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Buy-Sell Agreements: A Must For Multi-Owner Companies!

Buy-sell agreements are perhaps the most important planning device for multi-owner privately-held companies. These agreements commonly help avoid disputes between co-owners, prevent deadlocks in decision-making, create mechanisms for the departure of retiring or resigning employee-owners, protect the reasonable rights of both minority and majority shareholders, and protect the families of co-owners upon their deaths. Failing to put a buy-sell agreement in place, preferably when a company is commencing business, is a mistake which can have devastating consequences later.

Buy-sell agreements are used in both corporations and limited liability companies (LLCs) with two or more owners. In corporations, a buy-sell agreement is typically a stand-alone agreement, usually called a "shareholders' agreement." In LLCs, extensive buy-sell provisions are typically incorporated in the company's "operating agreement," which is the basic structural agreement for an LLC. The buy-sell provisions advisable for either a corporation or an LLC are relatively similar, and are equally crucial for both types of entity.

Buy-sell agreements are customized for the needs, circumstances and preferences of the specific company, but they typically include most or all of the following provisions:

1. Limitations on the transfer of company shares or membership interests to third parties;
2. Rights-of-first-refusal, by which other co-owners can buy the shares or interests of a departing co-owner, by matching a purchase offer made by a third party;
3. Provisions by which the company may, or may not be obligated to, purchase the shares of a deceased co-owner, thereby protecting both the company and the family of the deceased co-owner;
4. Funding the buyback of a deceased co-owner's shares with life insurance proceeds, and agreeing to have insurance policies in place to offset the economic loss of a key employee;
5. Agreements by which departing co-owners may be able to sell their ownership interests back to the company or the other co-owners, at a price determined by an agreed-upon mechanism, thereby alleviating the illiquidity of ownership interests in privately-held companies;
6. Provisions designating who will be members of the Board of Directors or Managers, as well as corporate officers, and clarifying how vacancies will be filled;
7. Protections for minority shareholders from possible abuses by majority or control co-owners, such as limitations on salary compensation and the issuance of additional shares or interests to existing co-owners;
8. Veto rights for co-owners on major company transactions, such as sale of the company, major purchases, or admission of new owners;
9. Agreements as to the respective rights of two or more classes of shares or membership interests;
10. Dispute resolution mechanisms, to address a major and fundamental disagreement between co-owners, or even a deadlock between the owners of two 50% ownership interests in the company; and
11. Restrictions on the ability of shareholders to compete against the company or divulge trade secrets to third parties.

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Preparing a buy-sell agreement is best done when the business is commencing operation. At that time, relationships between co-owners are invariably cordial, and the kinds of disagreements which the buy-sell is supposed to address haven't occurred yet. The emotional stakes are also lowest when the company doesn't have a substantial tangible value; once the company is worth real money, negotiations among co-owners are usually more difficult. Waiting to implement a buy-sell until after the company has prospered is like trying to obtain property insurance after your home has burned down.

A properly-drafted and well thought out buy-sell agreement can avoid all sorts of potential disputes among co-owners, and solve in advance some serious, or even catastrophic, problems for co-owners of privately-held companies. Minority owners in companies without a buy-sell agreement may have their interests unreasonably diluted, find that the other owners pay themselves outrageous salaries, or may be effectively unable to sell their ownership interests when they die or are ready to leave the company. They may also lose having a voice in the management of the company, be kicked off the Board, have the company sold without their consent, or even have their employment with the company terminated. A minority shareholder may die and his or her estate may not have any realistic way to sell their shares.

Companies without buy-sell agreements can also suffer unforeseen problems. A deadlock between two 50% owners can paralyze the company. Shares can fall into the hands of people who will be disruptive to the company's operations, or even a competitor of the company. The death of a key owner-employee without company-owned insurance can cripple the company. Minority shareholders can threaten the company with litigation if the company does not buy out their shares. They also may divulge company trade secrets, start a competing business, or sabotage the company in other ways.

In light of the importance of the agreement, it must be drafted carefully. This kind of agreement can easily result in unexpected consequences, and a poorly-drafted buy-sell agreement can aggravate the same problems it is intended to avoid. Because such an agreement is intended to remain in force for many years, notwithstanding changes in circumstances, the attorney drafting it must be able to anticipate, and avoid, unexpected and undesirable results.

If your company has multiple owners, the time to put a buy-sell agreement in place is now!

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