the departing partner is removed from liability for the bank debt of the partnership. Upon leaving the business, the departing owner would have to recognize $20,000 in ordinary income from the negative basis and $10,000 in capital gains. Assuming the owner was in a 25% state and federal capital gain rate and a 35% state and federal ordinary income rate, the total tax cost would be $9,500. He would net $500 after taxes. Needless to say, the departing partner may complain that the parties never intended this result and refuse to cooperate with the departure. To avoid this issue, the agreement should directly address the impact of a negative basis when an owner leaves.
• Many clients fail to realize that a flow thorough entity like an S corporation requires that the taxable income of the business be allocated to owners, but does not require that the income actually be distributed. To protect minority owners, the agreement may provide that a minimum percentage (e.g., 35%) of the allocated income actually be distributed to owners before the taxes are due. To aid owners in paying their quarterly estimated taxes, the agreement may even provide for quarterly distributions.

• To the degree that the business entity has the option of making tax elections, the buy-sell agreement should deal with how those elections are made. For example, if there are provisions for making an IRC 754 election in a family limited partnership (e.g., to increase the basis in the partnership's assets upon a partner's death), the agreement should provide for the manner in which that election is made and who votes on that decision (i.e., is it left entirely to the estate of a deceased owner?).

Indemnity and Other Protections. In many cases, the departing owner has been indemnified by the business for acts or omissions made in good faith while serving on the business's management team (e.g., serving as a director or officer). However, this indemnification may cease when the person is no longer an owner or member of the management. This issue should be addressed in the agreement. For example, indemnification provisions in the agreement, the articles or the bylaws may provide that a departing owner is still indemnified after leaving the company.

There is also the possibility that the departing owner should remain responsible for non-good faith acts or omissions, which will have a detrimental impact on the business. The parties should consider whether the agreement should include indemnifications from the departing partner to the business. Particularly where there is a long term buyout of the owner's interest, setoff rights should be granted to the business, particularly service businesses (i.e., those in which professional misconduct may create significant future liability to the business).

Voting. Buy-sell agreements are often designed not only to provide for the buy out of members, but also to govern the continuing management of the business. A central component to that ongoing business management is how voting will impact management of the business. There are basically three principal approaches. Depending upon the particular issue being voted upon (e.g., liquidation of the business might require a super majority vote, while a new bank loan only requires a majority vote), the type of voting requirement will vary.

• The first voting requirement is typically majority vote in which one vote over 50% governs.
• The second approach is a super-majority which requires the vote of over 50%, but less than 100%. Typically this percentage ranges from 66% to 80%.
• Last, are unanimous decisions in which all owners must concur. While this may be a workable approach in business entities with few owners (e.g., each of whom has a significant voting block) it is generally not a workable approach when there are minority owners who hold small blocks of ownership.

The agreement may also restrict the voting rights of each of the owners in a manner that is not proportionate to their ownership interest. For example, the agreement might provide that the buy-sell agreement, articles and bylaws of the company cannot be changed without approval of all owners who might be adversely affected by those changes.

Often the parties agree among themselves that each of the owners will serve as a member of the governing board of the business. Because most of the decision making of the company will occur at a board level, it often makes sense to provide that each of the members owning at least a stated percentage of the ownership (e.g., 20% of the business) will be entitled to be serve on the board or elect someone to represent their interests. However, to protect the majority owners, the agreement may allow the majority member to vote additional people onto the board to retain control.

Penalties. Declaring that an owner has a particular responsibility to the other owners without providing a penalty for abusing that responsibility can be a fruitless effort. Therefore, many buy-sell agreements provide that in the event that a member violates the requirements of the buy-sell agreement, certain penalties will result. For example, a person wanting to buy shares may decide that there is minimal risk in ignoring a buy-sell agreement, particularly if an indemnification is provided by the selling owner. However, if there is a penalty clause that creates a damage for the violation (e.g., the remaining owners can purchase the violated shares for 85% of the purchaser's purchase price), then all of the parties will be more reluctant to default on their obligations.

The central question that has to be addressed is the nature of the penalty and whether the penalty is fair and reasonable under the circumstances. Most such penalties are similar to liquidated damages.

Resolving Disputes. As in any marriage and any business relationship, disagreements should be expected. Among the methods of dealing with such disputes are the following:
• Eliminate the board of directors or restrict their authority.

• Subject to the insolvency distribution restriction, allow for distributions among shareholders which are not proportion to their ownership interests.

• Establish the roles of officers and directors, their terms and the manner they are appointed and removed.

