BUY-SELL AGREEMENTS GONE BAD

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Buy-sell agreements among shareholders are complex documents.[1] There are a lot of things for the drafter to get right. Here are some things that I have seen go wrong:

1. NOT GETTING THE CONSENTS OF SPOUSES WHO HAVE COMMUNITY PROPERTY INTERESTS IN THE SHARES

1.1 A spouse can't sell community property for less than its fair and reasonable value, without the consent of the other spouse.[2] To avoid a dispute over the reasonableness of the price, buyers want the signature of the seller's spouse unless the seller can make a credible case that the shares are not community property.

1.2 Sellers want their spouses to sign the buy-sell agreement to confirm that the seller has given prior notice of the arrangement and has fulfilled the seller's fiduciary duties to the spouse.[3]

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[1] For an overview of buy-sell agreements, see my outline *Buy-Sell Agreements for Owners of Closely-Held Businesses: An Overview* at: www.staleylaw.com/images/BSA_Overview_-_17344.PDF.

[2] Cal. Fam. Code § 1100(b).

[3] Section 1100(d) of the Family Code provides, in pertinent part:

> [Generally], a spouse who is operating or managing a business or an interest in a business that is all or substantially all community personal property has the primary management and control of the business or interest. Primary management and control means that the managing spouse may act alone in all

(footnote continued on next page)

2. TRYING TO DO A BUY-SELL AGREEMENT WHEN ONE SHAREHOLDER HAS A ROCKY MARRIAGE

2.1 If the spouse won't sign, or will use signing the buy-sell agreement as a bargaining chip, the other shareholders are likely to abandon the project.

2.2 This is one reason why the "best time for a buy-sell agreement" is after the business has proved viable and while the shareholders and their spouses are still talking to each other.

(footnote continued from previous page)

transactions but shall give prior written notice to the other spouse of any sale, lease, exchange, encumbrance, or other disposition of all or substantially all of the personal property used in the operation of the business (including personal property used for agricultural purposes), whether or not title to that property is held in the name of only one spouse. Written notice is not, however, required when prohibited by the law otherwise applicable to the transaction.

Remedies for the failure by a managing spouse to give prior written notice as required by this subdivision are only as specified in Section 1101. A failure to give prior written notice shall not adversely affect the validity of a transaction nor of any interest transferred.

Section 1100(e) of the Family Code provides, in pertinent part:

Each spouse shall act with respect to the other spouse in the management and control of the community assets and liabilities in accordance with the general rules governing fiduciary relationships which control the actions of persons having relationships of personal confidence [like partners in a general partnership], until such time as the assets and liabilities have been divided by the parties or by a court. This duty includes the obligation to make full disclosure to the other spouse of all material facts and information regarding the existence, characterization, and valuation of all assets in which the community has or may have an interest and debts for which the community is or may be liable, and to provide equal access to all information, records, and books that pertain to the value and character of those assets and debts, upon request.

3. TRYING TO DO A BUY-SELL AGREEMENT WHEN ONE SHAREHOLDER HAS A LIFE-THREATENING CONDITION

3.1 The ideal time to create a buy-sell agreement is when all of the shareholders are healthy, their marriages are good, the business is viable, and they are all comfortable with their roles in the business.

3.1(a) The parties can be most reasonable when they don't know which of them will end up being sellers and which will be buyers.

3.2 If there are more than two shareholders and one has received bad lab results, it's often better to negotiate a deal to buy that shareholder's shares and then, when those shares are bought, start a buy-sell agreement for the remaining shareholders.

4. UNREASONABLE RESTRAINTS ON THE ALIENATION OF PROPERTY

4.1 "Conditions restraining alienation, when repugnant to the interest created, are void."[4]

4.2 "A bylaw reserving a right of first refusal in other shareholders or the corporation does not unreasonably restrict the right of alienation."[5]

4.3 Prohibiting share transfers unless they are approved by the board of directors or the other shareholders might be an unreasonable restraint. To avoid a trip to the California Supreme Court as the test case, stick with the right of first refusal.

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[4] Cal. Civil Code § 711.

[5] Tu-Vu Drive-In Corp. v. Ashkins, 61 C.2d 283 (1964).

