

Buy-Sell Agreements

**Why have one? What document should be used?
What issues should be considered?**

Why have a buy-sell agreement?

What happens to the ownership of the company if an owner dies or becomes disabled and cannot work, or if their work with the company is terminated for any other reason? Is there a “way out” without a lot of litigation and cost if the owners do not get along at some point? Do you want to “keep it in the family”? In other words, if an owner loses his or her ownership in a bankruptcy or divorce, or if an owner receives an offer to buy his or her ownership interest, do you want the other owners to have a right to buy instead of letting it go to an outsider? If a buy-sell agreement is in place among the owners, these issues are addressed and can be handled much more easily when and if they occur.

What document should be used for these provisions?

We prefer to have the buy-sell agreement in a separate document devoted to these types of issues. That makes it easier to understand and focus on, both at the time you first put the agreement in place as well as at the time something happens.

However, you might find these in other documents, such as Articles (which are public and filed with the Secretary of State), the Bylaws of a corporation, the Operating Agreement of an LLC, or the Partnership Agreement of a partnership. These are not improper places to have these arrangements; we just find that the business owners understand them better and focus on them better if placed in a separate document.

What issues should be considered?

1. Regardless of whether Minor & Brown represents the entity or one of the owners:
 - a. Many provisions of the Agreement may not be completely in the client’s favor because you cannot fully predict what the situation will be at the time, and certainly cannot predict which owner might be the seller.
 - b. As a whole, it is in the best interests of the client is to avoid future problems.

2. Factors to consider

a. Number of owners – Examples of issues:

- i. If there are 5 owners a cross purchase arrangement (where the remaining owner buys stock from the departing owner) is unwieldy whereas for 2-3 owners this might work.
- ii. If there are 15 owners then amendment or termination of the agreement by unanimous consent could be unworkable.

b. Active owners v. inactive owners – Examples of issues:

- i. If there are inactive owners, then their disability or termination of employment would not affect the company so perhaps the agreement does not address this.
- ii. Consider whether the inactive owners would want to have to buy out the active owners if they die, etc.

c. Percentage ownership of each – Examples of issues:

- i. If there is some equality of ownership the agreement may be totally different than if there is vast inequality. If the ownership is 95/3/2% possibly just use a “buy-back agreement” for the minority owners.
- ii. If the minority owners are the future successors, then a complete buy-sell agreement covering both majority and minority owners could be more appropriate.

d. Age of the owners – Examples of issues:

- i. If you have two equal owners – one 40 and one 58 – you might think that the 58-year old is far more likely to leave first.
- ii. However, the 40-year old may have a 5-year plan and the 58-year old might have a 10 to 15-year plan.

e. Ages of children – Example of issue:

- i. If you have two owners – one who is 50 with children in grade school and the other who is 40 with children in college, then consider whether the 50-year old is really likely to leave first.

f. Children in the business – Examples of issues:

- i. If there are children of an owner in the business, how does that affect the succession plan?

- ii. Does the child buy (or receive a gift) from the parent?
 - iii. Is the child capable of being a successor owner?
 - iv. How does that impact other children of that owner?
 - v. How does this impact other employees of the company?
- g. Long term goals of each owner – Examples of issues:
- i. Each owner has a goal in mind (perhaps only vaguely, but it is there) as to how long to stay with the business, what it means to “retire”, how much they want to work, whether they want the business to take on new ventures, etc. These need to be discussed to achieve a good buy-sell agreement that meets each of their needs.
- h. Spousal consent – Example of issues:
- i. This is possibly more important in community property states.
 - ii. Many clients (even in community property states per an informal survey) do not want to involve spouses who are not owners in the document.

3. Structure

- a. Buy-sell agreement v. buy-back agreement –
- i. If there is “equality” between the owners, then a buy-sell agreement that treats each similarly is appropriate.
 - ii. If there is inequality, (e.g., in a 90/10% situation), then perhaps there is a “buy-back” agreement for the minority owner. For the majority owner, should there be any agreement as to his or her equity interest?
 - First right of offer/first right of refusal for the minority owner if the majority owner desires to sell or on an involuntary transfer?
 - Purchase on death of the majority owner?
 - Purchase on disability of the majority owner?
 - Purchase on (voluntary) termination of the majority owner?
- b. Organized by event triggering purchase-
- i. At Minor & Brown, we organize the document by the event triggering the purchase. For example, one section addresses what happens on death, another addresses what happens on termination of employment. We find that this makes it easier to understand what the document really does.

