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PRACTICING THE LAW OF BUSINESS

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The Buy-Sell Agreement: What is it and why is it important?

Introduction

Many new business owners overlook one of the most important aspects of starting a new business relationship: clearly stipulating how significant future changes will affect the management and control of the business. For example, what happens if your partner dies, becomes disabled, or is otherwise incapacitated? What if she files for divorce? Or bankruptcy? A well designed buy-sell agreement addresses these and other vital questions—before things get ugly.

If you don't have a binding buy-sell agreement in place, your business is at risk. Without a clear succession plan, disputes can arise among partners—or their surviving spouses—that lead to loss of valuable time, increased expenses, and costly litigation. That's why I cannot stress enough the importance of having a buy-sell agreement in place from the outset of any business relationship involving two or more people.

Fortunately, putting together an effective buy-sell agreement is not difficult. In this document, we address common "who, what, when, where, and why" questions that arise in a typical buy-sell agreement. Other names for this agreement include *shareholder agreements* or *succession agreements*. In the sections below, we'll explain in detail what a buy-sell agreement is, how it benefits business owners, and why it's so important to have one—even if your business partner is your best friend. We'll also provide a checklist that will help you or your client gather all the information you need to implement a standard buy-sell agreement.

What is a buy-sell agreement?

A buy-sell agreement is a legally binding agreement between a business[1] and its owners[2] that clearly stipulates how a significant event—such as death, divorce, or departure of a partner—affects the management and control of the business. A well drafted agreement anticipates the intent and needs of the owners, as well as the potential conflicts that may arise among them if one or more wishes to sell his/her interest in the business or is forced to dispose of such interest, as may happen in a bankruptcy proceeding.

An effective buy-sell agreement describes:

- When, and under what circumstances, a business may dispose of an owner's interest.

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[1] Unless otherwise noted, the word "business" generally refers to all typically used forms of doing business, including C and S corporations, limited liability companies, and general and limited partnerships.
[2] Unless otherwise noted, the term "owners" refers to any owner of a "business," to include the shareholders in a corporation, the members in an LLC, or the partners in a partnership.

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- Whether the other owners or the business have the opportunity to buy the interest from that owner prior to its disposition to an outside party.
- How much to charge for that interest.
- Whom the remaining owners are willing to accept as a substitute owner.

Why have a buy-sell agreement?

A buy-sell agreement facilitates the orderly transfer of business interests when certain specified events occur. A buy-sell agreement:

- Creates a market for the departing owner's interest in the business when no such market exists in the absence of such an agreement.
- Prevents a break in management and voting control of the business.
- Creates job stability for remaining minority owners and key non-owner employees.
- Ensures that the survivor of a deceased owner is compensated for the deceased owner's interest.
- Enables surviving owners to purchase a deceased owner's share promptly, thus preventing the deceased's interest from being locked up in probate and eliminating the possibility of a personal representative of the deceased becoming a voting owner.
- Sets an accepted value for the purchase of an owner's interest, eliminating the possibility for costly and time-consuming litigation.
- Determines each owner's interest in the business.

Primary Types of Buy-Sell Agreements

There are three primary types of buy-sell agreements: 1) the "redemption" agreement, pursuant to which the business purchases the interest of the departing owner, 2) the "cross-purchase" agreement, pursuant to which the remaining owners buy out the departing owner, and 3) the "hybrid" agreement, pursuant to which the business and the owner may have an option to buy out the departing owner.

Which Type of Buy-Sell Agreement is Appropriate?

Before deciding which version of a buy-sell agreement is best for your business, you should examine several considerations, including:

Number of Owners

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Under the terms of a redemption agreement, the business may purchase life insurance policies on the lives of the owners, with the corresponding death benefit approximating the value of the owners' interests in the business. When an owner dies, the business receives the proceeds of the policy, which it then uses to buy out the interest of the deceased owner. Of course, over time the business must increase the dollar amount of the policy to address the increasing value of the business.

Under the terms of a cross-purchase agreement, each owner purchases a life insurance policy on every other owner in an amount sufficient to cover the buy-out price of each owner's pro-rata share in the business. If the business has just two owners, then there are two policies; however, with each additional owner the number of policies increases. For instance:

Number of Owners	Number of Policies to Fund Cross-Purchase Obligation
2	2
4	12
6	30

Owners can minimize the potential disadvantages of an exponentially increasing number of policies by creating a separate partnership or trust to purchase the life insurance policies. If you choose this method, make sure that the proceeds that this second entity collects comply with the terms of the cross-purchase buy-sell provisions.

