Negotiating and Drafting Buy/Sell Agreements

September 20, 2013

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What is a buy/sell agreement?

A buy/sell agreement is a contract that provides for the disposition of an owner's interest upon the happening of certain events ("triggering event(s)") that could alter the ownership structure of the entity. A buy/sell agreement will address who has the right or obligation to purchase shares upon the happening of a triggering event.

Every closely-held business should attempt to anticipate and plan for such events. The agreement is often a separately negotiated and signed agreement. The agreement is sometimes included in the Bylaws, partnership agreement, or operating agreement. A separately executed agreement, signed by all owners, may have some advantages potentially with regard to enforceability.

Most buy/sell agreements provide that shares cannot be transferred without the prior approval of the company or possibly a percentage of the other owners. There may be a list of "permitted transfers" that would be exceptions to the general prohibition. If there are permitted transfers, or transfers with consent, the agreement may include some restrictions, such as rights of first refusal, tag-along rights, or drag-along rights for the company or for other owners. A permitted transfer need not also constitute a triggering event.

Raising the Issue/Ethical Considerations

Early in any conversation regarding a potential buy/sell agreement, counsel should address the conflict issues that are usually unavoidable. An attorney working with a small business in these discussions could be expected to represent the corporation and several shareholders, all with competing interests. It is helpful if each owner has an equal chance of being either a "buyer" or a "seller," but conflicts are bound to arise.

A discussion about potential conflicts is the first step in addressing this question. If all parties agree that only one counsel is required, then written consent of all parties should be obtained from all owners and from the company, which should: (i) acknowledge that the potential conflicts were revealed and discussed and that separate counsel was recommended; and (ii) consent to the single representation. An engagement letter is essential and may include an acknowledgement of the conflict potential:

> "In connection with our engagement to perform services for the company, we will be working with you to prepare a proposed Buy/Sell Agreement. Company shareholders may have differing, and sometimes conflicting, interests and objectives. Each shareholder should consider retaining a separate lawyer, who could act as an "advocate" for his or her position and could provide independent, confidential advice and counsel."

Iowa Rules of Professional Conduct relevant to this issue include Rules 32:1.7 and 32:1.8 (Conflicts of Interest) as well as Rule 32:1.13 (Organization as Client).

Raising the Issue/Client Introduction

Buy/sell issues are important for all closely-held business clients. An agreement can be key to succession planning and the long-term viability of the business. While the terms of a buy/sell agreement need to be determined by the client, it is counsel's responsibility to set the stage and educate those who may become parties to the agreement. Introduction of the following three general topics may result in weeks of discussion among the owners.

1. General Purposes:
    - From the point of view of an individual owner, there may be a desire
        - for liquidity or
        - to define value for estate planning purposes
    - From the point of view of continuing owners and the corporation - the goal is to protect the business' ability to operate in the best interests of its remaining owners.
2. Sample triggering events - i.e., circumstances in which rights/obligations are often addressed:
    - Death
    - Disability
    - Retirement
    - Termination of employment
    - Divorce
    - Voluntary transfers
    - Involuntary transfers
    - Loss of professional license
    - Deadlock
    - Violation of financing covenants
3. Who gets "rights" and who gets "obligations?"
    - Owner's right to "put" shares to the corporation
    - Corporation's right to redeem shares
    - Remaining owners' right or obligation to purchase shares
    - Are there permitted transferees?

What purpose is to be served by the Agreement?

This is a difficult, but vital question that must be answered by the parties. Answering the question involves the balancing of differing, sometimes conflicting, goals.

An owner's interest in liquidity is fairly obvious - desire to provide value to a surviving spouse or other family members, the ability to exit a business and invest funds elsewhere, etc. An individual owner's interest in defining the value of shares for gift and estate purposes may tug against the owner's desire for liquidity.

The corporation's (and the continuing owners') goals may include:

- limiting those who can own shares (who am I going to do business with?)
- limit ownership to employees - to provide incentive (keeping the team all on the same page) or to protect the confidentiality of certain company information
- protect a corporation's "S" status
- protect against the need to register with the SEC
- preserve the status of a corporation as a professional corporation
- comply with regulatory or license requirements
- comply with terms of financing documents
- provide a method for addressing "deadlock" situations.

Has there been a "triggering event?"