- c. Attachments – At Minor & Brown, we attach the form of promissory note and security agreement that will be used at the time of a purchase and sale of equity interests. If not, the agreement itself would have only a “brief description” of the terms and there may be a dispute at the time of the sale.
 - d. Legends on certificates – A notice about the buy-sell agreement is typed on any certificates. Under the UCC this helps prevent a sale to a “protected purchaser”, i.e., someone who can buy the certificate free of any restrictions under the buy-sell agreement – CRS Section 4-8-303
4. Types of purchases-
- a. Mandatory sale and purchase
 - b. Must offer for sale – To whom and in what order? If there are multiple people in the offeree group, in what percentages can they buy and what if someone doesn't want to buy his/her share?
 - c. Has option to buy – Who, in what order, and in what percentages? Also, if a person with a lower right to buy exercises the option first, what is the process? Usually they must give notice triggering the option and then those with the higher tier right can exercise their option first.
 - d. “Wait and see” - Offers followed by a mandatory purchase of any remaining equity interests. A “wait and see” provision allows for changes in circumstances. This is often used for death buyouts. First the other shareholders have the right to buy and then if they don't buy the company must buy.
 - e. If there is insurance funding (e.g., on death) then consider mandatory purchases to the extent of insurance proceeds.
 - i. What if the insurance is really supposed to be part “key person” insurance? Then consider providing only a percentage of the proceeds must be used to buy, or perhaps the first \$X are used as key person insurance and then the rest is funding for the purchase.
 - f. Company purchases – Often there are state restrictions on the company's ability to acquire its own securities. These are designed to protect creditors. Query, should the other owners have to guarantee the company purchase obligation?
 - i. Corporations – CRS Section 7-106-401
 - ii. LLCs – CRS Section 7-80-606
 - iii. Limited Partnerships (1981 Act) CRS Section 7-62-607

5. Triggering Events –

a. Ownership by an entity-

- i. If ownership of the company is held by an entity, consider how to address each of these events.
- ii. For example, for a corporation where a shareholder is an LLC owned by two people, you need to plan for transfers of ownership of the LLC and you need to plan for death of an owner of the LLC.
- iii. Phrasing can become more difficult.

b. Permitted Transfers-

- i. Are transfers to family members or family trusts or family owned entities allowed without having to get consent or being subject to some other first right to buy? Are those family members or trusts or entities allowed to retain the stock or must they sell (offer for sale) if the original owner had to sell (or offer for sale)?
- ii. Can the company or an owner sell to employees without having to get consent? On what terms, and are those employees bound by the buy-sell agreement?

c. Death

d. Disability

- i. For how long must the owner be disabled, and how is “disability” determined?

e. Termination of employment

- i. If an owner voluntarily quits, is a mandatory purchase and sale a good idea? This can result in the dreaded “race to quit” which is especially an issue when the price includes goodwill.
- ii. Can an owner be fired? If so, by what vote or for what reason? For purposes of the buy-sell provisions, does it matter if the termination is “for cause”, and if so how is “cause” defined?
- iii. Beware of language because of possible disputes as to “voluntary” v. “you forced me out” and as to what is “cause”.

- f. “We don’t get along” / Business divorce – Use of a Texas Shoot-Out can help avoid spending time, energy and money
 - i. Envision the Gunfight at the O.K. Corral – one person (or group) invokes the provision saying “either you buy me out or I’ll buy you out but we are done!”
 - ii. No one lightly uses this provision because the person invoking it does not control the outcome. Therefore, this encourages negotiations but an ultimate resolution is available.
 - iii. Can any owner invoke this? Is there a minimum percentage of ownership required?
 - iv. Does the offeror set the price and terms? If so, could be abusive. For example, the offeror knows that the other person is in financial straits because he/she has 3 children in college. The offer could be for a low price but paid in cash.

- g. Desire to sell / bona fide offer
 - i. What is a “bona fide offer”? Should this be more fully defined?
 - ii. Usually a first right of refusal (“must offer”) provision is used.
 - iii. Must the others match the offer price or is it the “lower of offer price or agreement price”? If lower of price and agreement price is lower, then consider an anti-abuse provision restricting resale to the bona fide offeror for some period.
 - iv. Must the others match the offer terms or are agreement terms used?
 - v. If the bona fide offeror buys, are they bound by the buy-sell agreement? E.g., what if that person dies, etc.?
 - vi. Drag along - Should a majority owner / group have the right to force the minority to sell if they don’t accept the offer and the bona fide offeror wants to buy all? Consider what percentage would be required to approve an asset sale.
 - vii. Tag along – Should a minority owner / group have the right to require the majority to force the bona fide offeror to buy the minority interest too (and if not then the majority can’t sell)?