Income Tax Brackets

Premiums paid on life insurance used to fund a buy-sell agreement are not deductible for income-tax purposes. Yet, with proper planning you can use this to your advantage. For instance, funding a redemption obligation through a C corporation in a lower tax bracket (than the owner's) might yield an overall lower aggregate tax burden.

Alternative Minimum Tax

The alternative minimum tax (the "AMT") may apply to life insurance proceeds payable to a C corporation in the case of a redemption buy-sell agreement. On the other hand, with a buy-sell agreement in the context of an S corporation, LLC, or limited partnership, the owners are subject to the personal AMT and there is no adjustment for life insurance proceeds.

Capital Gains vs. Ordinary Income

Take special care to understand the desires of shareholders when determining how the recipients of the buyout proceeds will be taxed. Redemptions by a C corporation may result in a combination of ordinary income (to the extent of earnings and profits) and capital gains. While this problem will not generally exist for typical S corporations, a converted S corporation with old C corporation earnings and profits must determine whether the IRS will characterize a redemption as a dividend that requires treatment as ordinary income. Special tax

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rules apply when determining whether to treat a redemption as a sale or a dividend. In a cross-purchase agreement, capital gains treatment usually applies.

Accumulated Earnings Tax

If a C corporation accumulates earnings to complete a redemption under the terms of a redemption buy-sell agreement, it may be subject to the accumulated earnings tax. However, an accumulation to buy out a minority interest may be a legitimate reason to accumulate earnings and may not, therefore, be subject to the accumulated earnings tax. This tax will probably not apply to C corporations that purchase life insurance to fund a potential buyout. With no tax at the entity level, these issues also do not exist for S corporations, LLCs, and limited partnerships.

Amount of Life Insurance

The amount of life insurance in relation to the buy-out price can also be an important consideration. In a C corporation, it may be difficult for the remaining owners to get insurance proceeds in excess of the interest's value without having to treat the proceeds as ordinary income, thus turning tax-free insurance proceeds into taxable ordinary income. Excess proceeds received by owners in a cross-purchase agreement, or by the business in the context of an S corporation, LLC, or limited partnership will generally retain their tax-free status (when distributed).

The Hybrid Buy-Sell

Unlike the case with a straight-forward redemption buy-sell or a cross-purchase buy-sell, a hybrid agreement gives purchase options to both the owners and the business. Either the non-departing owners have the first option to purchase the interest, or the business has the first option to purchase with the second option going to the other owners. This type of buy-sell agreement offers the luxury of flexibility. Once a triggering event occurs, the remaining owners can carefully examine the capital needs of the business and the existing tax laws at the time of the buy-out to determine the most appropriate choice for themselves and the business.

Give careful thought to the order of options and to whether a buy-out will be optional or mandated. Frequently, buy-sell agreements give the remaining owners the first option to purchase the business proportionately. However, in the event that the owners do not exercise this option, take special care when crafting the business's obligation. For instance, if the shareholders of a C corporation are obligated to purchase the departing shareholder's interest but choose not to do so, the C corporation's purchase could be deemed a constructive dividend to the other shareholders (because the corporation has engaged in an act which has alleviated an obligation of its shareholders).

Transfer Restrictions

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Shareholders in a large publicly held company, such as IBM, have a ready market for their shares. At any time, a shareholder may sell his or her shares to almost anyone at a price set many times throughout the day by the market. In closely held businesses, that ready market does not exist, and, indeed, in many cases it might not be desirable to sell the interest to an outsider.

In fact, most buy-sell agreements impose restrictions on an owner's ability to freely sell or transfer his or her interest to an outsider. While absolute prohibitions on such sales or transfers are probably not enforceable, it *is* reasonable to first give the other owners and the business an opportunity to buy the owner's interest (i.e., a right of first refusal). The terms of this opportunity could be the same as the terms offered by the third party, or could be the lower of the third party's offer or the price set in the buy-sell agreement.

