

Why Do You Need a Buy-Sell Agreement for Your Closely Held Company?

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Why do you need a Buy-Sell Agreement for your closely held company? In a nutshell, your business partner might die, become disagreeable, or just simply lose his or her mind, and you need a set of rules to resolve the matter. Disputes among business owners can be as intense and ugly as the worst divorce case, especially when the owners are family, and a good Buy-Sell Agreement can avoid some of this difficulty.

A Buy-Sell Agreement is an agreement among two or more business owners that establishes rules restricting, and sometime forcing, the transfer of ownership interests in the company or corporation. Buy-Sell Agreements ordinarily appear in shareholder agreements for corporations, operating agreements for limited liability companies, and partnership agreements for partnerships.

Unfortunately, too often we encounter business owners who failed to enter into appropriate Buy-Sell Agreements before irresolvable disputes arose, but which could have been resolved with a Buy-Sell Agreement. In those situations, the business owners invariably waste a lot of time, suffer through the stress of a long legal fight, and pay lawyers exponentially more than they would have paid for the preparation of a carefully considered and well-drafted Buy-Sell Agreement while the owners were on friendly terms.

Consider the following scenarios illustrating a few of the problems which can be solved with a good Buy-Sell Agreement:

SCENARIO 1 - YOU WANT ME TO PARTNER WITH HIM?

Leigh and David own 40% and 60%, respectively, of XYZ, Inc. Leigh manages the day-to-day business of XYZ, Inc. and relies upon her salary from the corporation to meet her personal financial needs. David, a passive investor, loses interest in his investment in XYZ, Inc. and sells his shares of the corporation to Rex without first consulting with Leigh. David erroneously thought that Leigh could not afford to buy him out of the business. Rex, having a different philosophy for the direction of XYZ, Inc., uses his majority voting interest in the corporation to install himself as the day-to-day manager, displacing Leigh and severely cutting her salary.

Solution: This situation could have been avoided with a basic Buy-Sell Agreement provision preventing transfers of shares without the consent of the shareholders. Alternatively, a Buy-Sell Agreement could have provided Leigh a first right of refusal, giving her the option to buy David's shares for the same price offered by Rex, before Rex has the option to buy. In that case, if Leigh did not exercise her option to buy David's shares, David could then sell them to Rex.

SCENARIO 2 – DON'T DENY ME THOSE ADDITIONAL FUNDS

After three years of operation, ABC, Inc. desperately needs cash to purchase additional equipment to meet the increasing demand for its product. Amy and Bill, owners of two-thirds of the corporation's stock, out-vote Clint, the remaining one-third owner, and adopt a resolution to have the corporation borrow the needed funds from their bank. As a condition to closing the loan, the bank requires personal guaranties from each of the shareholders. Clint refuses to execute his personal guaranty, effectively vetoing the loan transaction.

Solution: One effective way to avoid veto of the loan by Clint would have been a shareholder agreement that required all shareholders to execute personal guaranties, upon the majority vote of the shareholders. When Clint refused to sign the personal guarantee, the shareholder agreement could have given Amy and Bill the option to buy Clint's shares at a price much lower than fair market value.

SCENARIO 3 - MY PARTNER'S DEATH IS KILLING ME

Anne and Hugh are 50-50 owners of Acme, LLC. Both are members and managers of the company and work full-time for the company. Tragically, Anne is killed in an automobile accident on her way to work. In her will, Anne leaves all of her interests in Acme, LLC to her husband, Bob, who has always resented the close relationship Anne had with Hugh. Bob inherited no management rights in Acme, LLC, but did receive Anne's capital and profits and losses interests in the company. Bob refuses to help Hugh with the company's business and takes every opportunity to make things difficult for Hugh, including threatening a lawsuit to challenge the amount of Hugh's salary from the company. Hugh would love to buy Bob's interests in the company for fair market value, but Bob refuses to sell.

Solution: An operating agreement could have given Hugh the option to purchase Anne's interests in the LLC upon her death at a price determined by an agreed-upon valuation method, thereby preventing her surviving spouse from becoming a 50% owner. With additional careful planning, Hugh and Anne could have purchased life insurance to fund the purchase of each other's interests in the LLC upon their respective deaths.

SCENARIO 4 – STALEMATE

Peter and Greg are 50-50 owners of P&G, LLC. Both are members and managers of the company. The company has been quite successful in its internet mail order business and has accumulated a substantial amount of cash. Peter would like to invest the company's excess cash in a retail outlet store immediately. Greg believes that such an investment is unwise and would prefer to invest the cash in certificates of deposit until the economy becomes more stable. Both are adamant in their positions, and their 50-50 voting interests do not provide a way to break the stalemate. Resentment quickly builds between the partners. Each would like to buy out the other's interests in the company, but both refuse to sell.

Solution: The stalemate could have been broken by a compulsory buy-sell mechanism in an operating agreement, which could be triggered by either member, requiring the sale of a member's interests to the other member or the purchase of the other member's interests in the LLC. Such a provision, for example, will allow Greg to offer to either buy Peter's interests in the LLC for \$1,000,000, or sell Greg's interests in the LLC to Peter for the same price. Peter will then have to make the decision whether to buy or sell within a given time period. If Peter fails to act, Greg will have the right to buy Peter's interests in the LLC. This is a fair way to force a transfer of the interests to one of the members at a fair price. This provision also insures that Greg will not set the price too high, because he may have to pay that price, and that he will not set the price too low, because he will not want to be forced to sell for the low price.

SCENARIO 5 - UNINTENDED CONSEQUENCES

Deana and Joe own an equal number of shares of DJ, Inc., a corporation with a properly filed Subchapter S election. Following the advice of his brother, who has no legal or accounting background, Joe makes a gift of 10% of his shares of DJ, Inc. to a trust that was created for the benefit of Joe's children. Unfortunately, Joe's children's trust was not drafted well, and could not qualify as a proper owner of stock in a Subchapter S corporation. Joe's uninformed attempt at estate planning causes DJ, Inc. to lose its Subchapter S status and costs the corporation thousands of dollars in taxes. Deana, being familiar with the types of shareholders permitted to own stock in a Subchapter S Corporation, wishes Joe had been required to inform her before the transfer.

Solution: A shareholder agreement could have prohibited and voided any transfer of shares that would cause the corporation to lose its Subchapter S status. Further, a shareholder agreement could have required Joe to indemnify DJ, Inc. and Deana from any additional taxes they are required to pay as a result of the forfeited Subchapter S election, and could have given Deana the right to purchase Joe's shares at discounted price. Such harsh provisions could have also helped make Joe aware of the issue before he acted and served as a deterrent.

CONCLUSION

Each of the problems described above could have been prevented or resolved with a good Buy-Sell Agreement. However, it is important to note that there is no "one-size-fits-all" solution for Buy-Sell Agreements and they need to be tailored to the needs and expectations of the owners. What makes sense for one company may not make sense for another company considering the objectives of the owners. Further, a poorly thought out or drafted Buy-Sell Agreement can be worse than not having one at all.

Business owners should take the time to think through the circumstances that could happen and the outcomes they desire. The time commitment and legal costs of obtaining a carefully-considered and well-drafted Buy-Sell Agreement are minimal when compared to the time and cost of resolving problems when no agreement exists. The best time to consider and execute a shareholder or operating agreement is at the beginning of the business relationship before any conflict arises. However, it is never too late for willing business owners to enter into shareholder or operating agreements.

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