• Govern the exercise or division of voting power by directors or shareholders, including weighted voting rights and director proxies.

• Provide for the manner of transfer of property or services between or among the corporation and its directors, officers, shareholders, and employees.

• Transfer to shareholders or others the right to manage the business or exercise corporate power, such as when a deadlock occurs among existing members.

• Requiring dissolution of the corporation upon the request of one or more shareholders or the occurrence of a triggering event.

• Otherwise directs the exercise of corporate powers and management of the affairs of the corporation.

Corporate Restrictions. While LLCs and partnerships have almost complete freedom in the restrictions and requirements that can be placed in their operative agreements, corporations have traditionally had more significant restrictions. The Model Business Corporation Act specifically provides that shareholder’s agreements for a non-publically traded stock may be permitted to do any of the following, without regard to contrary provisions of the Georgia statutes:

• Eliminate the board of directors or restrict their authority.

• Subject to the insolvency distribution restriction, allow for distributions among shareholders which are not proportion to their ownership interests.

• Establish the roles of officers and directors, their terms and the manner they are appointed and removed.

• Govern the exercise or division of voting power by directors or shareholders, including weighted voting rights and director proxies.

• Provide for the manner of transfer of property or services between or among the corporation and its directors, officers, shareholders, and employees.

• Transfer to shareholders or others the right to manage the business or exercise corporate power, such as when a deadlock occurs among existing members.

• Requiring dissolution of the corporation upon the request of one or more shareholders or the occurrence of a triggering event.

• Otherwise directs the exercise of corporate powers and management of the affairs of the corporation.

Arbitration. Agreements can provide for arbitration of disputes and disagreements. However, the use of an arbitration clause is not that effective when the disagreements involve subjective decisions, such as the fundamental direction of the business.

Third Party Mediation. The agreement may provide that in the event of a deadlock between two owners (particularly when there is a 50/50 ownership), that a third party has the ability to vote to break the deadlock. This third party generally should be someone with a working knowledge of the business and whose judgement is trusted by the owners.

Put-Call. If the disagreements create a situation where the owners no longer want to work together, the agreement may provide that an owner has the right to trigger a “put-call option.” The approach generally uses one of the following techniques:

An owner can offer to buy the interest of another owner for a stated price per share, usually in cash at closing. The other owner must either agree to the sale, or purchase the shares of the offering owner upon the same terms and conditions.

An owner can declare that a deadlock has occurred. In such an event each owner submits a sealed bid at a price per share that the owner is willing to purchase the other owner’s interests. When the bids are opened, the highest bidder is required to purchase the interest of the remaining owners.

Salary Determinations. Particularly in service businesses (e.g., accounting and law firms) the buy-sell agreement may spell out the compensation structure of all of the owners. For example, the partners of a law firm might agree that their compensation is comprised of three allocated components: the source of the firm’s clients, the owner who actually did the work, and the length of time that an owner has been with the firm.

In most cases, income is allocated among owners on a cash basis. However, past efforts may have created a significant accounts receivable in the company. The agreement should directly address how a departing owner is paid for the accounts receivable. In particular, the departing owner should probably not be paid for the accounts receivable until they are actually collected. The manner that the receivable are paid should be reflected in the determination of the purchase price for a departing owner’s shares (e.g., the accounts receivable are removed from any purchase price calculation and treated as a separate item of the purchase price).

Negative Covenants. Buy-sell agreements are generally written for divorce not marriage. One pivotal element of the divorce is how much of the business leaves with the departing owner. Unless written restrictions are applicable, the departing owner has the ability to immediately begin competing against the former company, possibly using the funds received from the buyout as startup capital. This issue should be addressed in the agreement to assure that the value being paid for an owner’s interest in the business is not excessive (i.e., if the departing partner’s business moves to his new firm, what was the real value of his shares?). The types of restrictions could include non-compete agreements, non-solicitation of employees, non-solicitation of customers, non-solicitation of vendors and protection of the trade secrets of the business.

The Agreement May Provide for a Benevolent Dictator. Making business decisions by committee is an ineffective approach and many businesses provide that one person has the ultimate decision making authority (e.g., one child runs the family business). However, this approach has often lead to its own source of conflict when the benevolent dictator is less than benevolent or incompetent. Counter-balancing authority may be appropriately given to other owners (e.g., in the event of real or perceived abuse of the authority). For example, the agreement could provide that in the event a profit distribution is not made within a stated period of time, that the other owners have the ability to vote out the benevolent dictator. Obviously, every counter-balancing approach carries its own risks and concerns.