Buy-sell agreements often allow certain transfers of interest by owners that do not trigger any right of first refusal. For instance, transfers to revocable trusts are very often permitted, as are transfers to direct family members.

Triggering Events

Events which may prompt the purchase of a departing owner's interest by the remaining owners or the business are called "triggering" events (i.e., they constitute events which "trigger" a buy-out option in the remaining owners).

Although some transfers of interest are clearly advantageous and should be permitted, others may not be as desirable. In these circumstances, it may be better to force the business and remaining owners to purchase an owner's interest, particularly if the departing owner's interest is on the verge of being transferred to a potentially undesirable owner. That's why it's so important to plan ahead and craft a buy-sell agreement appropriate to the specific needs of your business and its owners.

Here are some of the most common triggering events:

Death. What happens when an owner dies? Should the owner's heirs inherit the role of ownership or is it more desirable for the surviving owners of the business be able to buy out the interest of the deceased owner?

Disability. What if an owner becomes disabled? Should disability trigger a buyout option in the business or for the remaining owners? If so, how is disability defined? Agreements that rely on the definition of "disability" within an existing disability policy may require the opinion of a physician or may depend on the interpretation of a formulaic description of disability that takes into account the tasks the owner performs in the normal course of business.

Termination of Employment. Are all owners employees of the business? Or are they all otherwise actively engaged in the business? What if an owner steps down, no longer plays an active leadership role, retires, or otherwise terminates employment with the business? Should

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this trigger an opportunity for the business or the other owners to buy out that owner's interest or is passive participation acceptable?

Divorce. It is almost universal that owners of a business will not want to be in business with an ex-spouse of a divorcing owner. There is no way to guess how a divorce judge will parse out a divorcing owner's assets (which include the owner's interest in the business). In light of this uncertainty, agreements will often allow the divorcing owner to have the first option to purchase his or her interest back from his or her soon-to-be ex-spouse. In addition, buy-sell agreements will often additionally provide that if the divorcing owner does not exercise this right, then the remaining owners and the business have the option to buy the owner's interest from the divorcing owner's spouse.

Bankruptcy. Most buy-sells prepare for the bankruptcy of an owner by mandating that the remaining owners and the business will have an option to buy out the bankrupt owner's interest, rather than be forced to tolerate having a bankruptcy trustee as a new owner of the business.

Pledging of an Owner's Interest. While owners of a business may be hard-pressed to find anything positive about allowing an owner to pledge his or her interest as collateral for a loan, there may well be some benefit. If the buy-sell agreement does not permit the owner to pledge an interest, the creditor can argue that the provisions of the agreement do not apply to a foreclosure's involuntary transfer. By specifically allowing the pledge of an interest, the buy-sell agreement can give the non-defaulting owners a chance to cure, or the opportunity to buy the interest from the creditor.

Determining the Purchase Price

Once you have defined the types of events that can trigger the purchase of an owner's interest in a business, you need to set a price. At the time the owners are drawing up the buy-sell agreement, each will not know whether he/she will be on the buying or the selling side. Therefore, it is best to put in place a neutral procedure for determining the purchase price of an owner's interest.

A buy-sell agreement can describe the purchase price of an ownership interest as being equal to the interest's "fair market value." But what is "fair market value" for this purpose? The IRS, in a 45+ year-old revenue ruling, set forth the following determining factors when defining the value of a closely-held business interest:

- Economic outlook (i.e., industry trends)
- Nature and history of the business
- Book value
- Financial position
- Earning capacity of the business
- Net profitability of the business

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- Market price of similar interests
- Existence of goodwill and other intangible/intellectual property assets
- Comparable sales of interests

When determining the purchase price, owners typically take several approaches, including:

Agreement of the Owners

This is an approach that is as ineffective as it is appealing to owners. From the owner's perspective, it is difficult to determine the value of the business early on. The prospect of an expensive appraisal every year or the use of a rigid formula that fails to take into account extraordinary events or trends that may substantially affect value means that owners will frequently want to avoid these methods. Getting together once a year to determine value after robust debate might sound great in theory. But do the owners really have the discipline to get together once a year? When they collectively value the business, will their optimism be so high that an unrealistic value is assigned to interests? If you *do* use this method, we strongly recommend that an alternative default valuation is automatically triggered if the owners neglect to set a new value for the purchase price within a certain number of months (say 12, 15, or 18 months) prior to the triggering event.

