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BUY-SELL AGREEMENTS ARE JUST SMART BUSINESS

Protect Your Share – and Your Heirs – With a Buy-Sell Agreement

BY RICHARD LUTRINGER

THERE ARE SEVERAL REASONS WHY YOU as a small business owner, need a buy-sell agreement. One reason may be to specify what will happen to your share of the business if you should die. Another reason is to protect yourself in the event of a disagreement or dispute between you and your partner (or partners), in which case a non-death option should be addressed ahead of time. Whatever the reason, having a buy-sell agreement is simply smart business.

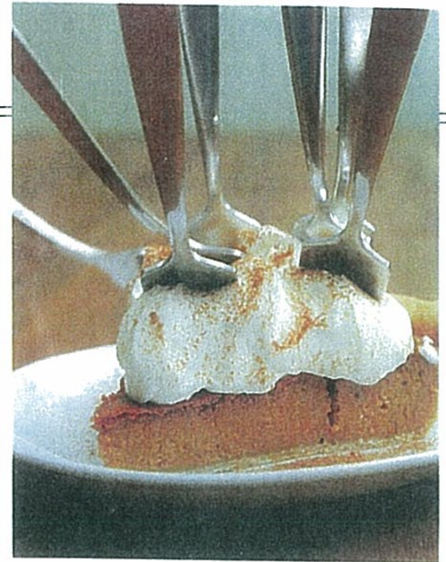
In one real-world example, when one of the three owners of a trucking company had a heart attack at 58, his widow expected to get her husband's proportionate share of the fair value of the business. But the two surviving owners did not want to borrow money to fund the purchase of the deceased's shares.

In New York State, as in most states, when there is no buy-sell agreement with regard to the shares of a corporation upon the death of a shareholder, there is no duty for the corporation or the other shareholders to purchase the deceased's shares. The widow's options in the trucking company case were extremely limited, since neither one of the surviving owners or the company itself had any contractual obligation to dissolve the company or buy her husband's interest in the business. Without illegal, fraudulent or oppressive actions by the controlling shareholders, or unless the shareholders have been unable to elect directors for at least two years, a minority shareholder of a New York corporation has no right to force a judicial dissolution, much less demand a buyout. In this scenario, since the two surviving owners owned 66% of the shares of the company, they were not obligated to purchase the widow's shares. Since the shares had no current value, the widow was effectively locked in as a passive minority investor in a business that traditionally paid no dividends.

In need of cash, the widow consulted with her attorney and sold her late husband's interest in the company for a 35% discount off the lower end of the range of one third of the business' fair market value, in accordance with a standard formula suggested by her tax accountant, payable one third up front and the remaining two thirds in monthly installments over 10 years.

It's not just shareholders of corporations who need to take care of themselves at an early stage. Judicial dissolution of a limited liability company (LLC) can be even less predictable since under New York LLC law a judge must be convinced that it is not "reasonably practical" to carry on the business of the LLC. There are few precedents in case law for what is or is not "reasonably practical" in such cases. The reality is that it is not easy to get New York courts to order dissolution of either a profitable, ongoing corporation or LLC without proof of an immobilizing deadlock or serious management or shareholder misconduct (which does not include refusal to buy shares from the estate of a deceased shareholder).

Death and disability are not the only things that create owner buyout issues. Disputes can also arise when one or more stakeholders voluntarily decide to go their separate ways — for example, when one major shareholder intends to set up a new business and there is no pre-existing agreement as to how the current business is to



be divided with regard to assets, customers, ongoing work or existing office leases. Even if the parties are not hostile to each other, the question of how to distribute the assets and liabilities fairly and efficiently with the least disruption to ongoing work and customer relations can be a major challenge. If not handled carefully, a situation like this can easily end up in litigation — usually a lengthy, expensive and emotionally draining process that can quickly reduce the size of the assets to be divided and leave the parties alienated. [See box on page 30 regarding the use of mediation to resolve these issues.]

What are the basic elements of buyout provisions in a shareholder agreement or LLC operating agreement? The key questions such clauses cover are "if, when and how much."

"If" – The Triggering Event: Typically, the triggering events for a mandatory buyout of a shareholder/LLC member's interest include, at a minimum, death, incapacity and bankruptcy of the owner. In most cases involving small businesses, shares are non-transferable. However, exceptions are made for the transfer of shares to immediate family members. Most non-related partners, however, don't really want the children or spouse of a deceased co-shareholder as their

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business partners, even as a minority interest. Other events, particularly with respect to employees with a minor shareholder interest, include leaving the company's employment with or without cause as defined in an employment agreement. With respect to substantial shareholders, the number of controllable triggering events should be kept to a minimum in order to create a bond to hold partners together during lean years when other opportunities may beckon.

How much will the ownership interest be worth? Typical formulas include the following, any of which need an in-depth discussion between the shareholder and his or her attorney:

(1) Pro rata share of company book value. Although perhaps useful in a company with primarily liquid assets, a book-value-based formula alone is usually inappropriate in most businesses, be it a real estate holding company with appreciated real property to a service business with many ongoing profitable contracts, none of which would be reflected on the books.

(2) Fixed value, with annual adjustments based on the increased value of the company to be agreed upon by the owners. Usually a fair result can be achieved if the parties sit down each year and negotiate a new value or there is some fair default method to adjust the price if the triggering event occurs after years of neglecting to make annual agreed adjustments, such as increase/decrease in net income before interest, taxes, depreciation and amortization.