In most cases, income is allocated among owners on a cash basis. However, past efforts may have created a significant accounts receivable in the company. The agreement should directly address how a departing owner is paid for the accounts receivable. In particular, the departing owner should probably not be paid for the accounts receivable until they are actually collected. The manner that the receivable are paid should be reflected in the determination of the purchase price for a departing owner’s shares (e.g., the accounts receivable are removed from any purchase price calculation and treated as a separate item of the purchase price).

Corporate Restrictions. While LLCs and partnerships have almost complete freedom in the restrictions and requirements that can be placed in their operative agreements, corporations have traditionally had more significant restrictions. The Model Business Corporation Act specifically provides that shareholder’s agreements for a non-publically traded stock may be permitted to do any of the following, without regard to contrary provisions of the Georgia statutes:

• Eliminate the board of directors or restrict their authority.

• Subject to the insolvency distribution restriction, allow for distributions among shareholders which are not proportion to their ownership interests.

• Establish the roles of officers and directors, their terms and the manner they are appointed and removed.

• Govern the exercise or division of voting power by directors or shareholders, including weighted voting rights and director proxies.

• Provide for the manner of transfer of property or services between or among the corporation and its directors, officers, shareholders, and employees.

• Transfer to shareholders or others the right to manage the business or exercise corporate power, such as when a deadlock occurs among existing members.

• Requiring dissolution of the corporation upon the request of one or more shareholders or the occurrence of a triggering event.

• Otherwise directs the exercise of corporate powers and management of the affairs of the corporation.

Arbitration. Agreements can provide for arbitration of disputes and disagreements. However, the use of an arbitration clause is not that effective when the disagreements involve subjective decisions, such as the fundamental direction of the business.

Third Party Mediation. The agreement may provide that in the event of a deadlock between two owners (particularly when there is a 50/50 ownership), that a third party has the ability to vote to break the deadlock. This third party generally should be someone with a working knowledge of the business and whose judgement is trusted by the owners.

Put-Call. If the disagreements create a situation where the owners no longer want to work together, the agreement may provide that an owner has the right to trigger a “put-call option.” The approach generally uses one of the following techniques:

An owner can offer to buy the interest of another owner for a stated price per share, usually in cash at closing. The other owner must either agree to the sale, or purchase the shares of the offering owner upon the same terms and conditions.

An owner can declare that a deadlock has occurred. In such an event each owner submits a sealed bid at a price per share that the owner is willing to purchase the other owner’s interests. When the bids are opened, the highest bidder is required to purchase the interest of the remaining owners.

Salary Determinations. Particularly in service businesses (e.g., accounting and law firms) the buy-sell agreement may spell out the compensation structure of all of the owners. For example, the partners of a law firm might agree that their compensation is comprised of three allocated components: the source of the firm’s clients, the owner who actually did the work, and the length of time that an owner has been with the firm.

In most cases, income is allocated among owners on a cash basis. However, past efforts may have created a significant accounts receivable in the company. The agreement should directly address how a departing owner is paid for the accounts receivable. In particular, the departing owner should probably not be paid for the accounts receivable until they are actually collected. The manner that the receivable are paid should be reflected in the determination of the purchase price for a departing owner’s shares (e.g., the accounts receivable are removed from any purchase price calculation and treated as a separate item of the purchase price).

Corporate Restrictions. While LLCs and partnerships have almost complete freedom in the restrictions and requirements that can be placed in their operative agreements, corporations have traditionally had more significant restrictions. The Model Business Corporation Act specifically provides that shareholder’s agreements for a non-publically traded stock may be permitted to do any of the following, without regard to contrary provisions of the Georgia statutes:

• Eliminate the board of directors or restrict their authority.

• Subject to the insolvency distribution restriction, allow for distributions among shareholders which are not proportion to their ownership interests.

• Establish the roles of officers and directors, their terms and the manner they are appointed and removed.

• Govern the exercise or division of voting power by directors or shareholders, including weighted voting rights and director proxies.

• Provide for the manner of transfer of property or services between or among the corporation and its directors, officers, shareholders, and employees.

• Transfer to shareholders or others the right to manage the business or exercise corporate power, such as when a deadlock occurs among existing members.

• Requiring dissolution of the corporation upon the request of one or more shareholders or the occurrence of a triggering event.

• Otherwise directs the exercise of corporate powers and management of the affairs of the corporation.
To be enforceable, the statute requires that all shareholders of the corporation sign the agreement and the agreement is “made known” to the corporation. Further, the existence of the agreement must be “conspicuously” noted on the back or front of the stock certificate if it is to apply to future shareholders who purchase that stock interest.