Use of a Formula

An important alternative to the agreed-value approach involves defining a formula that the owners or the business apply based on certain factors. Such factors typically include book value and company earnings. The formula should clearly specify which factors to use and how much weight to give to each in the determination.

In a book value approach, the formula would not typically use raw book value. Rather, the formula would allow the owners to make certain adjustments to the book value to better reflect the actual street value of the business in contrast to the fully depreciated book value. Typical adjustments include: appraisal of depreciated assets, taking bad debts into account, actual inventory (as opposed to book inventory), favorable lease terms as an asset of the business, contingent liabilities, work in progress that has not been billed, and appraisal of certain significant business assets.

If the owners use earnings as the benchmark, then they must determine which multiple to use and to what they must apply it. The following list illustrates several typical questions that you must consider when determining how the description of an earnings multiple appears in a buy-sell agreement:

- To what period of time is the multiple applied?
- Should the impact a departing owner will have on future earnings be a factor?
- Are anticipated future earnings included?
- Is the multiple applied to only the current year?

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- Does the multiple include the current year and a look-back period of some length?
- If several years are used, should more weight be given to the current year?
- Should the multiple be changed as the business and/or industry changes?

With so many constantly shifting factors to consider, this process can quickly become highly complex. At the very least, we encourage business owners to consult the expertise of a valuation expert.

Pricing by Appraisal

Instead of using a valuation expert only to help find an appropriate multiple, the business or owners can also employ his or her expertise to set the actual purchase price. There are many ways to value a business interest and many questions to consider in determining how the appraisal provisions are to be crafted. For example:

- Will the appraisal focus only on hard assets and liabilities?
- Will the appraisal look at the value of the business as an ongoing concern?
- Who picks the appraiser and how is the appraiser paid?
- If more than one appraiser is selected, is an average of their appraisals used?
- What if the two or more appraisals vary widely?
- What is the time limit?

"Fish or Cut Bait" Pricing

Another approach to take, especially when there is a stalemate among the owners, is to have a "fish or cut bait" pricing mechanism as a final default. Often, when members wish to go their own ways, they all may wish to continue to run the business without the participation of the others. So who buys whom out? With this approach, similar to a silent auction, each member sets forth the price at which he or she would be willing to buy out the other owner(s) on a type of secret ballot. When the mutual offers are revealed, the owner with the highest bid wins the right to buy out the other owner(s).

Additional Tax Considerations in Funding the Purchase Obligation

In deciding who will fund the purchase obligation, you should also consider whether or not the purchase will trigger any additional income tax liability. For instance, if a corporation uses appreciated property in a redemption, corporate level gain is triggered. Under the terms of a cross-purchase redemption, the purchasing owners receive a cost basis in the interest acquired. If payment over time is desired, then care should be taken to determine whether the purchaser will be able to avail him/herself of the deductions for interest payments.

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Some Issues by Entity

One thing to keep in mind when dealing with all business forms is that you can often modify the statutory provisions that govern the obligations and rights of the owners by agreement.

LLCs

There are certain "default" provisions within the Beverly-Killea Limited Liability Company Act (the "LLC Act") that apply in the absence of a specific agreement to the contrary. For instance, the LLC Act allows any member to assign the member's economic interest, but that transferee only steps into the assigning member's economic role – i.e., with full right to vote on LLC matters and have a say in management – if a majority (by percentage interest) of the other members approves. Members may generally also pledge their LLC interest as collateral, but the creditor (upon foreclosure on the interest) will generally only have the rights of an assignee. Give special thought to whether the default provisions within the statute are acceptable to all members.

The circumstances that can cause a member to cease being a member of the LLC are usually set forth in the company's operating agreement. Such events can include:

- The expulsion of a member (keep in mind that without express provision for an expulsion, dissolution of the LLC may be the only viable alternative for ending a relationship with a member with whom certain members have become displeased).
- A member's active withdrawal from the LLC (while the operating agreement may not set forth a "right" to withdraw, members generally continue to possess a "power" to withdraw).
- Assignment of a member's interest in the LLC (whether to a third party buyer, creditor, or involuntarily to a bankruptcy trustee).
- Termination of a trust, or the ending of a partnership or the dissolution of a corporation which is also a member.
- Death or incapacity of a member.

