

“THE LEGAL CORNER”

By Sam A. Moak

BUY-SELL AGREEMENTS FOR SMALL BUSINESSES

The information in this column is not intended as legal advice but to provide a general understanding of the law. Any readers with a legal problem, including those whose questions are addressed here, should consult an attorney for advice on their particular circumstances.

The transfer of ownership interests in a small business should take into account all of the considerations that make each business, and especially a family-owned business, unique. The vehicle for accomplishing the transfer is usually called a buy-sell agreement. Its name barely begins to describe the buy-sell agreement's various purposes. With professional advice, the agreement can be tailored to meet the objectives of each small business, whether the business is in the form of a close corporation, partnership, limited liability company, or some other structure.

By creating a market for the ownership interest of a shareholder who has retired, become disabled, or died, a buy-sell agreement insures that such an interest can be converted into cash when cash is more important than having shares in the company. Since small businesses often pay out most or all of their profits in salaries, an equity interest in the business would be much less valuable if its owner A typical buy-sell agreement for a family business provides that, on the death or departure of one shareholder, the remaining shareholders have the right to purchase his or her shares. Those participating in the buyout usually acquire those shares in an amount

was not assured of being able to sell that interest back to the business or to other shareholders.

When a triggering event in a buy-sell agreement causes the interest of one owner of a business to be purchased by other owners, or by the business as an entity, a critical issue is placing a dollar value on that interest. It is difficult to set a market value for shares in closely held corporations, whose stock by its nature has little or no liquidity. An agreement can set the price for shares according to a predetermined formula, value as shown on the company's books, an appraisal by a third party, or some other method. In any event, it is important that the provisions on the valuation and purchase price of shares in the company be kept current.

A buy-sell agreement also may serve as an orderly method for maintaining control over the company despite a change in the composition of its owners. In a family-owned business, this may mean a clause in the agreement effectively keeping the business in the family by allowing remaining family members to buy the interest of a departing owner. For children who decide not to carry on in the business, cash, perhaps generated by life insurance on a senior owner, might be an alternative to inheriting part of the business.

commensurate with their holdings. An alternative could give the corporation itself the right to purchase the shares. However, this option may bring into play laws for the protection of creditors that limit the power of corporations to purchase their own shares. A hybrid

approach sometimes used in buy-sell agreements allows the business to buy its own shares, only to the extent permitted by relevant statutes, but the remaining shareholders could then purchase any shares not acquired by the corporation.

Since one of the triggers for application of a buy-sell agreement is a shareholder's death, shareholders should avoid conflicts between the terms of the agreement and their estate plans. When the terms of an agreement and a will cannot easily be reconciled, the odds increase for litigation, rather than the smooth transition for which the agreement was designed. If a will predates the agreement, it may be necessary to draft a new will that is consistent with the agreement. A less complicated approach is to amend the will with a codicil providing that business interests are to be disposed of according to the buy-sell agreement.

Consistency between an estate plan and a buy-sell agreement is important not only as to disposition of shares, but also as to voting or management rights in the company. A shareholder should determine whether his estate or heirs should have such rights, and then be sure that the documents accurately reflect the shareholder's wishes. Similarly, a shareholder should consider whether limits on his executor's voting rights are desirable, so as to avoid the possibility that the executor will act to frustrate the shareholder's intent.

One purpose of any contract is to avoid future disputes between the parties by establishing rights and duties for future contingencies. Aside from dealing with the substantive issues raised by

transferred ownership, a buy-sell agreement also can head off conflict, or at least help solve it, by providing for a form of alternative dispute resolution or mediation.

When buying or selling a business entity, you should consult with an attorney for help in protecting your rights and to insure a smooth transition.

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