Restricting the Restrictions. Virtually every buy-sell agreement is designed to restrict the rights of the owners in some manner. However, there are a number of issues which must be addressed in designing the restrictions, including:

- **Insolvency.** Company distributions to an owner may result in the business becoming insolvent. The Model Business Corporation Act provides that a corporate redemption is not permitted if it would result in the insolvency of the entity. LLCs may contain similar provisions. For example, in Georgia, the failure to adequately provide for the liabilities of the LLC can expose the members of the LLC to personal liability to the extent they received assets from the LLC (i.e., if the LLC distributes assets to a withdrawing member and later cannot pay its creditors, the withdrawing member may be liable to the extent of the assets received).

- **Right of Alienation.** One of the fundamental concepts in the English common law was the right of alienation. That is, that an owner of property always retained the fundamental right to transfer his or her ownership interest. Although the right was primarily a real property rule, there is some concern that it might apply to an owner of a business interest. While the right of transfer might be restricted in such manner (e.g., a right of first refusal), agreements which declare that an owner may never transfer his or her ownership in the business may be unenforceable. The better approach is to provide restrictions that result in a transfer not being a viable choice for an owner or a transferee.

Moreover, you cannot provide that a creditor will never be permitted to foreclose on the shares of one of the owners. First, the right of alienation may restrict the ability to deny pledges or collateral assignments of the shares. Second, even if the restriction holds, if the owner goes into bankruptcy the provision would not be enforceable. What is the better approach? Provide that in the event that a creditor obtains the shares of an owner, that the business entity and the other owners retain the ability to acquire that interest for the amount of the creditor’s “investment” in the shares.

- **Constructive Dividends.** As discussed previously, the owners should make sure that any purchase of an owner’s shares is not treated as a constructive dividend.

- **Time Limits.** In a number of states, buy-sell agreements and voting trusts are of limited duration. For example, under the Model Business Corporation Act neither shareholder agreements nor voting trusts can extend for more than ten years. However, the Model Corporation Business Act does allow a shareholders agreement to extend beyond ten years if the agreement so provides. Many states have adopted longer durations for such agreements. For example, a Georgia shareholders agreement can exist for up to twenty years. Planners should make sure the agreement deals with any state restrictions on the duration of the agreement. If it is important that the agreement extend beyond any statutory limits, the owners should consider creating the entity in a state without such restrictions.

- **Loss of Estate Tax Benefits.** In many cases, the use of a buy-sell agreement may result in the loss of estate tax elections, such as the extension of time to pay estate taxes on the business (see IRC section 6166), the estate tax business deduction (see IRS section 2057) and special use valuation discounting (see IRC section 2032A).

**WHEN is the Buy-Sell Agreement Triggered?**

Buy-Sell Triggering Events. One of the more complicated aspects of buy-sell agreements is clearly defining when the buy-sell is triggered. Death is obviously a known event, but how does one define disability? It might be defined in terms of someone applying for and obtaining disability benefits under a disability insurance plan or social security. However, the delays that often accompany such applications may be unacceptable to the company and the disabled owner.

In some cases, the agreement will state that if an owner is unable to work in the company for a stated period of time (e.g., 90 days), then the other owners have a right to exercise a buy-out option. Particularly in the case of disability, the agreement should not provide for just a stated period (e.g., 90 consecutive days), but rather a number of days within a period (e.g., 60 days out of consecutive 120 days). This would prevent someone from being out of work for eighty-nine days, coming back to work for one day and then disappearing for another eighty-nine days.
The more problematic issue is a triggering event which coincides with termination of employment. A minority owner who is fired and then required to sell his shares, may feel at a significant disadvantage. In such a case, it would behoove the minority owner to make sure that the business’s right to terminate employment (i.e., the trigger for the right of buy out) be as clearly defined as possible.

On a related note. Many small businesses are owed by employee/owners. A minority owner might argue that he or she believed that his or her employment could not be terminated without cause as long as the employee held shares in the business. The agreement should expressly state that the being an owner is not a guaranty of employment with the business.

The agreement may also reflect the possibility that the triggering event is not an event to the owner, but rather an event to another owner. For example, assume a company is owned by three owners. A & B are married and C is unrelated. A & C actually run the business. C would be well advised to require B to sell B’s shares if A departs the business.

