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BUY-SELL AGREEMENT CHECKLIST

This checklist has three purposes:

- To acquaint you, as the shareholder of a closely-held business, with key choices that you should consider for your Buy-Sell Agreement among the owners of a closely-held business,
- To serve as a record of your choices, and
- To see if your existing Buy-Sell Agreement fits your current needs.

(This checklist is not for selling a business. See www.staleylaw.com for information about selling a business.)

Take a minute now to **mark your choices** on this checklist. You don't have to be positive about your choices. Then call.

1. **What events will trigger a buy-out?**

   ☐ A proposed **sale** of the shares.

   - This generally triggers a **right of first refusal**
   - Generally, transfers of shares to or from a **living trust** are permitted, but the transferred shares remain subject to the agreement.

   ☐ Transfers among **family members** (generally prohibited, except as part of a plan to transfer ownership rights and/or management responsibilities to the next generation)

   ☐ Termination of an employee-shareholder's **employment** by the corporation.

   ☐ For **licensed professionals**, any action that terminates their license to practice the profession.

   ☐ The **death** of a shareholder.

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- [ ] An employee-shareholder's complete **disability**.

- [ ] **Divorce**

    - Divorce generally triggers a buy-out if any shares are awarded to the non-employee spouse.

    - The employee-spouse generally has an option to purchase the shares of the other spouse.

    - If the employee-spouse doesn't purchase all of the available shares, the corporation and then the other shareholders generally have options to purchase the shares which remain available.

- [ ] Death of a **spouse**

    - Generally triggers a buy-out if any shares go to someone who does not already own shares of the company.

    - The employee-spouse generally has an option to purchase the shares of the deceased spouse.

    - If the employee-spouse doesn't purchase all of the available shares, the corporation and then the other shareholders generally have options to purchase the shares that remain available.

2. **Who will be entitled (or required) to buy the shares**?

- [ ] The corporation.

- [ ] The person who sold or transferred the shares to the selling shareholder. (For example, if Dad gifted shares to his children, but one child wants out, Dad might have a first option to buy the shares back.)

- [ ] The other shareholders.

    - Often a goal is to allow each shareholder an opportunity to retain his or her ownership position in relation to the other remaining shareholders.

3. **Will the purchase be optional or mandatory**?

This can depend on the type of triggering event.

☐ The corporation can have an **option** and, if it is not exercised in full, the other shareholders can:

- Have an *option* to purchase the balance of the available shares or

- They can be required to purchase any shares which the corporation does not purchase.

Note: The selling shareholder is **always** required to sell his shares if the option is exercised.

☐ If neither the corporation nor the other shareholders are required to buy the shares, are there circumstances in which a shareholder should have a right to require them to buy his shares? Examples:

☐ Death,

☐ Complete disability, or

☐ Retirement after a particular age or period of service.

4. **How will the value of the shares be determined**?

The three principal methods of valuing the shares are an **appraisal** of the shares when a triggering event occurs, a **formula** written into the agreement, or an **agreed value** that is reviewed periodically by the shareholders.

☐ **Appraisal**

- **Advantages**

Relatively **objective** and can take into account developments that are not anticipated when the agreement is signed.

Leaves much less room for tactical maneuvers to reduce or increase the value of the shares. A formula or agreed value price invites such maneuvers, which can lead to litigation and bad feelings.

- **Disadvantages**

  An appraisal can be **expensive** ($10,000 to $15,000 per appraiser is not unusual).

  Appraisals take **time** to prepare.

  The value might be a **surprise** to the shareholders. This risk can be reduced by appraising the business now.

☐ **Formula**

- A formula price is **usually** based on **book value**, **earnings**, or a **combination** of both. Formulas can be simple or quite complex. For example, a mature manufacturing business with appreciated real property might use book value (substituting the appraised value of the real estate) plus five times the most recent year's earnings. If earnings are an important measure of value, several years of earnings can be considered, with the most recent years weighted more heavily.

- **Advantages**

  Less expensive and **faster** than an appraisal.

  No surprises, since the parties can determine the formula value at any time.