When a member does terminate, is the member still entitled to allocations and distributions? What is the price at which the remaining members or the LLC can purchase the withdrawing member's interest?

Partnerships

The buy-sell or partnership agreement for a partnership should address several issues that are unique to this business relationship. Some of these include:

- Provisions dealing with expulsion and the rights of the partners and the partnership upon expulsion.

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- The situations that could result in a withdrawal from the partnership (e.g., active withdrawal, death, incapacity, retirement, etc.), and whether a withdrawal automatically results in termination of the partnership.
- How to value a partnership interest upon withdrawal, and how that purchase price is to be paid to the former partner or the partner's estate.

S Corporations

Because S corporations have strict definitions of what a permissible shareholder is, much of the focus for these organizations is on the on protection of their special tax status. If the voluntary or involuntary transfer of shares results in an impermissible shareholder owning stock in the corporation, then the S corporation could lose its tax status. Such provisions and issues include the following:

- Allocation of income and loss. In the absence of any special election, a withdrawing shareholder bears the tax consequences for the shareholder's proportionate share of the income and loss of the corporation for the entire taxable year, allocated on a per day basis. However, a special election is available, pursuant to which the S corporation engages in a theoretical "closing of the books." Under this approach, the income and loss is allocated to the departing shareholder only for the period commencing on the beginning of the taxable year and ending on the date of termination. The buy-sell agreement could require all shareholders to participate in this election and should require the corporation to distribute pre-termination net earnings to the departing shareholder (after all, the shareholder will be taxed on these earnings).
- It is a good idea to require quarterly distributions of dividend income sufficient to allow shareholders to pay the taxes owed on allocations to income.
- Transfers to trusts for estate planning purposes should be allowed, but only if the trust meets the specific requirements for a "Subchapter S Trust" or an "Electing Small Business Trust."
- If a transfer that jeopardizes the corporation's S election should occur, an immediate option in the remaining shareholders and/or the corporation to purchase the interest should be triggered.
- Careful consideration should be given to loans, stock options, restricted stock, or other equity and pseudo-equity to ensure no impermissible second class of stock is created which could terminate the S corporation election.

Estate Planning Consideration

Aside from the obvious business benefits associated with a buy-sell agreement, such agreements can also support the estate planning goals of the individual owners. Typical estate planning objectives include the following:

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Continuity and Control. An advance agreement that clearly stipulates what happens upon an owner's death enables the business to continue operating with little interruption.

Eliminating Need to Negotiate Price. Having a detailed, pre-determined pricing mechanism set forth in a buy-sell agreement can remove the burden of negotiating a purchase price from the heirs.

Fixing Interest Value for Estate Tax Purposes. One of the major estate planning benefits of the buy-sell agreement is the opportunity to set the value of a decedent's ownership interest for estate tax purposes. If the decedent will not have a taxable estate, then it may not be desirable to set the price as low as possible. This will only increase the amount of gain in the hands of heirs when the business is eventually sold. Aside from the possible estate tax planning benefits, a closely held business interest is simply a difficult asset to value. The executor of a deceased owner's interest benefits greatly from the clear guidance contained in a buy-sell agreement.

Valuation Discounts. Often, for estate planning purposes, the value of minority interests in a business is "discounted" to reflect the fact that a disinterested third party would probably not pay as much for a minority interest in a business as for a controlling interest. After all, what real say in management does such a buyer hope to gain? Also, because a purchased interest is subject to the restrictions on transfer set forth in the buy-sell agreement, the purchase price of the minority interest would receive an additional discount in value.

These discounts can be useful in an estate plan that hopes to accelerate the transfer of a family business to the next generation through maximization of annual, tax-free gifts of interests in the business.

Preservation of Entity Tax Status. In an S corporation, allowing shares to become owned by the wrong kinds of shareholders can jeopardize the S corporation status. An effective buy-sell agreement can ensure that such shares are not purchased by a tainting shareholder. In general, if shares *are* allowed to pass to a trust, the trust instrument should be examined to ascertain whether the terms comply with the S corporation requirements.