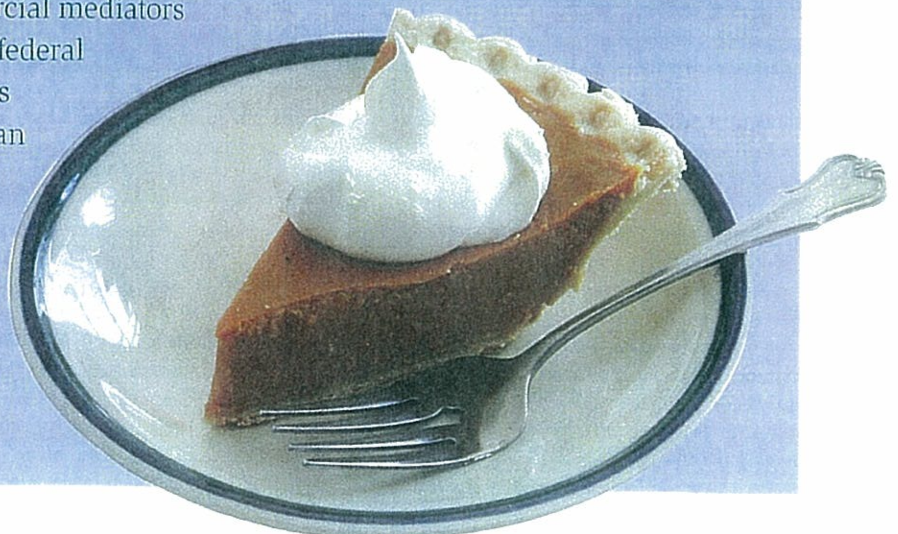
(3) Independent third-party appraisal at the time of the triggering event. One of the fairest methods is to use an independent, third-party appraiser, but the independence and qualifications of the appraiser are important. Not every accountant is trained or experienced in company appraisals. It is also important to clearly define what standard the appraiser is to use, e.g. fair market value (either on liquidation or as a going business; with or without a minority discount; any special industry or agreed valuation standards, etc.).

(4) "I set a price; you choose whether to buy or sell at that price." This is generally inappropriate in a situation of withdrawal because of illness or death of a partner or in any situation where the parties are at different life stages or have different competencies or there are significant wealth discrepancies. However, this is a great option if a partner wants to get out of the business.

(5) Right of first refusal. This method depends on the withdrawing owner or his or her estate securing an offer from a third party to buy the withdrawing owner's interest, even though there is an existing right of first refusal. Obtaining a reasonable, bona fide offer for a minority interest in a small company would in most cases be difficult, if not impossible, because of the limited shareholder rights to have any input on management or predictable monetary return.

Alternative Ways to Resolve a Buy-Sell Dispute

Litigation and, recently, arbitration, the traditional means of dispute settlement, are expensive, time-consuming and unpredictable. More and more businesses and their attorneys are choosing to use a third-party mediator to assist them in resolving contentious issues in one or two days, leaving good relationships and bank accounts intact. Mediators, usually paid on an hourly or daily basis, are trained in negotiation and dispute-settlement skills and have no stake in the outcome. Lists of experienced commercial mediators are available through many state and federal courts as well as such organizations as JAMS (jamsadr.com) and the American Arbitration Association (www.adr.org). Related articles: "Let's Keep the Jury Out of This" (▸ 164) and "Put That Handshake in Writing" (▸ 46)



"When will payment be made?" Once the triggering event and a formula for determining value are agreed on, [or more likely, as part of the negotiation of the "if, when and how much" issues,] the next question is how and when is payment to be made. There is a world of difference between 100% cash at the time of purchase and 10% cash down with the balance paid in 10 annual installments at a modest interest rate. Regardless, a plan must be put in place that will ensure cash will be available for a payout. In addition, you must ask if the continuing shareholders are willing to give a security interest (i.e., mortgage) on the assets of the company to secure payment or even to personally guarantee payment.

In addition to the basic business questions, there are significant tax issues, which play a role in deciding whether the buyout right or obligation should first go to the company or the remaining shareholders (or one major shareholder), as well as the most efficient use of life and/or disability insurance on each shareholder from a funding and tax standpoint.

Because of different family and other personal interests, it is important that each significant shareholder or LLC member have his or her own advisors and not simply rely on one lawyer to provide a "standard" buy-sell agreement. The professional fees payable are not significant when compared with the potentially unfair results of a one-sided formula. A buy-sell agreement needs to take into account the particular needs of the company and the shareholder. Although a standard form document may be better than nothing, for shareholders whose wealth is tied up in the business, it is worth the investment to obtain the advice of an experienced business/estate lawyer and a tax advisor at the time the buy-sell agreement is entered into, rather than hiring a litigator years later to negotiate from a weak position because the buyout issues were overlooked or consciously left unresolved. □

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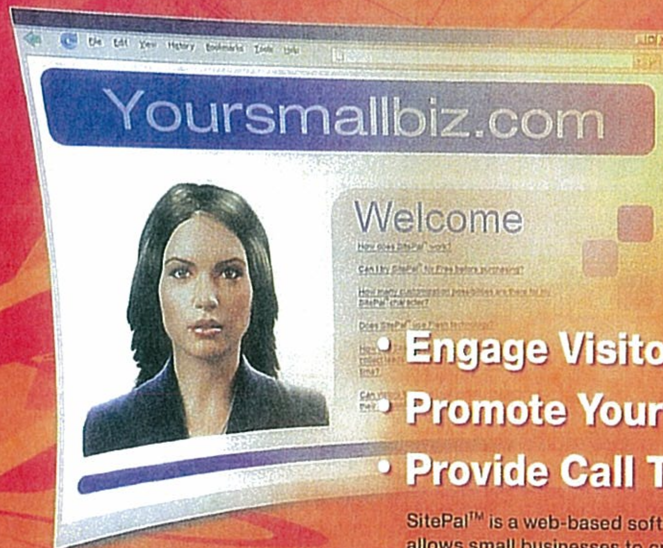

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