- **Disadvantages**

  The formula looks backward at past operating results and does not take into account future events such as a recently obtained favorable contract, a promising new customer or the loss of an important account.

  Over time, the variance between the formula value and the perceived actual value may increase.

☐ **Agreed value**

The parties can agree to value the shares annually or at some other interval.

- **Advantages**

  Reflects the parties' subjective **expectations** concerning the prospects of the business.

  Can take into account economic trends and the sale price of comparable businesses.

  If you are using insurance to fund the eventual purchase of shares, **you probably have a specific value** of the shares in mind when you purchase the insurance. That can serve as the initial agreed value. If you intend to review periodically whether the insurance coverage is sufficient, you should plan to update the agreed value at those intervals.

- **Disadvantages**

  Requires **unanimous consent** to change. So if one party becomes seriously ill, the others may be unwilling to update the value to increase the purchase price.

  Shareholders often are **too busy** to consider valuation, which may become controversial and tangled with other sensitive issues. *An agreement that uses an agreed value should always include a formula or appraisal value as a backup*. The **backup method** would apply if no agreed value had been determined for a period of time (often 15 to 24 months).

5. **How will the purchase price be funded and paid?**

The principal ways to fund the purchase price are **advance funding** in the form of insurance or corporate reserves, **future funding** in the form of installment payments of the purchase price, or some **combination** of these.

Note: It is always possible that the business will be sold or the corporation liquidated before any triggering event occurs. In that event, or if the stock becomes publicly traded, **no buy-out** under the agreement would ever occur.

☐ **Lump sum payment**

This method is most often used for shareholders with a small percentage interest in the business.

If the **value** of the stock is **low** (as it might be for an S corporation with few valuable assets or for a shareholder with a small interest in the business) or the corporation has reserved **substantial liquid assets** to fund the buy-out, it might be best to require payment for the stock to be made all at once.

If the corporation or the other shareholders needed additional cash to fund the purchase, they would **borrow** from a lending institution at that time. (Although the lender might be reluctant to make a loan for this purpose.) Or they could consider the tax advantages of a leveraged ESOP to buy the shares.

- **Advantages**

  The selling shareholder (or the surviving family) is not dependent on the **future success** of the business (as they would be under an installment payment arrangement).

  Avoids the necessity of **fine-tuning** a payment plan in advance.

  The leveraged ESOP offers tax advantages to both the seller and buyer.

- **Disadvantages**

  For many companies, this is not realistic for the purchase of a large block of shares because the purchase **price** will be **too high** in comparison to both the corporation's anticipated liquid assets and the likely borrowing capacity of the corporation and its shareholders.

  The leveraged ESOP is essentially an unfunded pension plan.

☐ **Life insurance**

The corporation could purchase life insurance on its shareholders to fund the eventual purchase of their shares.

- **Advantages**

  Life insurance shifts to the insurance company the **risk** that of an early death and buy-out obligation.

  Assures that at a shareholder's death the **funds** to purchase his shares **will be available** and can be distributed to the decedent shareholder's family. The payment to the decedent's family **does not depend** on the future success of the business.

  The owners of a whole life policy can benefit from the **tax-free "inside build-up"** of the funds invested in the policy.

  If a shareholder terminates employment before death, a policy of permanent insurance can serve as a **downpayment** for his shares. The terminating shareholder then has several attractive alternatives: use the policy for retirement or estate planning, borrow against it, or surrender it to the insurance company for its cash value.

- **Disadvantages**

  Uses current funds to purchase insurance to pay for a future buy-out. If the business needs capital, this use of funds might **retard the growth of the business**, particularly if the funds in the business generate a higher after-tax return than funds in the insurance policy. (If this is a concern, consider a **leveraged life insurance purchase** to leave the finds at work in the business but achieve the risk-shifting benefits of insurance.)

  If a shareholder terminates employment for a reason other than death, the life insurance provides funds only to the extent of its **cash surrender value**, which may be low in the first few years after the policy is acquired. (If this is a concern, consider a **no-load** or **low-load** policy.)

Note: Separate policies are usually necessary to cover termination of employment resulting from **disability**.