5. MANDATORY PURCHASES BY INDIVIDUALS, THEN THE CORPORATION ACTUALLY BUYS

5.1 If the purchase by the remaining shareholders is mandatory, but the corporation buys, the payments are constructive dividends to the remaining shareholders.[6]

5.2 But if the corporation buys the shares when the remaining shareholders have no obligation to buy them, there is no constructive distribution.[7]

5.3 So give the shareholders a mandatory purchase after the corporation has a first option.

5.3(a) The purchase by the corporation will have the least effect on the proportionate shareholdings of the shareholders. (Example: 4 shareholders with 25% each; corporation buys the shares of one; they are now 3 shares each with 1/3 of the outstanding shares.)

5.3(b) But it could still push one shareholder over 50%, giving that shareholder effective control over the corporation. (Example: 1 shareholder with 43% and 3 shareholders with 19% each; corporation buys the shares of a 19% shareholder; there is now 1 shareholder with 53% and two shareholders with 23.5%.)

5.3(c) Even if the shareholders have life insurance on each other, starting with the corporation's option provides flexibility.[8]

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[6] Berger v. Commissioner, 33 T.C.M. 737, *aff'd by unpub. opin.*, 538 F.2d 334 (9th Cir. 1976); Rev. Rul. 69-608, 1969-2 C.B. 42.

[7] *See* Stout v. Commissioner, 273 F2. 345 (4th Cir. 1959).

[8] The shareholders could contribute their life insurance proceeds to the capital of the corporation if for some reason they wanted the corporation to buy.

5.3(d) With optional purchases, it is best to start with the corporation's option to provide the opportunity to preserve the relative shareholdings.

6. DIFFERENT PRICES FOR VARIOUS TRIGGERING EVENTS

Example - $100 per share if the shareholder dies or becomes disabled

$80 per share if a shareholder walks away from the business

$60 per share to the divorced spouse of a shareholders who ends up with shares after the divorce

6.1 I have always been concerned that a judge would not enforce a price that is manifestly less that fair market value, especially in family law court. I am also concerned that once the judge starts improvising, the judge will do rough justice as the judge sees fit.[9]

6.2 So one value for all buy-out event is most likely to result in the agreement being enforced as written (and as negotiated by the parties)

6.3 Caveat 1: It's probably OK to have a "penalty" value (like book value) for messing with the S corporation status. I would include a preamble explaining the need for a quick determination to facilitate a quick purchase to minimize the risk to the valuable S corporation status.

6.4 Caveat 2: Different pay-out periods don't offend me, such as a three-year pay-out normally but a ten-year pay-out for a shareholder who walks away but does not sign a covenant not to compete. I would use the same interest rate and other note terms for all triggering events.

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[9] Family law attorneys have shared this concern,

7. THE NEW SPOUSE WHO WILL NOT SIGN THE AGREEMENT

7.1 If the parties want to be able to buy shares from a non-shareholder spouse who ends up with company shares after a divorce, that spouse needs to have signed the agreement.[10]

7.2 So the buy-sell agreement should require a new spouse (that is, a person who was not a spouse of a shareholder when the buy-sell agreement was originally signed) to sign the agreement.

7.2(a) Even though the shares are initially separate property, the new spouse can acquire a community property interest in the shares if the shareholder is under-compensated for the shareholder's efforts on behalf of the corporation.[11]

7.2(b) Consequently, it is possible that company shares would be allocated to the new spouse in a later divorce. If the parties wanted the divorce provisions of the buy-sell agreement to apply to the spouses at the time of signing the buy-sell agreement, they will want those provisions to apply to a possible divorce of the new spouse.

7.3 Sometimes a new spouse who has successfully said "No pre-nup" will also refuse to sign the buy-sell agreement. So there needs to be a penalty for not signing.

7.4 There might be better ways, but the way I use is to give the corporation and the other shareholders the right to buy the shares of the shareholder at a non-penalty value if the new spouse will not sign within 60 days after the marriage.

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[10] Note that there might be other ways to address the possibility of the spouse later claiming ignorance of the terms of the buy-sell agreement.

[11] Pereira v. Pereira, 156 Cal. 1 (1909); Van Camp v. Van Camp, 53 Cal. App. 17 (1921).

7.4(a) In situations where there are shareholders who are not active in the business, this would apply only if the shareholder was active in the business – or became active in the business after the marriage (because then the new spouse could acquire a community property interest).

7.5 I would also give the board of directors the right to extend the period in which the new spouse must sign.

7.6 If there is a pre-nup and the board is satisfied that the shares will never become community property, it is possible to give the board of directors the right to waive the requirement that the new spouse sign the buy-sell agreement. Consider whether this will put the board of directors in an untenable situation if the newly married shareholder begs them not to buy back the shares, but the board of directors thinks that the shares are likely to become community property.

