

## § 21:2 Checklist

### BUY-SELL AGREEMENT DRAFTING CHECKLIST

#### I. Purposes of Agreement.

##### A. Determination of Purpose.

1. It is important to determine, at the outset, the purpose or purposes that the buy-sell agreement is to serve.

2. The type of buy-sell agreement used and its terms of the agreement should be consistent with its purpose or purposes.

##### B. Purposes.

1. There are a variety of reasons for corporations to have buy-sell agreements.

2. Some of these reasons are as follows:

a. Limiting ownership of shares of the corporation.

(1). Limiting ownership to existing shareholders by restricting transfer of shares to third parties.

(2). Limiting ownership to individuals who are actively and regularly employed by the corporation by providing for purchase of shares held by persons who are not in this class.

(3). Preserving the corporation's S corporation election by restricting transfers that would cause the election to terminate.

(4). Preserving the status of a corporation as professional corporation or other specialized form of corporation that may have only certain types of shareholders.

(5). Preventing transfers in violation of securities law limitations.

(6). Preventing transfers in violation of licensing requirements to which the corporation is subject, such as stock ownership restrictions imposed on the corporations that hold liquor licenses.

b. Providing a means for a deceased or disabled shareholder to liquidate his or her shares of the corporation upon death or disability.

3. Defining the value of shares of the corporation for gift and estate tax purposes, although this is typically an issue in the family-owned corporation context and it is difficult, if not impossible, to limit the

transfer tax value of shares in this context given IRC §2703.

4. Dealing with issues such as the possibility of deadlock if there are two equal shareholders.

#### II. Type of Agreement.

##### A. Form of Restrictions.

1. An initial decision must be made as to whether restrictions on transfer of stock should be included in the articles of incorporation or bylaws of the corporation or in a buy-sell agreement.

2. A buy-sell agreement is ordinarily the best choice due to its flexibility.

3. However, restrictions in the bylaws or articles may be required for corporations subject to regulatory requirements restricting stock ownership.

##### B. Type of Buy-Sell Agreement.

1. There are three types of buy-sell agreement:

a. Cross-purchase agreement.

b. Redemption agreement.

c. Hybrid agreement.

2. The appropriate type of agreement can be selected after consideration of the comparative advantages and disadvantages of each type given the circumstances presented and the purpose or purposes of the agreement.

#### III. Restrictions on Transfer.

##### A. Prohibited Transfers.

1. The buy-sell agreement should prohibit transfers of shares of the corporation by the shareholders and provide that such transfers are invalid unless the transfer is of a type permitted under the agreement.

2. For this purpose, "transfer" must be defined, and generally should be defined broadly.

##### B. Permitted Transfers.

1. If certain transfers of shares of the corporation are to be permitted, the types of transfers that are permitted should be identified in the agreement.

2. For example, buy-sell agreements typically permit transfers to be made if all shareholders consent to the transfers.

3. Transfers may also be permitted if they are made to a limited class of persons specifically defined in the buy-sell agreement, such as the families of

shareholders, or persons who are eligible to own stock of an S corporation.

4. Since a flat prohibition on the transfer of shares may be an unreasonable restraint on alienation, buy-sell agreements also typically provide that shares may be transferred if they are first offered for sale to the corporation or the other shareholders.

#### IV. Purchase of Shares.

##### A. Mandatory Versus Optional Purchase.

1. The other shareholders (under a cross-purchase agreement) or the corporation (under a redemption agreement) may either have an option to purchase shares upon the occurrence of a triggering event or an obligation to purchase shares upon such an event.

2. The agreement may provide for optional purchase upon some events (such as a proposed transfer of shares to a third party) and mandatory purchase upon other events (such as the death of a shareholder).

##### B. Person with Option or Obligation to Purchase.

1. The buy-sell agreement should specify the person or persons, the other shareholder or shareholders or the corporation, who have the option or obligation to make a purchase.