☐ **Installment payments**

- Generally, the corporation should be required to make as large a **downpayment** as you anticipate will be feasible, and the balance should be paid over a number of years. (Life insurance can be used to fund just the downpayment, rather than the entire purchase price.)

- **Interest**

  How **often** should interest be paid?

  Generally, for the sake of simplicity the interest **rate** should at least equal the minimum rate necessary to avoid imputed interest for tax purposes. The rate can be **fixed** at the buy-out date based on the prime rate or the corporation's cost of borrowed funds at that time. Or it can **float** with the prime rate or another interest rate.

- **Security and Operating** restrictions

  The selling shareholder can have a security interest in the shares sold or in other assets.

  The corporation could be prevented from using its cash for any unusual purpose until all of the installment payments are made, unless the note holder consents to the extraordinary expenditure. Financial ratio requirements could be imposed.

  Note: If the restrictions constrain management too much, they could harm the business and increase the risk to the recipient of the payments.

- **Acceleration events**

  Generally, the entire unpaid purchase price for the shares would be due if the corporation dissolved, merged into another corporation, sold its business or entered bankruptcy.

Promissory notes made by the remaining shareholders could accelerate if they sold their stock in the corporation or became bankrupt.

- **Advantages of Installment Payments**

  Compared to insurance funding, an installment payment arrangement frees current cash for investment in the business.

  Matches future payments with funds earned in the future.

  Both insurance funding and installment payments are complex. Installment payments **defer most of the complexity** until a buy-out occurs.

- **Disadvantages**

  The payment to the selling shareholder (or the family) **depends** on the success of the business. If the business does poorly, they may never receive full payment or payments may be delayed. This risk is aggravated if the only security is the shares of the other shareholders.

6. **Will all community property interests in shares be covered**?

This section applies if you are reviewing your existing Buy-Sell Agreement. If we prepare a Buy-Sell Agreement for you, it will cover these issues.

- If stock is held in the name of a husband and wife, the agreement should specify which one of them has the right to vote and to sell the shares.
- The agreement should provide a way to recover shares from a non-employee **spouse** at divorce or at the spouse's death. (See *Divorce* and *Death of a Spouse* in Section 1 above.)
- The spouse of each **shareholder** should sign the agreement.
- If an employee-shareholder marries, the law might permit the new spouse to acquire a community property interest in the shares -- but

the new spouse might not be bound by the agreement unless the new spouse signs it. Accordingly, the new spouse should be required to sign the agreement.

7. **Should the buy-out arrangement affect related businesses**?

   - If the same persons own more than one active business together, should a triggering event in one business also trigger a mandatory or optional buy-out in the other businesses?

   - Often a corporation rents real estate and equipment from a partnership formed by the shareholders. They do not usually require a buy-out of the partnership interest at the same time that the shares are repurchased. (The existing partnership agreement should write out the **"business opportunity" rule** so that the remaining shareholders can form a new partnership and acquire new property in the new partnership, not the old one.)

8. **Should a departing shareholder agree not to compete with the corporation**?

   - If a shareholder with a substantial interest in the corporation agrees not to compete with the corporation within a reasonable geographic area and for a limited time, California courts generally will enforce the agreement if it is activated by a sale of all of the shareholder's stock of the corporation. The agreement generally would remain in effect from two to seven years.

9. **Will the agreement affect anyone else**?

   - Are the shares currently **pledged**?

   - Is an **existing** buy-sell agreement or shareholders agreement in effect? Do the **articles** of incorporation or the **bylaws** restrict the transfer of shares?

10. **Is the corporation an S corporation for tax purposes**?

    - Because certain issuances or transfers of shares can terminate the S corporation status, a Buy-Sell Agreement can help to retain the valuable S status by prohibiting such transactions.

- Will the S corporation be required to make **distributions** in an amount sufficient to enable the shareholders to pay their taxes on their shares of the corporation's income?

The Next Steps

- If you are not sure about an issue, call us. We have helped many business owners through this process.

- After a short telephone conference, we usually estimate the legal fees involved. We prepare a Buy-Sell Agreement for a client's review. With this agreement our client receives a **summary** of the main deal points and a **memo** discussing issues that merit particular attention.

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