7.6(a) It is possible for the corporation and the shareholders to sign a waiver (of their right to buy the newly married shareholder's shares) at the time. This will generally require the consent of all of the shareholders.

8. USING AN ANNUALLY AGREED PRICE WITHOUT AN EXPIRATION DATE AND A BACK-UP VALUATION METHOD

8.1 So, you have the conversation about appraised value, formula value or agreed value, and they pick an agreed value. You tell them they need to update it every year, and they say that's no problem.

8.2 Give the agreed value an expiration date – 15 or 18 months after they agree on it. Don't make someone sell in 2025 at the 2019 price. That is likely to lead to litigation.

8.3 Include a back-up valuation method. I like appraisal, since it can look back in time like a formula, but also forward in time (we just got the Microsoft order; we just lost the Airbus account; the Riverside plant burned down last week, etc.).

9. USING ONLY ONE APPRAISER

9.1 If the shareholders have recently had an appraisal of the shares, they might be comfortable specifying that the recently-retained appraisal company will appraise the shares if a triggering event occurs, using appraisal standards consistent with the recent appraisal.

9.2 Otherwise, I would have the agreement instruct the company to hire an appraiser and notify the selling shareholder who the company hired. I would require appraisers who are members of the American Society of Appraisers with at least five years of experience valuing closely held businesses in the geographic area of the business (for example, Los Angeles County or Southern California). I would specify whether discounts for lack of control and lack of marketability are permitted.[12]

9.2(a) Then the selling shareholder can decide whether or not to hire a second appraiser.

9.2(b) If two are hired, they would present their reports. If they are "close," I would average the two to determine the purchase price. I define "close" as the lower value being 85% or 90% of the higher value.

9.2(c) If the appraised values are not "close," I would have the two appraisers pick a third appraiser. I would discard the outlier and average the two appraisals of the three that were closest to each other. So if the appraised values were $7x, $8x and $10x, I would discard the $10x appraisal and average the $7x and the $8x values to arrive at the purchase price. The intent is to drive the values to the mean and away from the extremes, since the extreme value will be discarded.

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[12] I would ask the shareholders to check with their estate planners before making a decision about this last issue.

9.3 I would have the company pay if there is one appraisal. If there is more than one, the company and the selling shareholder would split the costs of the two or three appraisals.

9.4 I would allow the parties at any time to reach a consensus value and to abandon the appraisals.

10. STARTING THE OPTION PERIODS BEFORE THE APPRAISAL REPORTS ARE RECEIVED

10.1 It takes time for an appraisal, and more time for two or three.

10.2 No one can make an informed decision about whether to exercise an option until they know the price for the shares.

10.3 This is not a concern for a right of first refusal or a sale of the company approved by the board of directors (if this is one of the triggering events, to eliminate hold-outs).

10.4 This is also why it might make sense to use a different value (such as book value) for a triggering event that threatens the S corporation status.

11. TRYING TO PROTECT THE S CORPORATION ELECTION BY A ONE-LINE "NO TRANSFERS TO INELIGIBLE SHAREHOLDERS" CLAUSE

11.1 Consider the "no transfer" threats to the S corporation status:

11.1(a) A timely QSST election is not made (by the *beneficiary*) for a QTIP trust after the shares are "transferred" to the trust.

11.1(b) A timely ESBT election is not made (by the *trustee*) for an exemption trust after the shares are "transferred" to the trust.

11.2 Note that in many cases there will be no new stock certificates. The S corporation will begin to issue K-1s to the trust, and the trusts will begin to file tax returns. For tax purposes, the shares have been trans-

ferred at that point, even though no new stock certificates have been issued.

11.3 Note also that there are provisions for late elections without filing a ruling request (or paying a user fee), and there is also the possibility of a requesting a private letter ruling permitting a late election (and paying the user fee) if the revenue procedure does not apply.

11.4 Consider providing that the damages for termination the S corporation status without the consent of a majority of the outstanding shares are the additional corporate-level taxes.