Liquidity to the Estate. There is no ready market for closely held business interests. A buy-sell agreement can provide much-needed liquidity to a deceased owner's estate. What makes that liquidity even more assured is the funding of the buyout obligation with life insurance.

Use of Life Insurance

General Uses

One of the most common triggers for a buy-out of an owner's interest is the death of an owner. Fortunately, funding this type of buy-out is very easy with the advance purchase of a life insurance policy by either the business (in a redemption buy-out) or the other owner(s) (in a cross-purchase). Although the premiums do not generally qualify as legitimate tax deductions, the proceeds are usually tax-free.

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There are two basic types of life insurance: term policies and those policies which allow for the build-up of some cash surrender value. Because the premiums for a term policy can escalate as the owner ages, and because of the possibility that such a policy will terminate at a certain age, businesses and owners often prefer the latter type of policy. Cash surrender policies are further subdivided into two categories: Variable Whole Life and Universal Life. These policies allow for an internal build-up of funds that may be invested in equities. Policy owners may also borrow against the cash surrender value to fund a buy-out obligation that is triggered while the owner is still alive. If an owner leaves the company, he or she may also have the opportunity to purchase the policies insuring his or her life.

In some cases, when there are more than two or three owners, a cross-purchase buy-sell arrangement funded with life insurance can be complicated and have undesirable tax consequences. For example, if a shareholder dies and the remaining shareholders purchase the policies held by the estate of the deceased shareholder, the purchase will be a transfer for value. In these situations, the death benefits of the newly purchased policies will normally be subject to income taxes. To avoid these and other complications, attorneys have created several alternatives to the standard cross-purchase buy-sell arrangement, including:

Trustee Cross-Purchase Arrangements. In a trustee arrangement, a trustee purchases life insurance on the life of each shareholder who is a party to the arrangement. Upon the death of a shareholder, the trustee (1) collects the life insurance proceeds, (2) purchases stock from the estate of the deceased shareholder, and (3) distributes the shares to the surviving shareholders. The trustee may facilitate the transfer by holding the shares of each shareholder subject to the arrangement. It is uncertain whether the use of a trusted arrangement avoids the transfer for value problem. The death of a shareholder could be construed as causing a transfer of the deceased shareholder's beneficial interest in the insurance policies on the lives of the survivors to the surviving shareholders for value.

Partnership Cross-Purchase Arrangements. Because the transfer of value rule may apply to a trusted arrangement, the "partnership" arrangement has become popular. This arrangement is similar to the trusted arrangement. However, instead of creating a trust, the shareholders form a partnership. The partnership then purchases a single life insurance policy on each shareholder. The partnership arrangement should avoid transfer for value problems because the transfer of a life insurance policy to a partnership in which the insured is a partner is an exception to the transfer for value rule. However, if the partnership is created exclusively (or primarily) to facilitate the buy-sell arrangement, the IRS may not respect the validity of the partnership. Although the IRS approved of a partnership structured solely for the purpose of funding a buy-sell arrangement in PLR 9309021, the IRS subsequently adopted a no-ruling position on the use of partnerships to fund buy-sell arrangements in Rev. Proc. 96-12.

Community Property Considerations

In community property states (California, Nevada, Arizona, Idaho, Washington, Louisiana, New Mexico, Texas, and Wisconsin), the interest of an owner in a business most often belongs to the marital community (i.e., "community property"). That means that both the owner and

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his/her spouse have an equal stake in the interest—even in case of divorce. Unless otherwise stipulated in a legally binding document, each spouse has a claim against all of the marriage's community property when the court divides the marital assets.

To avoid giving third-party spouses a say in the management of the business, all buy-sell agreements should clearly grant the divorcing owner the right to buy the interest from his or her former spouse. If the divorcing spouse fails to exercise this option, the business and other owners should then be given the right to buy the interest.

Minority Interests

Corporations are governed by a board of directors elected by the shareholders. The Board is responsible for electing the officers who are in charge of the day-to-day affairs of the corporation. For the election of a Board Member to be binding, a minimum specified percentage of shareholders must vote for him or her. Unfortunately, when that percentage is a simple majority, minority shareholders can lose say both in the day-to-day operations of the business and in weightier decisions, such as whether or not to sell the business or to merge with another corporation. That's why it is important to take special care when drawing up corporate bylaws. Ask yourself: How much protection do we want to offer minority shareholders? In what circumstances should we amend the bylaws? Are there situations where we will require a supermajority (66%, 75%, or higher)? Another option when electing directors is to permit each shareholder to select one director. Although this approach may not give a shareholder any real decision-making influence, it does keep him or her apprised of the Board's actions.