The agreement should address, to the extent possible, how to determine when a triggering event has occurred. A definition for "disability" should be included. Generally, "disability" is limited to permanent disability. Evaluation of a medical expert retained by the company may be utilized. A reasonable lapse of time is usually included - such as six or twelve months. The buy/sell rights and obligations attached to the termination of an owner's employment may differ depending upon whether the termination was voluntary or involuntary - or whether an involuntary termination was for cause. The agreement should address how those questions can be determined. There are likely other triggering events that should be defined and explained by the terms of the agreement.

What types of buy/sell agreements are used?

There are a number of approaches that can be taken in structuring a buy/sell agreement, including:

1. Redemption agreement. This type of agreement binds both the owners and the company. Upon the death of owner, or other triggering event, the company may be entitled to, or have the option to, purchase shares.
2. Cross-purchase agreement. This type of agreement binds the owners to purchase each other's shares upon death or other triggering event. Upon the death of an owner, or other triggering event, the other owners may be entitled to, or have the option to, purchase shares.
3. Hybrid agreement. The agreement is often drafted so that purchases may be made by the company or by other owners. The company may be given the first opportunity, with other owners then given the right to purchase what the company does not. Rights are usually based upon proportional holdings, but often owners have the right to purchase what other owners do not.
4. Shotgun Approach. Under this approach, one owner may offer to buy another's interest at a specified price. The owner receiving the offer has the right to accept the offer and sell, or can purchase the initiating owner's offer at the same price. This is not a common approach and is generally used where there are only two owners.

In order to protect the value of the shares subject to purchase, the agreement probably should provide that all of the transferring owner's shares must be purchased, rather than only a portion.

Before agreeing that purchase by the company or by other owners is mandatory, the question of funding has to be considered. A corporation's ability to continue its business could be materially weakened by a purchase requirement. Statutory limitations on distributions should be considered. A funding source for any purchasing shareholder should also be addressed. The tax treatment of the transaction should be considered (redemption or dividend).

How will the purchase price be determined?

If an owner wishing to transfer shares has received an offer from a third-party, that offer often may be considered the fair value for the shares. If there is no third-party offer, the agreement should address the methodology for determining the purchase price for the shares.

Methodologies may involve, for example: (i) independent appraisals, (ii) annually agreed-upon values, or (iii) calculations based on revenues, EBITDA, EBIT, earnings, book value, or adjusted book value. While appraisals may be expensive, when no third-party offer is involved, an appraisal may provide the most supportable valuation. It is risky to rely on annually agreed-upon values unless an alternate method is agreed upon in the event the process has not been followed consistently. If any valuation is to stand up to scrutiny, the components of the formula should be reasonable, should be based upon an accepted methodology, and should be applied consistently.

In discussing potential formulas or methodologies, the owners should be incented to work toward a fair methodology, understanding that each owner could be either the seller or the buyer as a result of any particular triggering event. Here are some of the issues owners should consider:

- Is the valuation method likely to give the last man standing a windfall? Does the surviving spouse get a windfall?
- What are the triggering events?
- Do surviving owners want a surviving spouse or other transferee as an owner?
- Will the financial obligations harm the company?
- How will the buy/sell agreement be funded by the company or by any owners who may have purchase obligations?
- Will installment payments be allowed?

- Will an unrelated purchaser be admitted as an owner - or only as an unadmitted transferee (in the case of a limited liability company)?
- Are minority discounts to be applied?
- Should the price differ in the event of a termination for cause?

How and when will the price be paid?

The agreement should address the timing for payments, i.e., whether payment of the purchase price will be made in a lump sum or over time. The agreement should include terms regarding timing of the payment, amount of any installments, interest rate on any amount not paid at closing, remedies for default, the right to prepay, and any security for the payment obligation. The agreement may require owners or the company to obtain and maintain life insurance on the lives of owners.

In a cross-purchase agreement that is funded by insurance, the owners would be the policy owners, premium payers, and beneficiaries. In a redemption agreement that is funded by insurance, the company would be the owner, premium payer, and beneficiary.

If the agreement results in a company obligation to purchase shares, thought should be given to the right of the company to delay payments in the event the obligation would constitute a financial burden on the company.

n the event of the purchase of shares following termination of employment, care should be taken to avoid the possible application of deferred compensation rules under IRC 409A.