Put-Call Agreement. Sometimes partners just do not want to work together any longer, but both may want to run the business. The agreement may provide for such a possibility by providing for a put-call option. This approach was discussed earlier in this article. This approach eliminates the need for appraisals and third party judgements of value of the business. It also gives a relatively good determination of value by the persons who know the business the best. An owner is not going to offer too high or too low a price for fear that the best deal will be made by the person receiving the offer. However, this approach does provide more protection to the person who can readily obtain the cash to fund the buy out and has the ability to run the business.

Divorce. Forty-nine percent of the marriages in this country end in divorce, but many buy-sell agreements fail to address the issue. The agreement may provide for a mechanism by which remaining owners could buy out the interest of the divorced ex-spouse of an owner. Because these provisions should not punitive, it will be necessary to assure that the purchase price is comparable to the sale price of any other owner.

Gifts. Many rights of first refusal provide that no transfers of any nature can be made without a prior offer to the other members. But how do you value a non-sale transaction? If the agreement fails to address how a gift is valued, the court might deny that the right of first refusal applies to the gift. A gift may be valued using a formula or appraised value.

Successor Entities. In many cases, the owners of the business are themselves other entities (e.g. the business is a joint venture of two other businesses). Most owners have no desire to bring new individuals into the business. Therefore, a change of majority ownership and/or control of a parent owner might be a trigger. Be careful to avoid “incremental” changes in ownership. For example, if the agreement provides that a transaction in which more than 50% of the business is transferred triggers a buy-sell option, the buyer of the interest might buy 49% and obtain a proxy right and purchase option on the remaining shares to get around the change of control restriction.

Block Sales. In a typical right of first refusal, all of the owners have a right to exercise the right of first refusal and those that do not decide to exercise that right defer their rights to other owners. As a result, a minority owner can dictate terms to all of the owners or delay the transaction until all owners go through the various right of first refusal notice periods. In the alternative, it may be better to provide that if all owners are offered the same price on the same terms (excluding non-compete, compensation, employment and consulting agreements) and a super-majority of the owners (e.g., 66%) vote in favor of the sale, that all rights of first refusal are automatically void.

A second element is also important. The above block sale provision merely terminates the right to first refusal, it does not require the minority owner to sell his or her shares. Most buyers do not want a minority interest owner. As a result, the block sale language should also give the buyer a right to purchase all shares in the company, even those of owners who voted against the sale.

**HOW Will the Buy-Sell Agreement Determine and Pay the Purchase Price?**

Setting Price. Probably one of the most difficult issues in a standard buy-sell agreement is setting price. The normal approaches include:

- Having the price set by a third party in some manner (e.g., a right of first refusal).
- Providing that the price is set on an annual basis by the owners with a proviso that the failure to provide for such agreed value within a certain period (e.g. one year) results in an alternative valuation approach (e.g., an appraisal)
- The parties may agree on a formula which they believe approximates the business’s value. For example, they might agree that 150% of the book value is an appropriate formula. Many service businesses are valued at a multiple of their gross revenue. For example, a law firm might be valued based upon it’s annual gross revenue.
- As previously discussed, in the right context, put-call arrangements can provide an excellent method for setting value. However, it does not work when the departing owner does not want to buy the business (e.g., upon disability, death or retirement of the owner).
- Many clients are unwilling to gamble on other approaches and provide for a formal appraisal of a departing owner’s shares.
In any situation in which price is being determined, it is also necessary to directly address the issue of minority and lack of marketability discounts. That is, should a 95% owner’s shares be valued on the same per share value as a 5% owner? If that is the intent of the parties, then it should be spelled out in the agreement. If it is not the intent of the parties, then the minority owner may want to make sure that there is some provision in the agreement protecting him from unexpected discounts of value.

Particularly in intra-family transactions, clients must be extremely cautious in how they set value. Chapter 14 of the Internal Revenue Code allows the IRS to ignore unrealistic valuations in intra-family transactions, even when these transactions were legally binding on each of the owners. Although similar restrictions do not generally apply to unrelated parties (i.e., the supposition being that these people have no donative intent), these restrictions can result in significant problems for a family business. For example, assume two brothers agree that if either of them should die, that the surviving brother can buy out the deceased brother’s shares for $100,000. At the time of the death of the older brother, the fair market value of the shares is $500,000. For estate tax purposes, the Internal Revenue Service could treat the shares as being worth $500,000, while the deceased brother’s estate has a legally binding obligation to sell the shares for only $100,000. If the remaining assets of the deceased brother’s estate were significant (i.e., the deceased brother has taxable estate), the proceeds from the sale might not even cover the estate tax liability (e.g., if the tax rate was 41%, the tax on the “deemed” value would be $205,000, while the sales proceeds might only be $100,000).

