Corporate Aspects of Buy-Sell Agreements

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I. Introduction – Why have a buy-sell agreement?

When forming a business, it is important to plan for ownership changes in the future (e.g., in case of death or incapacity of a partner or if a partner wants to get out of the business for any reason). Business partners protect themselves in advance by specifying when and how a partner can leave the business and to whom the exiting partner can sell or transfer his or her interest as well as what will happen to a partner's interest upon his or her death. Also, a buy-sell agreement can specify under what circumstances a partner can be forced out. Finally, a buy-sell agreement can ensure that a person recoups his or her investment in a business by specifying the method of valuation of such person's share in the business.

The following analysis applies regardless of the form of business entity used (i.e., corporation, partnership or limited liability company). For ease of discussion, the term "Partner" as used herein refers equally to (i) a member of a limited liability company, (ii) a shareholder of a corporation or (iii) a partner of a partnership. The term "Company" as used herein refers equally to any entity, whether limited liability company, corporation or partnership. See your state's Limited Liability Company, Business Corporation or Partnership/Limited Partnership law as applicable.

Usually a "buy-sell" agreement is not a stand alone agreement. It generally appears within a shareholders agreement (if the entity is a corporation), within an operating agreement (if the entity is a limited liability company) or in a partnership agreement (if the entity is a partnership).

The current vehicle of choice seems to be the limited liability company or LLC. It provides limited liability for its members (owners), can be taxed as a "pass-through"

entity for income tax purposes, and is extremely flexible. Hence, buy–sell provisions would be dealt with in the operating agreement signed by the members.

II. Structure of the Agreement – Cross Purchase/Redemption

A buy-sell agreement can be structured in one of two ways: (i) as a cross purchase or (ii) as a redemption.

In a cross purchase agreement, the Partners agree to buy each others' shares when a Partner retires or passes away.

A redemption agreement requires the Company to purchase an exiting Partner's shares during his lifetime or from his estate upon his death.

A crucial consideration in deciding whether to do a cross-purchase or a redemption is to consider which party will pay for the buyout (i.e. the Partners or the Company). Obviously, the economics differ. The client will usually know. When the corporation is buying, in effect, the seller's own money is helping to buy him out. In addition, concern must be given to tax issues.

III. Provisions in a Buy-sell Agreement

Listed below is a discussion of the key provisions in a typical buy-sell agreement:

1. Parties.
    a. The Partners are defined by name, residence address and percentage interest in the Company (usually done in the "Whereas" clauses).
    b. The Company must be a party if it is a redemption agreement or if the Company is otherwise obligated to do something.
    c. Who is your client? Conflicts of interest – Consider whether an attorney can ethically represent the Company and/or more than one

Partner in preparing a buy-sell agreement or whether there is an inherent conflict of interest. If an attorney represents more than one Partner, consider what conflict issues need to be waived by the clients.

2. Restrictions on transferability of shares. Buy-sell agreements usually contain restrictions on a Partner's ability to sell his shares. These restrictions allow business owners to retain control over who owns the business. Some examples of restrictions are listed below. They may be used in combination in a buy-sell agreement. Ultimately, the goal is to provide the Partners some sort of exit strategy, while protecting the remaining Partners.

    a. Absolute prohibition. I've seen a few agreements that provide that Partners may not sell shares under any circumstances. Though the law regarding the validity of absolute restrictions differs from state to state, these restrictions are generally unenforceable. Most states require that restrictive provisions be reasonable and not be of unlimited duration.

    b. Consent required. Some agreements provide that any sale requires the consent of all of the other Partners. These restrictions are enforceable provided that the Partners are required to act reasonably and in good faith.

    c. Right of first refusal. Here, the exiting Partner must first offer his shares to the other Partners (and/or the Company), for a limited period of time, on the same terms as are offered by a third party before accepting a bid from such third party.

d. Right of first offer. Here a Partner must offer to sell his shares to the other Partners or the Company (possibly at a stated price or formula) before offering to sell his shares to a third party.

e. Option to purchase by Partners pro rata. The Partners each have an option to purchase the shares of an exiting Partner in accordance with their ownership percentage in the Company.

f. Option to purchase by Company. The Company can have an option to purchase shares from a Partner upon the occurrence of certain events e.g., death, permanent disability or the cessation of employment. Formulas need to be set forth.

g. Option to purchase first by Partners pro rata and then by Company or vice versa. This is a combination of (e) and (f) above in a specified order so that if there are any shares left after the first option is exercised, the second option is exercisable with regard to the remaining shares.

h. Other permitted transfers (affiliates, family members, trusts & estate planning). Buy-sell agreements typically contain provisions allowing transfer of shares under these limited circumstances. Usually the agreement provides that the assignee in these transfers must agree to be bound by the terms of the agreement. Sometimes the assignee is not granted the right to vote or rights with respect to management.