Buy-Sell issues specific to limited liability companies in Iowa

1. Transfers of Member Interests or “Transferable Interests

- <u>A “transferable interest” is defined by Iowa law.</u> Under the Revised Uniform Limited Liability Company Act (“RULLCA”), a “transferable interest” represents only the right to receive distributions from the company in accordance with the operating agreement. A “transferee” is a person to whom all or a part of a “transferable interest” has been transferred. A transferee may, or may not, be a “member” of the LLC.
  - Though members have governance rights, under the default rules of the RULLCA, a mere transferee does not have the right to participate in management, nor does the transferee have full access to records or other information concerning the company’s operations.
  - Unless an operating agreement provides otherwise, the RULLCA gives a mere transferee only the right to receive distributions to which the transferor would otherwise be entitled. Such a transferee has the right to receive an account of the company’s transactions in the event of a dissolution and winding up, but only from the date of dissolution.
  - An operating agreement may provide for a transferee to become a member, or the remaining members may consent to admit a transferee as a member. If admitted as a member, the transferee becomes liable for any obligations of the transferor to the company, such as additional contributions or repayment of any wrongful distributions.
- <u>A member has the “power” to dissociate</u>
  - Unless the operating agreement expressly authorizes a member to do so, a member has no right to withdraw or cease from being a member prior to termination of the company. Although there is no “right” to withdraw, a person has the “power” to leave or withdraw from the LLC, even if it is in breach of the operating agreement. Withdrawal is characterized under the RULLCA as a “dissociation.” Dissociation:
    1. does not entitle a withdrawing member the return of his or her contribution,
    2. may render the member liable in damages,
    3. may leave the member liable for payment of contributions he or she may be obligated to make under the operating agreement, and
    4. likely relegates the member to the status of a mere transferee.

There are exceptions to the above. The RULLCA authorizes a member to withdraw where the operating agreement or certificate of organization is amended over the member's written dissent, and the amendment "adversely affects the rights or preferences of the dissenting member's transferable interest" by, for example, altering or abolishing a member's right to receive a distribution or right to vote on any matter.

- **A member has the "right" to dissociate under limited circumstance.** The Iowa Act authorizes a member to withdraw in certain circumstances where the operating agreement or certificate of organization is amended over the member's written dissent, and the amendment "adversely affects the rights or preferences of the dissenting member's transferable interest" in ways described in the Act, e.g., altering or abolishing a member's right to receive a distribution or right to vote on any matter.
- **Dissociation can be "wrongful."** Dissociation is "wrongful" under the RULLCA if it is in breach of an express provision of the operating agreement, or if it occurs before termination of the company and:
    - the person withdraws as a member by express will;
    - the person is expelled as a member by judicial order;
    - the person is dissociated by becoming a debtor in bankruptcy;
    - in the case of a person that is not a trust other than a business trust, an estate, or an individual, the person (e.g., a corporation or another LLC) is expelled or otherwise dissociated as a member because it willfully dissolved or terminated.
- **Notwithstanding the above, the operating agreement controls.** It is important to note that issues relating to the transfer of a member's interest in an LLC will be governed by the operating agreement. To the extent the operating agreement is inconsistent with the default provision of the RULLCA, the operating agreement will control.
- **Obligations and amendments to the Operating Agreement generally may be enforced against transferees and dissociated members.** The obligations of an LLC and its members to a mere transferee or to a dissociated member are governed by the operating agreement. Except as may be provided in any buy/sell agreement, and to the extent necessary to effectuate a charging order, the RULLCA provides that "an amendment to the operating agreement made after a person becomes a transferee or dissociated member is effective with regard to any debt, obligation, or other liability of the limited liability company or its members to the person in the person's capacity as a transferee or dissociated member."
    - Dissociation of a member is not permitted to "freeze the deal" and amendments following dissociation and transfer are effective.
    - RULLCA provides that a transferee or dissociated member may seek judicial dissolution if the transferee or dissociated member can establish illegality, fraud, or oppressive conduct that "was, is, or will be directly applicable to the applicant." A court may order dissolution or lesser remedy such as a buy-out.
    - A transfer by itself does not cause a member's dissociation or a dissolution of the LLC. |

2. Death/Disability of Member

Under the RULLCA, if a member dies, the deceased member's legal representative has the right to receive distributions to which the deceased member would otherwise be entitled, and for purposes of settling the estate, has the rights of a current member.