- h. Involuntary transfer – This relates to loss of ownership interest in divorce or bankruptcy.
 - i. Usually a first right of refusal (“must offer”) provision is used.
 - ii. Is such a provision enforceable? Even if not, money is the key. Ex-spouses and creditors prefer money to ownership in a company they don’t control. Divorce courts may not allow price to be governing for purposes of settlement.

6. Purchase Price

- a. How is price determined?
 - i. By agreement (include automatic adjustment in case they don’t readdress this for many years)
 - ii. By formula – be sure to take company debt into account. E.g., a formula such as 3 x EBITDA sounds like something that a third party buyer could use, but that assumes that the company is debt free (or at least has enough working capital to pay debt).
 - iii. By appraisal – just appraising the assets and business does not take into account company debt
- b. Is a discount used for minority interests, or is it simply “company value x percentage ownership”? If a discount is used, how is that determined?
- c. Per share price v. liquidation value – for an LLC / partnership, use liquidation rights rather than “times percentage”. Often one owner has a much larger capital account with preferred returns (or not) and that causes a problem is straight percentage ownership is used. The same can happen with corporations with preferred stock.

7. Payment Terms

- a. Down payment – This is usually a percentage of the price. However, if there is insurance funding and it is greater than that percentage, the entire insurance amount should be used.
- b. Promissory note – Select the term of the note and the payment scheme. Select an interest rate or a way to determine the interest rate (e.g., prime plus 1%) and use at least the applicable federal rate. The rate can be adjusted annually and this is especially appropriate for long term notes. (The rate could be adjusted even daily, but the result is an administrative nightmare.)

- c. Security
 - i. Often only the ownership interest sold is used as collateral.
 - ii. The agreement could also require security interest in company assets. However, company assets are also needed as collateral for business financing.
- d. Rights on default of payment / restrictions during payment
 - i. Normal acceleration and collection remedies
 - ii. Does the seller have the right to review books and records? Is this only on default?
 - iii. Should there be restrictions on actions that reduce the company's ability to pay its note obligations – e.g., the remaining owners pulling money out as compensation or dividends?
- e. Release from guarantees – Business owners often sign personal guarantees for business financing. On departure they should be released from these to the extent possible or at least indemnified against harm.

8. Amendment / Termination

- a. Usually unanimous consent is required to amend or terminate the agreement.
- b. Where there are many owners and some with very small interests, sometimes the agreement can be terminated or amended with less than unanimous consent. In those cases, should the dissenting owners be allowed some special right to sell under the pre-existing terms?

9. Non-Competition from the departing owner

- a. This is especially important if the purchase price includes good will.
- b. Should any part of the purchase price be allocated to the non-compete agreement?
- c. What are remedies for violation of the non-compete agreement?

10. Life Insurance

- a. Should owners be required to cooperate to acquire life insurance?
- b. Does a departing owner have the right to buy insurance on his life at the time of leaving?

- c. Does a remaining owner have the right to buy insurance on his life from the departing owner?

Tax and insurance Considerations

1. IRC Section 101 – Transfer for Value rules provide that transfer of a life insurance policy results in tax issues on receipt of the proceeds. Beware of any such transfers.
 - a. Transfer of a policy to a corporation of which the insured is a shareholder or officer does not cause that problem
 - b. Transfer of a policy to a partnership of which the insured is a partner or between partners does not cause that problem.
 - c. Transfer of a policy between shareholders is an issue.
2. Cross-purchase v. redemption
 - a. Number of insurance policies increase dramatically in a cross-purchase agreement as the number of owners increase = # owners x (# owners – 1)
 - b. “C” Corporation has AMT issues due to corporate insurance proceeds
 - c. Basis increases
 - i. Redemption for cash does not give remaining owners an increase in basis in their equity
 - ii. Basis increases in pass-through entities as the company makes money to pay a note obligation
 - iii. There may be a partial or full step up in basis in pass through entities on receipt of life insurance proceeds
 - d. Family / Affiliate Ownership - IRC Sections 301, 302, 318 – family ownership of “C” or former “C” corporation stock may convert capital gain on redemption of stock by one family member into ordinary income.
3. Do you want to set value for estate tax purposes?
 - a. Rev. Rul. 59-60
 - b. IRC Chapter 14, Section 2703

Other Possible Provisions

1. Employment – e.g., payment of compensation during disability, and can an owner be fired.

2. Pass-through entities – any required distributions for taxes (and consider what tax rate should be applied)
3. Maintaining and/or changing “S” corporation status and decisions about closing the books on sale of stock.
4. Financial, tax, and accounting issues, such as limits on incurring company obligations might be placed with management / voting provisions. (Dated: February 2010)

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