Legal Pad

Buy-Sell Agreement for Your LLC?

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What is a Buy-Sell Agreement? It is not an agreement to buy or sell your business. It is an agreement between the owners of a business that governs who can buy your interest or another owner's interest in the business and at what price. Its primary benefit comes when you or another decides to sell or is in a position that it must sell or transfer an interest in a business. Examples might be retirement of an owner, a dispute with a partner, a serious injury or illness that makes the owner unable to continue with the business, a divorce where a part of the business is owned by an unfriendly former spouse, a creditor claim against an owner's interest, or the death of an owner. A Buy-Sell Agreement can be just as useful in a family owned business as it is in a business that is not family owned.

If you don't have a Buy-Sell Agreement, there is a chance you could be operating the business with a co-owner who is (1) an inexperienced or untrustworthy stranger to the business; (2) the spouse of a deceased or divorced owner; or (3) a bankruptcy trustee or creditor. Or you may find a situation in which no buyer can be found or with a dispute over the value of the ownership interest on transfer to beneficiaries.

Here's how it works. Let's suppose that John and Jane, who are cousins, start a business and the business succeeds. Jane wants to continue to build and grow the business but John becomes bored and wants to do something else. A conflict results and to escape the conflict, John sells his 55% ownership in the business to Don who Jane does not know. Don decides to maximize his profits so he elects himself to the Board of Directors and begins to participate in the management of the Company. He wants to terminate some long term employees so he can increase short term profits, sell the business profitably and move on to something else. Jane is very unhappy about losing long term loyal employees who can contribute to her long term plans. They soon reach an impasse and litigation results as well as stagnation of the Company.

With a Buy-Sell Agreement in place, John would have to offer the shares to Jane at the same price Don has agreed to pay, if she buys the shares of John, then she becomes the sole

stockholder and can control the direction of the Company.

Most businesses with more than one owner need a Buy-Sell Agreement. You don't need one if you are a sole owner or if you and your spouse own it. If that is not your situation, then you probably need a Buy-Sell Agreement.

What are the most important things to accomplish with a Buy-Sell Agreement?

1. Restrict the possible buyers so that the existing owners can either buy the shares being sold or control the sale to limit it to friendly buyers (by requiring approval of any buyer).
2. Require the existing owner or the Company to buy the shares at a reasonable price.
3. Set up a fair price for the sale and a workable method for paying for and funding a buyout (such as an installment buyout).

Restrictions on buyers. The owners of an existing business will want to protect their interest by having a right of first refusal to buy any shares offered to anyone, before any outsider can buy shares. A typical provision would say "no owner shall have the right to sell, transfer or dispose of any or all of his or her ownership interest unless a written Notice of Intent to Transfer the interest with the name and address of the proposed transferee and the terms and conditions of the proposed transfer." The notice can be required to be given to the Company and to the Stockholders. A typical provision would allow existing stockholders or owners to be able to purchase the shares for sale at the same price as they are being offered. Another method is to put in a contract provision that prohibits any transfer of ownership without the specific consent of all other owners.

The right to force a buyout. In the event an owner goes through a traumatic life experience, by becoming disabled, losing a required license, retires, gets divorced, dies, or goes through a personal bankruptcy, (all involuntary transfers), then a Buy-Sell Agreement can require the remaining owner or owners to buy out the departing owner and can call for a preexisting price that has been agreed upon in less trying times. A need for a transfer can arise if an owner wants to stop working to go do something else or to retire. A fair approach can be to require the remaining owners to buy out the interest at a price the formula of which has been predetermined. If an owner becomes mentally or physically disabled and unable to work, then the remaining owners will want the right for force a purchase of the shares/ownership of the disabled owner. Sometimes the Company can be in a position to purchase the shares of the departing or disabled owner.

Pricing of a buyout. The parties can agree in advance to a price or a formula to determine the price at which an interest should be sold. An agreed to price can include a mechanism to update the price on an annual basis by referring to the balance sheet or net revenue. An outside appraiser can be hired to determine the fair market value of the business at the time.

How is the buyout to be funded? Several methods are common. Cash is the simplest method to buy out the interest in a business. But since not everyone has currently adequate cash, borrowing is another available method. A payout is sometimes used, where the Company or the remaining owners agree to pay the amount of the purchase price over a period of time, such as 5 years. Another frequently used funding method is through insurance, life or disability. This works by having the owners take out life insurance policies on each other. The death of one of the owners triggers a payment to the remaining stockholder(s) which is used to pay to the family of the deceased owner for the interest of that owner in the business. The insurance can be either life insurance or disability insurance.

This article is an overly brief review of the topic of Buy-Sell Agreements. My objective is to introduce the subject for further study and thought so that company owners will be aware that there is another option to think about and prepare for. If company owners have adopted a Buy-Sell Agreement that provides a mechanism to buy and sell the shares of a departing owner for whatever reason, then they can rest with some degree of assurance that one more phase of their business is well cared for and prepared for.

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