Determining the buyout as a result of different events is a critical issue in most agreements. For example, if death is the triggering event, the buy-sell agreement may fund the purchase using a life insurance policy. As a result, the price may be far higher than the fair market value of the shares. If the purchase is because of disability or retirement, the remaining owners may be unwilling to pay an “excessive” price. The loss of the expertise, generated revenue and business contacts of the retired or disabled owner will often have an impact on the future value of the business. Thus, at a time when the company can least afford the financial drain of a buyout, it may be forced to do so. The answer may be to value shares in a non-death buyout at a different price or provide for a long term purchase of an owner’s shares.

A major problem with many buy-sell valuation approaches is that they fail the test of time. For example, at the time of the creation of their LLC, two owners agree that book value is a good approximate of value. Twenty years later the LLC owns equipment worth $1,000,000, but which has been depreciated to $100,000. The departing 50% owner is not going to be happy about leaving $400,000 on the table. Because of this issue, many buy-sell agreements allow a dissatisfied owner to trigger an alternative valuation of the business, usually an appraisal.

Negative Covenants. The value of most small businesses, particularly service businesses, is usually determined by the personal work efforts and relationships of the principals of the business. If one of the principals is able to leave the company and take his customer relationships, employees and vendors, the future value of the company will be reduced. Therefore, clients should be strongly encouraged to account for the impact of a principal leaving the business and taking his business contacts, employees and vendors. If such a possibility can occur, the price should be accordingly reduced.

The other alternative is to adopt one or more negative covenants which restrict the ability of a departing owner to take advantage of his or her contacts with the business. The typically problem with such an approach is the inability of the business to prove the nature of the departing owner’s violation. These negative covenants are:

- **Non-Compete.** Restricting the ability of the person to compete against the company for a limited period of time within its market.
- **Non-Solicitation of Customers.** Restricting the ability of a departing owner to solicit the customers of the business. However, in most states, there is no limitation if the customer solicits the departing owner. Satisfying the burden of proof that the departing owner made the solicitation can be incredibly hard.
- **Solicitation of Employees.** The agreement can also restrict the ability of the departing owner to encourage employees to leave the company. In many cases, the employee is the most valuable part of the business. But again, the question arises of who solicited who.
- **Solicitation of Vendors.** Particularly in distribution companies, the relationship with the vendors that supply materials to the business may be the most important relationship and the departing owner who attempts to have contracts terminated can severely damage the business.
- **Trade Secrets.** Probably the most important element to protect is the company’s trade secrets, including the customers, (e.g., their names, needs and credit history) and business plans.

Installment Notes. Most businesses cannot survive the pay out of a substantial portion of their capital. In such cases, an installment note is probably the appropriate approach. To protect the business and its remaining owners, the note should generally be non-negotiable and allow for set-off against the departing owner for any indemnities or post-sale violations of the buy-sell agreement (e.g., the above negative covenants).
Limits with Deferred Payments. Where there is a deferred payout (e.g. an installment note payment), there should also to be restrictions designed to protect the holder of the note. These may include any of the following:

- A limit on new liabilities (especially collateralized loans) in the business.
- Providing collateral to the selling owner of more than the shares he has sold (e.g., collateral interest in the underlying assets of the business entity). As a counterbalance, the agreement may also provide that such collateral is released as a loan is paid down.
- A limit on the right of the existing owners to merge the business with another company without first paying off the installment note.
- Personal guarantees from the remaining owners may protect the former owner from intentional or unintentional mismanagement of the business.
- Limits on the salary of the remaining owners may create incentives to pre-pay the installment note.

Debt to or from the Business. The buy-sell agreement should provide that the debts between the company and the departing owner are satisfied. Debts due to the company may be used to reduce the purchase price of the shares. Debts due to the departing owner may increase the amount of the purchase price.

One important issue is often ignored. Most small business owners are required to guaranty most commercial liabilities of the company (e.g., to suppliers or banks). When an owner leaves the business, he or she should make sure that the agreement requires that the owner is released from all personal guaranties. However, a problem often arises. Either the company cannot determine what guarantees have been signed, or the creditors are unwilling to release the departing owner. There are several options:

- The agreement may require that the remaining owners indemnify the departing owner for any personal guaranties.
- The departing owner could send a return receipt letter to all known or possible guaranteed creditors indicating that any increase in the credit obligations after the date of the receipt of the notice will not be guaranteed.
- The departing owner may require that the company pay-off all guaranteed debt within a defined time frame.

WHY ARE THEY SIGNING THE AGREEMENT?
Perhaps one of the most pivotal issues which gets lost in the process of focusing on the details of the buy-sell agreement is “Why Should the Client Sign the Document?”