Restrictions (b) through (h) are typically enforceable.

3. Forced Sales. Under certain circumstances, business owners may want to force a Partner to sell his shares. These circumstances include (i) termination of employment, (ii) death, or (iii) permanent disability. In a forced sale, the other business partners or the Company itself will likely be required to purchase the shares being sold. Forced sale provisions are generally enforceable.

4. Purchase Price Determination. There are various methods for determining the sale price of shares under a buy-sell agreement. Some examples are:

(a) Fixed price - If the price is fixed, there should be an automatic mechanism (e.g., a CPI factor) or another method of dealing with inflation or changes in value. Without such a mechanism, values today may be far too little or too great years from now.

(b) Book value or a Multiple of Book Value – Book value is rarely used. These formulas probably makes sense only in businesses with significant hard assets, without much value as an ongoing concern, as opposed to a primarily service business.

(c) Multiple of earnings or EBITDA (Earnings Before Interest, Taxes, Depreciation & Amortization).

(4) Appraisal by a third party at the time of sale.

(5) Consider discounts for minority interests.

5. Funding the buy-out by a "sinking fund". The partners could regularly put aside money to fund all or part of a buy-out. Some law firms do this.

6. Funding the buy-out by insurance. The purchase price (or a portion) of a deceased Partner's interest under a buy-sell agreement may be funded by life

insurance. Usually term life insurance is used. Note that there are also insurance products which can fund a buyout upon disability (this product is more expensive than life insurance).

a. Cross purchase agreement. The Partners take life insurance policies out on each other with themselves as beneficiaries.

b. Redemption agreement. The Company takes out life insurance on its Partners with itself as beneficiary.

Either way, the agreement provides that the proceeds of the policy are to be used to fund the purchase of the shares from the deceased's estate. If this method of funding is used, the agreement should also discuss how the balance of the purchase price will be paid for if the proceeds of the insurance policy are insufficient to cover the purchase price of the shares, i.e. what will be the payment terms, interest, security, will there be promissory notes and security agreements etc..

Some agreements also contain a provision permitting a retiring person to purchase the life insurance policy on his life from the Company or the remaining Partners. This is particularly useful when the policy is a whole life policy.

7. Terms of Payment. The agreement should cover the method of payment for the shares, i.e., cash versus a payout, and if a payout, what the terms are, including when principal payments are to be made, amounts and timing of interest payments and whether the shares will be put in escrow (or pledged) pending the payment of the full purchase price. Usually a promissory note evidences the debt. The promissory note may or may not be negotiable. The agreement should also

specify the mechanics of closing the purchase (where and when). The agreement must provide whether title passes at closing or upon payment in full of the deferred purchase price.

8. Security. If the purchase price is paid over time and title passes at closing, the shares are often pledged back to the seller as collateral security. If so, a security agreement is done. The security must be secured pursuant to the terms of the UCC. Blumberg has good, simple security agreement and financing statement forms.

9. Representations and Warranties. Typically, the selling Partner (who will represent less here than in a sale of a business) must represent as to the following.
    a. he has good title in the shares, free and clear of any liens, claims or encumbrances;
    b. he knows of no other outstanding shares (other than those of the remaining Partners);
    c. he may have to make representations regarding the status of the business. This is a matter to be negotiated.
    d. he is not aware of any obligations of the Company which are not terminable at will except as set forth on the annexed schedules.

    The selling partner in a cross purchase/redemption typically makes fewer representations and warranties than in a sale of an entire business.

10. Preserving the value of the Company Pending a Sale. If the contract and closing are not simultaneous, provisions prohibiting a sale of assets or other significant

transactions will prevent the dilution of the value of a selling Partner's interest in the business pending closing.

11. Non-competition. Frequently the departing Partner will agree not to compete with the Company or do business with the Company's clients for a specified period of time. Non-compete Agreements are enforceable if reasonable as to length of time and geographic scope. The departing Partner may have to agree not to solicit employees for a period of time.
12. Choice of Law, Choice of Jurisdiction, Arbitration. These are typical contract provisions mandating what state law will govern disputes regarding the contract and what courts will be used. These provisions may mandate that disputes go to arbitration instead of court. If you represent the smaller party, you generally choose arbitration. It's quicker, cheaper and the arbitrator tends to "split the baby".
13. Legends on Stock or Membership Certificates. Share or membership certificates should include a legend specifying that the shares represented by the certificate are subject to a cross purchase or redemption agreement, as the case may be. (LLC companies and partnerships may or may not have membership certificates.)