11.4(a) Note that non-voting shares are treated as voting shares for purposes of making and terminating the S corporation election. This is because the tax rules do not distinguish between voting and non-voting shares.[13]

12. LOSING TRACK OF NOMINAL AND BENEFICIAL INTERESTS IN SHARES HELD IN TRUST OR BY CUSTODIANS

12.1 Don't require the trustee to make a QSST election for a QTIP trust.

12.2 Don't require the beneficiary to make an ESBT election for an exemption trust.

12.3 Note that when shares are held in trust, the buy-sell agreement will generally make demands on the trustee, as the nominal holder of the shares. But the beneficiary might be the employee, so if termination of employment is a triggering event, it is the employment of the beneficiary and not the trustee that counts.

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[13] I.R.C. § 1362(a)(2), (d)(1)(B); Treas. Reg. §§ 1.1362-1(a), 1.1362-2(a)(1).

13. HAVING THE PAYMENTS FOR SHARES MADE PURSUANT TO THE AGREEMENT AND NOT A SEPARATE PROMISSORY NOTE

13.1 A buy-sell agreement is a complicated document that must cover several possible triggering events. In contrast, a promissory note is focused on one issue – make the specified payments on time or the note accelerates.

13.2 If the seller who is not being paid had a choice, the seller would always prefer to sue on the simple promissory note as opposed to the complex buy-sell agreement.

13.3 I like to attach a form of promissory note to the buy-sell agreement. Others set out the terms of the note in the agreement.

13.3(a) I would attach separate notes for the corporation or an individual shareholder. This avoids disputes later about how a note for one should be converted to a note for the other.

13.3(b) Consider having the note accelerate if the remaining shareholders sell the company or if a new owner acquires a majority of the voting shares.

◊ It is possible to limit distributions or compensation, to avoid the remaining shareholders looting the corporation and leaving as the debtor an empty shell.

13.3(c) If there is a guarantee or a pledge, I would attach the forms for those, too.

14. THE CORPORATION PLEDGING UNISSUED SHARES

14.1 When a California corporation redeems its shares, the shares become authorized but unissued shares.

14.1(a) So in that situation there is no stock certificate for the selling shareholder to hold as security.

14.1(b) If the corporation buys the shares, consider having the remaining shareholders provide a non-recourse guarantee of the corporation's obligation, and provide a pledge of some or all of their shares to secure the guarantee.

14.2 Note that if the remaining shareholders buy, their pledge to secure their notes would be full recourse.[14]

15. IGNORING CHAPTER 5 OF THE GENERAL CORPORATION LAW

15.1 If the corporation is obligated to buy the shares (for example, if it buys the life and/or disability insurance), and the corporation is prohibited by Chapter 5 of the General Corporation Law from buying the shares, then the contract might be unenforceable as an illegal contract to violate a law. The judge or arbitrator will then have authority under the severance clause to pick and choose what in the agreement to enforce.

15.2 Avoid this by making the corporation obligated only if it can buy without violating Chapter 5.

15.2(a) If the corporation can't buy (possibly within a set period of time), consider requiring the shareholders to buy.

15.2(b) Consider requiring the corporation to use its best efforts to become legally able to purchase the shares.

15.3 Also, consider this issue in the "entity purchase or cross purchase" conversation.

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[14] It is probably possible to include a single form of pledge agreement attached to the buy-sell agreement and change one paragraph, depending on whether the pledge secures a recourse or non-recourse obligation.

16. NOT IDENTIFYING THE LIFE INSURANCE PROCEEDS TO AVOID CHAPTER 5 LIMITS

16.1 The Chapter 5 limitations do not apply to redemptions funded by the proceeds of life insurance in excess of the premiums paid for it.[15]

16.2 For the exception to apply, the premiums must be paid pursuant a buy-sell agreement.

16.2(a) So identify the policies as an exhibit to the buy-sell agreement.

16.2(b) The buy-sell agreement should require the corporation to pay the premiums.

◊ It's also a good idea to give the insured a right to advance the premiums as a loan to the corporation if the corporation does not make the payments. The policy will need a rider requiring notice to the insured if the premiums are not paid on time.

16.2(c) The approval by the board of directors of the buy-sell agreement with the insurance language and the exhibits should be sufficient to make the exception for insurance-funded redemptions apply.

17. LEAVING LIFE INSURANCE POLICIES IN UNFRIENDLY HANDS AFTER A BUY-OUT

17.1 If a shareholder ceased to be a shareholder for reason other than death or disability, it is a good idea to give the departing shareholder a right

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[15] "The provisions of Sections 500 and 501 shall not apply to a purchase or redemption of shares of a deceased shareholder from the proceeds of insurance on the life of that shareholder in excess of the total amount of all premiums paid by the corporation for that insurance, in order to carry out the provisions of an agreement between the corporation and that shareholder to purchase or redeem those shares upon the death of the shareholder." Cal. Corp. Code § 503(a). Subsection (b) applies a similar rule for disability insurance.

to buy the life and disability policies on him or her (and give the remaining shareholders the right to buy from the selling shareholders the policies on their lives).