Advisors must not only be insightful on the detailed terms of a buy-sell agreement, but, before the agreement is signed, the client must address whether the agreement is in her or his best interest. A cost/benefit analysis should be a vital part of this decision process. For example, assume a young client with significant potential is offered 5% of a company’s stock with a five year vesting requirement, a buy-back at book value and a non-compete and non-solicitation built into the agreement. The client’s advisor may want to make sure there is a letter in his file advising the client that he or she may be giving up (i.e., future work opportunities and clients) more than is being received (i.e., a low value stock right).

Another example may highlight the issue. Many business owners own 100% of the business, but would like to sell the business to key employees if the owner dies. Often the owner will enter into an agreement with the key employees and increase their salary to fund the cost of an insurance policy on the owner’s life. Not exactly great planning. The business owner would be well advised to obtain the same insurance, place it in his or her own irrevocable life insurance trust and sell the business to the key employees who will use the income stream of the business to pay off the owner or the owner’s estate.

THE ATTORNEY’S ROLE
In order to properly draft a buy-sell agreement, the attorney needs to have a through understanding of not only the intent of the parties, but also of their business and its operations. The attorney should avoid being just a scrivener of the client’s expectations and intentions. Instead, the attorney should see his or her role as serving as a counselor offering objective advice and experience to help the client craft a proper document.

I tell my clients that they are entering into a unique marriage when they go into business. In many cases they will spend more time with the business partners then they do with their marriage partners. While the buy-sell is a helpful agreement, it is usually ignored until the divorce appears imminent - and then, like a pre-nuptial agreement, each party runs to the attorney to see what was agreed to so many years ago. At the inception, the client is often more eager to just sign a document, then to think about its consequences. It’s only later, when the divorce is looming, that the client will begin to fully understand the consequences of the document signed so many years ago - and blame the attorney if the job was inadequate. The role of the attorney cannot be to just draft a “simple” document. Like a minister or rabbi counseling a young couple entering into a marriage, the attorney has an obligation to brush aside the romantic notions and make sure the clients fully understand the consequences of what they are doing.

While the attorney may be engaged to just prepare a buy-sell agreement there are related areas which may need to be reviewed. Has the client examined how the buy-sell will impact the client’s estate planning? Is the business properly structured? Are there other documents such as minutes or employment agreements which need to be drafted? Some of these issues can be pulled from the checklist at the end of this article.
SUMMARY

Buy-sell agreements are a bit like pre-nuptial agreements. No one wants to ever use one, but they are extraordinarily helpful if disaster strikes. Until then, most business owners (like most married couples with a pre-nuptial agreement) ignore the provisions of the agreement. But business divorces are probably more prevalent than marital divorces and the business owner who fails to properly plan for the contingencies addressed in this article may find himself working through a disaster which could have been prevented or reduced with a bit of forethought.

Author: John J. Scroggin is a Roswell, Georgia based tax attorney whose practice is primarily devoted to tax, estate and business planning. He holds a B.S. in accounting, J.D. and L.L.M. Degree from the University of Florida. Mr. Scroggin is a nationally recognized speaker and is the author of over 230 published articles, outlines and speeches on estate and business planning. He can be contacted at: www.Scrogginlaw.com

Helpful Sources on Buy-Sell Agreements

Books:
• Mancusco & Laurence, How to Create a Buy-Sell Agreement to Control the Destiny of Your Small Business (Nolo Press 1999).
• Zaritsky, Structuring Buy-Sell Agreements: Analysis with Forms (WG&L).

1 See IRC section 1361.
4 O.C.G.A. section 14-11-601(d).
6 528 S.E.2d 260(2000).
7 C.F., O.C.G.A. section 48-7-21(b)(7)(B)
8 C.F., O.C.G.A. section 48-7-24 which taxes non-resident partners on Georgia based income.
12 See: O.C.G.A. section 14-11-605(b)
13 See: Model Business Corporation Act (1984) section 7.30. But note that section 7.31 allows a voting agreement to be entered into without regard to time limits.
14 See O.C.G.A. section 14-2-731.
Checklist for Buy-Sell Agreements

This checklist is designed to help deal with some of the preliminary issues in the discussion of your buy-sell agreement and other business issues. Please complete the checklist and send it to our firm before our meeting to discuss the agreement.

Name of the Business: ________________________________________________________________

Does the Business Operate under any other name? Yes ___ No ___.
If yes, have you filed a fictitious trade name filing? Yes ___ No ___.