2. The use of successive options and obligations might be considered.

a. For example, the corporation might have the first option to purchase shares that are to be sold to a third party, with the other shareholder or shareholders having the second option.

b. In addition, the other shareholder or shareholders might have the option to purchase the shares of a deceased shareholder, with the corporation having the obligation to purchase any shares not purchased in accordance with this option.

c. Giving the corporation a first option and then requiring the shareholders to purchase shares should be avoided, since the corporation's purchase will satisfy an obligation of the shareholders and will thus be a constructive dividend to them.

##### C. Triggering Events.

1. The buy-sell agreement should define the events triggering an option to purchase or a mandatory purchase of shares of the corporation.

2. Triggering events may include the following:

a. An actual or intended transfer of shares by a shareholder.

b. The death of a shareholder.

c. The disability of a shareholder. If disability is a triggering event, disability must be defined.

d. The termination of a shareholder's employment by the corporation.

#### V. Purchase Price.

##### A. Purchase Price Provision.

1. The purchase price of shares to be purchased under a buy-sell agreement must be set forth in the agreement.

2. The purchase price should be fixed or determinable under the terms of the agreement.

a. Both fixed and determinable price provisions might be included in the same agreement. For example, the price may be fixed in the agreement but subject to determination by appraisal if the shareholders fail to periodically update the fixed price.

b. The price may depend upon the circumstances giving rise to the purchase. For example, a fixed price might be used on death of a shareholder, and a determinable price, based upon the proposed sales price, might be used if a shareholder intends to sell his or her shares.

##### B. Fixed Purchase Price.

1. The purchase price for shares under the buy-sell agreement may be specified in the agreement.

2. If a fixed price is used, provisions might be included for periodic adjustment to ensure that the price reflects current value.

3. If provision is made for periodic adjustment, provisions might be included providing for a method of setting the price, by appraisal or otherwise, if the parties fail to make periodic adjustments.

##### C. Determinable Purchase Price.

1. A mechanism may be included in the buy-sell agreement providing a means of determining a purchase price. The agreement should describe in detail the mechanism for determining the purchase price, which may take the form of either a formula or a process.

2. The purchase price might be determined by application of a specified formula at the time of purchase, based on one or more of the following:

- a. Book value.
- b. Book value with adjustments.
- c. Capitalized earnings.

3. The purchase price might be determined by a specified process, such as an appraisal, at the time of purchase. Alternatively, the purchase price might be determined by the price at which a shareholder proposes to transfer shares to a third party.

#### VI. Terms of Payment.

A. The terms of payment for shares purchased under a buy-sell agreement should be specified in the agreement.

B. The terms may depend upon the circumstances giving rise to the purchase.

1. The terms might be based upon the terms of the proposed transfer to a third party in the event of purchase arising out a proposed transfer of shares to a third party.

2. If insurance proceeds will be available to fund a purchase upon the death or disability of a shareholder, consideration should be given to requiring that those proceeds be paid to the deceased or disabled shareholder forthwith.

3. More favorable terms of purchase may be provided if stock is purchased upon disability or death of a shareholder than if stock is purchased as result of a proposed transfer to a third party.

C. The precise terms of purchase should be set forth in the agreement, including:

- 1. Time of closing of the sale and the obligations of the parties to the closing.
- 2. Amount of any down payment.
- 3. Amount and periodicity of installment payments.
- 4. Interest rate on the unpaid balance of the purchase price.
- 5. Remedies for default if the purchase price is not paid in accordance with the terms of the agreement.
- 6. Right to prepay installments.
- 7. Security for the obligation to pay the purchase price.

#### VII. Life Insurance.

##### A. Required Purchase.

1. In the case of a cross-purchase type buy-sell agreement, it may be appropriate to require that shareholders obtain and maintain life insurance of a

particular amount on the life of each of the other shareholders.

2. In a redemption type buy-sell agreement, it is more common to leave it to the corporation's discretion as to whether to purchase life insurance and the amount.

##### B. Use of Death Benefits.

1. If the purchase of life insurance to fund the obligation to purchase shares of deceased shareholders is contemplated, consider whether the proceeds of this insurance should be earmarked for payment to deceased shareholders and whether the owner's incidents of ownership in the life insurance should be restricted.