Bankruptcy Considerations

As mentioned above, a buy-sell agreement can effectively prevent the business from becoming tied up in the personal bankruptcy proceedings of one or more of the owners. Under the terms of a buy-sell agreement, an owner can be required to notify the other owners before filing for bankruptcy protection. The company or other owners can then exercise a right to buy out the bankrupt owner's interest. The funds from the buy-out will appease the bankruptcy trustee and the business will operate without interruption.

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BUY-SELL AGREEMENT CHECKLIST

Introduction

Use this checklist as a starting point when discussing business transition issues with your fellow equity owners. A robust discussion of these points will yield valuable insights into each owner's styles, needs, objectives, and level of commitment to the business. It will also help everyone clearly define and express their personal and business goals. It is important to get all of this information out in the open right from the start—before any differing goals and visions potentially cause major disruptions. When caught early, you can plan around these potential challenges and even turn them into new opportunities. But without a clear roadmap in place, dissolution of the business can result.

We've covered a lot of information in this document. But don't be overwhelmed. Just tackle the big issues first, one at a time, and get them on paper. If you forget something, you can always add it later. The most important thing is to get started and not put off this vital aspect of starting a new business.

General Considerations

- ✓ What is the nature of the business and who owns it?
- ✓ Who is on the management team (e.g., officers, board of directors)? Are there outside managers, officers, or directors?
- ✓ How does the buy-sell agreement address continuity in operations during a transition, particularly with respect to key employees who have no equity stake in the business?
- ✓ Employee issues to address: compensation paid, non-compete agreements upon termination or departure, confidentiality and trade secrets, protection of intellectual property and intangible assets.
- ✓ Do certain key employees have equity interests in the business? Options? Restricted stock or units? Are there vesting provisions associated with these interests?
- ✓ How will the owners resolve disputes? Should mediation or arbitration be compelled?
- ✓ What events will trigger a buy-out under the terms of the buy-sell agreement? Some of the common triggers include death, disability, retirement or other termination of employment, the desire to sell an interest to a non-owner, dissolution of marriage or domestic partnership, bankruptcy or insolvency, disputes among owners, and the decision by some owners to expel another owner.
- ✓ May owners sell their interests to non-owners, or transfer an interest to a revocable living trust?
- ✓ If the business is an S corporation, it is advisable to include provisions within the buy-sell which ensure the corporation will not lose its S status.

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- ✓ Should there be restrictions on new equity issues (such as anti-dilution provisions or pre-emptive rights) for minority owners?
- ✓ Once you know the buy-out triggers, will that buy-out be mandatory, optional, or a combination of the two? And, will the business, the owners, or both have the option (or requirement) to purchase?
- ✓ How will the value of the interest be determined? What are the terms of payment? If payment over time is permitted, what is the down payment, duration, interest rate, and security?
- ✓ Is term or whole life insurance desired? Who are the owners and beneficiaries?
- ✓ What is the tax effect upon purchase? Transfer taxes, capital gains, or ordinary income?
- ✓ Do professional licensing requirements come into play?
- ✓ Are there any securities law concerns?
- ✓ Questions owners should ask themselves in the process: If I need cash, can I sell my interest? Am I happy with my percentage interest; and, if not, can I purchase a larger interest? What is my total economic and legal exposure? Do I have a sufficient say in management in relation to the size of my investment?

Some Do's & Don'ts

- Be sure to consider the specific roles of the owners, directors, managers, and officers (these roles often get confused in these agreements).
- Thoroughly explore the short- and long-term objectives of all the owners. It is better to understand now whether all owners share the same vision.
- Don't worry about the language of the agreement. You should be able to decide what you want in clear terms and trust your legal advisor to translate that desire into the agreement.
- Seek out tax advice. There is considerable tax planning which can save you millions of dollars and position owners to satisfy their long-term objectives.
- Don't limit your vision to the upside. Consider worst-case scenarios under your buy-sell agreement as well. What if people just don't get along when a buy-out trigger occurs?

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