17.1(a) It's creepy when someone who no longer has an insurable interest will have an economic windfall at your death or disability.

17.1(b) And the insured might be happy to buy a policy that was issued when the insured was a lower risk.

17.1(c) Note that a transfer of a life insurance policy to the insured does not raise "transfer for value" issues.[16]

18. NOT GETTING WAIVERS OR TERMINATING THE AGREEMENT WHEN SHARES ARE SOLD

18.1 If (a) there is a buy-sell agreement in place with a right of first refusal, (b) one of the shareholders plans to sell shares, and (c) the other shareholders don't object, prepare a waiver of the right of first refusal for the corporation and all of the non-selling shareholders to sign. Having this signed will prevent grief and litigation in the future.

18.2 When the shareholders amend and restate their buy-sell agreement, it is easy to remember to provide in the "Entire Agreement" clause that the new agreement supersedes the old agreement.

18.3 When the shareholder last standing buys the shares of the penultimate shareholder, have them terminate the buy-sell agreement. Otherwise, when shares are issued to a new shareholder, it is possible that the old deal will apply, much to their surprise.

18.3(a) If you can't have the penultimate shareholder sign the termination of the buy-sell agreement, have the last standing share-

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[16] I.R.C. § 101(a)(2)(B).

holder and the corporation agree to terminate the old buy-sell agreement before shares are issued to the new shareholder.

19. NOT BINDING THE OWNERS OF AN ENTITY THAT OWNS SHARES

19.1 Let's say the professional corporations of three professionals own interests in the LLP that operates the firm.

19.2 A buy-sell agreement among the professional corporations, as the members of the LLP, will not bind the shareholders of the professional corporations. You will probably need buy-sell provisions in the LLP agreement and a separate buy-sell agreement among the shareholders of the professional corporations.

20. NOT INCLUDING REPS AND WARRANTIES

20.1 It's a good idea to have basic reps and warranties in a buy-sell agreement.

20.2 The whole agreement is predicated on certain assumptions:

20.2(a) The signors of the agreement are the owners of the shares and have the right to enter into and perform the agreement.

20.2(b) The spouses who sign are married to the shareholders.

20.2(c) No shares are held in trust unless the stock certificate says so.

20.2(d) There are no voting agreements, except the ones that all of the shareholders know about.

20.2(e) No shares are held as a nominee for someone else.

20.3 For an S corporation, it's good to know if the shareholders and their spouses are U.S. citizens or resident aliens for U.S. tax purposes.

20.4 The shareholders might feel like they know these things about each other. But it's good to be explicit.

20.5 As the drafter of the agreement, you will want to know if any of your assumptions are not correct.

20.6 If there is a bad surprise later, it will be better for the drafter to ask for the reps and then have the clients ask to take them out, than to have never asked for them.

21. NOT PUTTING A LEGEND ON THE STOCK CERTIFICATES

21.1 A bona fide purchaser for value, with no notice of the buy-sell agreement, is probably not bound by it.[17]

21.2 The role of the legend is to notify BFPs that there is a buy-sell agreement.

21.2(a) So require in the buy-sell agreement that all certificates subject to the agreement contain a legend about the existence of the transfer restrictions. One reason to do this is to remind professionals after us to add the legends to the stock certificates.

21.2(b) When shares change hands or lost certificates are re-issued, remember to add the legend. If there is doubt, resolve the issue before delivering the new certificate without the legend.

21.2(c) It is a good practice write "SEE LEGEND ON REVERSE" at the top of the front of the stock certificate if there is a legend on the back. That way, someone who receives a copy of only the front of the certificate will be alerted that there is a legend.

21.2(d) It is a good practice to include on the receipt for the stock certificate a copy of the legend in full. If it is too long, attach it to the receipt. This will be helpful when the certificate is replaced or the shares are transferred, and the attorney does not

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[17] Cal. Comm. Code §§ 8102(a)(1), 8105, 8303(b); Cal. Corp. Code § 418(a)(1), (b)/

see the old certificates at all, or only at the closing. (But don't wait until the closing to see at least copies of the front and back of the certificates.)

[End of outline.]