2. If life insurance is to be obtained, consider whether the agreement should require that the full amount of the death benefit be paid to the estate of the deceased shareholder as part of the down payment for the purchase of the deceased shareholder's stock.

#### VIII. Corporate Redemption.

##### A. Corporate Authorization.

1. If the corporation may be the purchaser of shares under the buy-sell agreement, the purchase may require authorization by shareholder action.

2. If authorization by shareholder action is required, a provision might be included in the buy-sell agreement requiring all shareholders to vote their shares to facilitate the purchase. This may include voting shares to create the necessary capital surplus to permit purchase of shares under applicable state law based on the Model Business Corporation Act.

##### B. Restrictions on Corporate Purchase.

1. The corporation may be subject to statutory or contractual restrictions that prevent its purchase of stock under a buy-sell agreement.

2. If the corporation is unable to make a required purchase, the buy-sell agreement might require that the other shareholders make the purchase.

#### IX. Optional Provisions.

##### A. Corporate Indebtedness.

1. Consider inclusion of a provision requiring that, at the time of the purchase of a shareholder's shares under the buy-sell agreement, all indebtedness of the corporation to the shareholder be paid in full.

2. Consider inclusion of a provision requiring that, at the time of the purchase of a shareholder's shares under the buy-sell agreement, the shareholder be released from all guaranties of corporate indebtedness.

3. Consider inclusion of a provision requiring that, at the time of the purchase of a shareholder's shares under the buy-sell agreement, the shareholder's property be released as security for all corporate indebtedness.

#### B. Solomon's Choice Provision.

1. In the context of a corporation with two equal shareholders or two equal groups of shareholders, where deadlock is possible, consider including a provision giving the shareholders an option to purchase or sell shares to one another.

2. In using such a provision, the financial ability of the shareholders must be considered to avoid giving an undue advantage to one shareholder or group over another.

#### C. Termination of Agreement.

1. Consider inclusion of a provision terminating the buy-sell agreement if circumstances inconsistent with the agreement occur.

2. Circumstances inconsistent with the agreement may include the insolvency or dissolution of the corporation, the cessation of its business, and the deaths of a majority of the shareholders in short order.

#### D. S Corporation Provisions.

1. In the context of an agreement for an S corporation, consider including provisions designed to preserve S corporation status and to deal with issues of corporate administration unique to S corporations.

2. Provisions dealing with preservation of S corporation status may include specific restrictions on transfers that would cause termination of the S corporation election, provisions making it clear that transfers in violation of the agreement are ineffective for all purposes, provisions requiring super-majority approval of a revocation of the S corporation election, and provisions requiring shareholders to consent to the cure of an inadvertent termination.

3. Provisions dealing with corporate administration of S corporations may include a provision for making the election to close the corporation's books on the purchase of a shareholder's stock, a provision limiting corporate distributions in the year of a redemption

under the buy-sell agreement, and a provision requiring minimum corporate distributions to enable shareholders to pay taxes on corporate income.

#### E. Consent of Third Parties.

1. Under certain circumstances, the consent of third parties to the terms of a buy-sell agreement may be necessary or desirable and provision for this consent should be added to the agreement.

2. Circumstances in which third-party consents are required include the ownership of stock as community property by married shareholders and the holding of security interests in stock by third parties.

#### X. Miscellaneous Provisions.

A. Specific Enforcement. Include a provision for enforcement of the buy-sell agreement by specific enforcement.

B. Binding Effect. Include a provision making the buy-sell agreement binding on persons who acquire stock in the corporation in the future, as well as on the parties to the agreement.

C. Stock Certificate Legends. Require that a legend be included on all share certificates of the corporation so that third parties are notified of the existence of the agreement.

D. Boilerplate. Include boilerplate provisions dealing with issues such as notice, litigation expense, waiver, applicable law, and the fact that the buy-sell agreement is the entire agreement.