IV. Other Provisions in Shareholder Agreements/Operating Agreements

A buy-sell is usually part of a broader Shareholders' Agreement (for corporations), Operating Agreement (for LLC's) or Partnership Agreement (for partnerships) that also contains the following provisions:

1. Control of the Company.

(a) Board of Directors /Managers. These provisions specify the size and composition of the board (for corporations) and the managers (for LLCs). (LLCs may be member managed.)

Note that in a corporation, since the shareholders elect the board, an agreement by a shareholder to vote for certain individuals as directors is enforceable. However, the board of directors appoints officers. Once elected, the directors have a fiduciary duty to act in the best interest of the corporation and a shareholders' agreement provision specifying who will be the officers is not binding on board members.

(b) Corporate actions requiring a super-majority vote. Certain extraordinary actions such as a sale of assets by certain corporations formed before 1998 require the consent of a super-majority (see BCL Sections 903 and 909).

(c) Proxy, Voting Trust. On occasion, a shareholders agreement will have one shareholder give a proxy to vote his shares to another shareholder or may have all the shareholders placing their shares into a voting trust to be voted by the trustee. However, these provisions are rarely seen in small, closely-held companies.

2. Distribution of Profits. How and when will the money come out of the Company as dividends or distributions?

3. Employment. The following issues should be addressed with respect to any Partner who is to be an employee of the Company:

(a) Term. What is the term of the Partner's employment with the Company?

(b) Compensation and perquisites. How much will the Partner be paid?

(c) Duties. What duties does his job entail?

(d) Termination with or without cause. Include definition of cause.

(e) Sale-back of shares if employment ceases.

(f) Restrictive Covenant. Does the departing employee agree not to compete with the Company or do business with the Company's clients and/or employees for a specified period of time?

4. Puts and Calls. A Partner may have a right to "put" his shares to the Company or the Company may have the right to "call" a Partner's shares under specified conditions and at specified prices.

5. Preemptive rights. Are there preemptive rights? The effect of Partners having preemptive rights is that upon issuance by the Company of additional shares or interests for cash, each Partner shall have a right to acquire a pro rata portion of such shares according to the number of shares of such class held by him. This is an anti-dilution provision. Note that to be enforceable with regard to a corporation, it must be in the charter. The answer will be found in your individual state's Limited Liability Company, Business Corporation or Partnership/Limited Partnership statutes.

6. Bring Along (or Co-sale Rights)/Come Along. If a majority owner sells his shares to third parties, the other Partners may have a right to "come along" i.e. join in the sale and/or the majority owner may have the right to "bring along" the

other Partners in a sale. In a case where less than 100% of the Company is being sold, the Partners each sell an amount which is proportional to their percentage ownership in the Company.

7. Registration Rights. If the Company goes public (at which point it will likely be a corporation), the shareholders may have a right to demand their shares be registered or to "piggy back" their shares onto the Company's registration of shares.

8. Liquidation of Company. Are there certain situations which should trigger the dissolution of the Company? This provision is rarely used.

9. Capital Call. Is there any? Usually not.

10. Confidential information. What information is considered confidential? What are the limitations on confidentiality?

11. Corporate Opportunity. While a principal generally may not take for himself a business opportunity that could have gone to the Company, the parties by agreement may waive such prohibition.

12. "Collar" – if too many partners exit at once. Sometimes agreements provide that if a Partner retires or wishes to sell his interest that the Company will purchase his shares for a fixed or formula purchase price. While the Company may be able to afford this if only one Partner (or a limited number of Partners) exercises this right within a given period, it may not be able to afford it if multiple Partners exercise it. Therefore, a provision like this is added to provide that if multiple Partners exercise such a right, the price will be reduced according to a certain formula. In this way, "the first one out the door" is not rewarded.

V. Deadlock

1. Deadlock/Dissolution – Despite the best drafting, sometimes two owners of a corporation are deadlocked and cannot live with each other. See Section 12620-12629 of the California Code. In certain cases, one of the shareholders can force the dissolution of the corporation. A receiver may also be appointed under certain circumstances.

2. Deadlock/Instant Fairness on Price - Sometimes if two partners cannot live with each other and are negotiating buying each other out, you can have one party pick the price and have the second party then determine if the second party wishes to be a buyer or a seller at that price.

VI. Miscellaneous

1. In preparing a buy-sell agreement you should seek the advice of tax counsel and consult with the Company's accountant.
2. The parties may wish to include indemnification provisions in the event of breaches or have a provision where the prevailing party is entitled to reimbursement of attorney fees from the defaulting party.
3. Obviously, in certain fields (law, medicine, architecture, etc.), only a member of certain professions may become a shareholder.
4. In my opinion this is a very challenging agreement. Clients often view it as a simple matter or form. As I hope this presentation indicates, there are many complex issues to be thought through and discussed with the client.