Have you filed a state or federal trademark to protect your business's name? Yes ___ No ___.

This Business is a: ___ C Corporation, ___ S Corporation, ___ LLC, ___ General Partnership, ___ Limited Partnership ___ Other _____________________.

The Business was created in the state of _______________. The date of creation is _____________________.

The Business is qualified as a foreign entity in the states of _____________________________________.
Note: If you do business in other states, please check this box _____. We will discuss foreign qualification issues in our next meeting.

The business's last minutes were done on _________________________________.

The Business's Board consists of the following persons: _________________________________.

The Business's Officers are (list office and name): _________________________________.

The Business's Owners are: Name State of Residence Ownership %
____________________ _______________ ___________
____________________ _______________ ___________
____________________ _______________ ___________

Is there any existing buy-sell agreement? Yes ___ No ___. If yes, please send it to us with this checklist.

Have you addressed how the buy-sell agreement will impact each owner’s personal estate planning? Yes ___ No ___

Please send us copy of any documents (e.g., articles of incorporation) which have been filed with the Secretary of State and your most recent financial statement.

Our Accountant is: ______________________________ Phone #: __________________________
Please complete each question by circling your answer. If you have questions, leave the question unanswered.

I. Should the transfer of any ownership interest be subject to a Right of First Refusal? Yes No
   A. Should the Right of First Refusal go to both the company and other owners? (Typically recommended) Yes No
   B. Should the Right of First Refusal require that the owner provide a copy of a written bona-fide offer to the other owners? Yes No
   C. Should the agreement provide that the other owner’s exercise price is the lesser of the offer price or an appraisal price? Yes No
   D. Even if the third party offer is an all-cash offer, should the remaining owners be able to pay over time (i.e., to reduce cash flow issues)? Yes No

II. Should the Right of First Refusal go to all transfers? Yes No
    A. Does the Right of First Refusal apply to all sales transactions, including sales between owners? Yes No
    B. Should the Right of First Refusal apply to non-sale assignments of the business interest (e.g., a pledge of stock)? Yes No
    C. Should the Right of First Refusal apply to gift transactions? Yes No
    D. Gifts to a spouse? Yes No
    ii. Gifts to descendants? Yes No
    iii. Gifts to a trust or other entity for family? Yes No
    E. Should the Right of First Refusal apply to divorce transfers? Yes No
    F. Are some transactions exempt from the Right of First Refusal? (If yes, describe: ____________________________________) Yes N
    G. If all owners are offered the same price and a majority agrees to sell the business, is the Right of First Refusal automatically waived? Yes No
       In such an event, must all owners sell their ownership interest? Yes No

III. Is an owner required to sell his or her interest at death? Yes No
     A. Will the death transfer be funded in whole or part by a life insurance policy? Yes No
     B. If life insurance proceeds are insufficient to pay the purchase price, will a note be delivered to pay the balance? Yes No

IV. Is the disability of an owner a triggering event requiring the owner to sell his or her interest? Yes No
    A. Will there be a disability insurance policy to fund all or a part of this buy-out? Yes No
    B. If not, will a note be delivered to fund the purchase? Yes No

V. Is the retirement of an owner a required sell event? Yes No
    A. Does the termination of the employment of an owner require them to sell their ownership interest? Yes No
    B. Can an employee/owner be fired for cause? Yes No
       If yes, must the owner sell the ownership interest upon termination? Yes No
    C. Can an employee/owner be fired without cause? Yes No
       If yes, must the owner sell the ownership interest upon termination? Yes No

VI. How will the determination of value be made:
    A. By independent appraiser? Yes No
       Note: If owners are related Chapter 14 of the Internal Revenue Code may require an appraised value.
    B. By annual agreement of a set price among the owners? Yes No
    C. By a formula agreed upon by the owners? Yes No
    D. By a hybrid method? Yes No

VII. Should departing owners be able to:
    A. Compete against the business? Yes No
    B. Solicit customers of the business? Yes No
    C. Solicit employees of the business? Yes No
    D. Solicit vendors of the business? Yes No
    E. Be able to use the business’s trade secrets? Yes No
VIII. Other provisions of the agreement:

A. Is there a desire to offer preemptive rights to owners?  Yes  No

B. Is there a desire to keep one owner from owning a controlling interest?  Yes  No

C. Can each owner be assured a membership on the Board of Directors?  Yes  No

D. Should the agreement for a flow-through entity (S Corporation, LLC, Partnership) require distribution of a minimal amount to cover the state, federal and local income taxes of any taxable income allocated to a member?  Yes  No