BUY-SELL AGREEMENTS SHOULD COVER ALL THE BASES

It’s hard to cover every contingency, but a buy-sell agreement should do just that. Here’s a handy checklist

By Donald F. Shelly, Jr,

Retirement may be a happy occasion for the one departing, but the remaining partners or shareholders are left to redistribute the business. A buy-sell agreement should cover this or any other contingency requiring an orderly transfer of ownership.
Map out exactly what (you) wish to happen when a shareholder dies, retires, leaves or wishes to sell

A buy-sell agreement among shareholders of a closely-held corporation provides for an orderly transfer of ownership by requiring one party to buy or sell shares of the corporation, usually at a stated price. Every contractor has heard a buy-sell agreement is a necessity—but what exactly should be contained in one?

Specific provisions which should be included in a buy-sell agreement depend upon ownership objectives. Before any legal documents are drawn up, the owners need to map out exactly what they wish to happen when a shareholder dies, retires, leaves the company, or wishes to sell or transfer stock. In most situations, the eleven areas outlined below should be addressed in the agreement:

Specific value. The value should be either a specific dollar value per share, or based on some easily calculated formula. A specific dollar value per share is preferable to avoid disputes over how valuation calculations were performed.

Date of the value. The date of the value should be the year end, quarter end or month end preceding the event which triggers the sale. If the date of value to be used is after the shareholder’s death, then the value for federal estate tax purposes can be challenged by the IRS.

Triggering events. Events which typically activate the buy-sell agreement are death, disability, retirement, resignation or termination of employment for any other reason. Depending on the goals and objectives of the shareholders, any of the following arrangements (state law permitting) for limiting ownership and control can be used:

• Mandatory Buy-Sell Agreement. The owner agrees not to sell his shares during his lifetime to anyone except the corporation or other shareholders at a predetermined formula or price. In addition, the owner or his estate is required to sell all shares upon termination, and the corporation or other shareholders are required to buy the shares.

• Option to Buy. Corporation or other shareholders have the option to buy the stock at a predetermined or formula price. This, in effect, allows remaining shareholders the option to...
retain exclusive ownership and control.

- **Right of First Refusal.** At no time is the shareholder required to sell shares to the corporation or other shareholders. The agreement simply provides that if and when the shareholder proposes to sell his shares, the corporation or other shareholders must be first given the right to purchase the shares at that price. This arrangement does not require the corporation or other shareholders to purchase the shares.

**Terms and conditions.** The agreement should specify whether payment will be in a lump sum or in installments. If the installment method is used, interest must be paid on the remaining balance; otherwise, the IRS will impute interest on the transaction.

**Dispute clause.** In situations where two shareholders each own 50 percent of the stock, some method for handling disputes should be included in the buy-sell agreement. The most common dispute clause is the “forced buy-sell” or “O.K. Corral” clause. Under this provision, the shareholder who “wants out” approaches the other shareholder with the dispute. The second shareholder then places a per share value on the stock. The shareholder bringing the dispute is then required to either buy or sell at the price given by the other Party.

**Trusted agreement.** Rather than distribute stock certificates to shareholders, certificates are held by a trustee to avoid shareholders refusing to surrender stock under terms of the buy-sell agreement. In addition, the trustee should hold any life insurance policies and be charged with executing terms of the agreement.

**Non-compete clause.** A non-compete clause is often included in a buy-sell agreement, but must be reasonable. The enforceability of non-compete clauses varies from state to state.

**Gifts to heirs.** Buy-sell agreements are typically drawn up to prohibit gifting. In some cases, the agreement will allow gifting; however, the terms of the original agreement will then apply to the giftee.

**Stock redemption vs. cross purchase.** Should the corporation or the other shareholders(s) purchase the departing shareholder’s stock? More often than not, the company is designated to purchase the stock since it usually has the cash remaining shareholder(s) do not. The agreement can be structured to allow both the corporation and the other shareholders the right to purchase the stock.

**Effect of redemption on control of the corporation.** Where there are more than two stockholders, shareholders should examine how control of the corporation is affected when a departing shareholder’s stock is either redeemed by the corporation or purchased by the remaining shareholders on a prorata basis. If A owns 40 percent of the outstanding stock, and B and C each own 30 percent, and C dies and his stock is redeemed, A is now in a majority position. Whether B wants this to happen needs to be addressed before the agreement is finalized.

**Protect major shareholder against minority shareholder problems in the event of a sale.** The agreement should provide that if the firm is sold, all minority shareholders agree to sell their stock to the buyer or back to the corporation.

What the buy-sell agreement should accomplish depends on the owners’ objectives. All possible scenarios must be thought out before documents are drafted. Finally, since state law governing buy-sell agreements varies, a competent attorney familiar with the laws of the state in which the company is incorporated should draw up the agreement.

---

**About the Author:** Don Shelly is a senior consultant for The Fails Management Institute in Denver, Colorado. He provides in-house consulting services in the areas of acquisitions, valuations, business continuation and issues involving stock ownership.