# Protecting Your Corporation From Outsiders

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Whenever a corporation is owned by more than one individual, there are always questions as to what will happen if an owner dies, becomes sick, stops showing up to work, or decides to sell his or her stock in the corporation to someone else. A great way to protect from the "what ifs" is by implementing a "**Buy/Sell Agreement**".

## Purpose

The basic premise of a Buy/Sell Agreement is to set forth the terms and conditions of which:

- To provide for a buyer in the event of a stockholder's termination of relationship with the corporation ("**Terminated Shareholder**").
- To protect the Terminated Shareholder and his or her estate from being locked into the ownership of the corporation.
- To provide a source of funds with which to pay estate taxes or to generate income for Terminated Shareholder and/or his or her family.
- To provide a stock value for the purposes of buying/selling a Terminated Shareholder's shares in the corporation.
- To preserve control of the corporation among the remaining shareholder(s).
- To limit shareholders from selling their shares in the corporation without the consent of the other shareholder(s).

## Types of Triggering Events and Restrictions

1. **Death**. Almost all Buy-Sell Agreements are triggered by death. The purchase price may be covered or supplemented by life insurance on the deceased shareholder which is owned by the corporation or the remaining shareholder(s).

2. **Disability**. It is also recommended that a Buy/Sell Agreement cover "Total and Permanent Disability". If a shareholder is no longer capable of performing his or her duties, it is quite possible that profits will be reduced. This too can be covered by disability buy-out insurance.

3. **Termination of Employment**. If a shareholder is active in the operation of a business, consideration should be given to providing for a buy-out upon the termination of employment. You may want to consider having a buy-out only if employment is terminated for certain events. For instance:

(a) **Voluntary Termination**. If a shareholder voluntarily terminates his or her employment with the corporation, this may, depending on the circumstances, cause a hardship on the corporation and could affect the operation of the business. Options available in such an instance are to provide for vesting schedules and/or alternative payment provisions.

(b) **Termination for Cause**. If a shareholder is terminated "for cause", certain limitations on the buy-out of the shareholder's interest may be imposed.

(c) **Retirement**. The Buy/Sell Agreement may also define when a shareholder will be considered as having terminated employment as a result of "retirement" (i.e., notice requirements, etc.). This ensures that there are no surprises caused by sudden termination of employment.

4. **Transfers**. Every Buy/Sell Agreement should prohibit transfers by any shareholder other than in accordance with the terms of the Buy/Sell Agreement or with the consent of the other shareholder(s).

5. **Right of First Refusal**. It is appropriate to have a provision in the Buy/Sell Agreement that prohibits a shareholder from selling his or her stock without first granting the remaining shareholder(s) an opportunity to acquire the stock. Therefore, if one of the shareholders wishes to sell his or her shares, he or she would notify the other shareholders of his or her intention to do so and the other shareholder(s) are given a reasonable period of time to acquire the selling shareholder's interest in the corporation. The purchase price, in such an event, is generally the lesser of the offer from a third party or the value as determined pursuant to the Buy-Sell Agreement.

## Who Should be the Buyer?

The purchaser of a Terminated Shareholder's shares may be the corporation ("redemption") or the remaining shareholder(s) ("cross purchase").

If the corporation redeems the stock of a Terminating Shareholder, the remaining shareholder(s)' cost basis is unchanged. Gain on all subsequent sales by the remaining shareholder(s) will be measured by the difference between the original cost for their stock and the sale price. The Terminating Shareholder typically will have a capital transaction. If the corporation is a "C" corporation, there will be no step-up in basis for the remaining shareholder(s)' stock if the corporation redeems the stock. If, however, the corporation is an "S" corporation, the Buy/Sell Agreement and the ownership of life insurance can be structured so as to provide for a step-up in basis of the remaining shareholder(s)' stock.

If a cross purchase is used, the remaining shareholder(s) will have paid for the stock of the Terminated Shareholder. The purchasing shareholder's basis would, therefore, increase upon the purchase of the stock. Any gain on a subsequent sale would be reduced. If the sale occurs by reason of death, typically there is no gain recognized by the Terminated Shareholder's estate because the estate benefits from a "step up" of the deceased's cost (or "basis") to the fair market value as of the date of death.

## Determining the Purchase Price

The most difficult issue to overcome in any Buy/Sell Agreement is the purchase price of a Terminated Shareholder's shares. There are numerous methods of valuing stock that include, but are not limited to: (i) a fixed price, which is periodically reviewed; (ii) book value; (ii) appraisals, or (iii) values set by a formula such as multiple of average earnings.

However, there are many factors to consider when determining which method is most appropriate to use for valuing the stock of a closely-held corporation. For example, some of the factors the shareholders should take into consideration include: (i) the nature of the business; (ii) the overall economic outlook; (iii) the corporation's net worth; (iv) the corporation's financial condition; and (v) the market price of similarly situated corporations.

## Terms of Payment

There are a number of ways to pay for a Terminated Shareholder's shares.

1. **Death Buy-Out**. If a death buy-out is contemplated, the purchase price may be totally or partially funded by life insurance. If a redemption is used, the corporation would be the owner and beneficiary of the policy. If the purchase price, all or partially, is funded by life insurance, the balance could be paid in cash or by installment note.

2. **Installment Payments**. In all situations, the purchase price could be paid by a combination of a cash down payment and an installment note. The note could be for a stated number of years at a reasonable rate of interest. The note could be for a stated monthly or annual amount. The length of the pay-out can be different for each triggering event. The pay-out should balance the needs of the Terminated Shareholder (and his or her family) and the operating capital requirements of the corporation.

3. **Discount/Vesting**. It may be appropriate to have a discounted purchase price if a shareholder voluntarily terminates his or her employment with the corporation prior to retirement. Also, for a new shareholder it is appropriate to have a vesting schedule under which he or she will forfeit all or a portion of their interest if they terminate their employment. Generally, discounts and vesting schedules do not apply in the case of death or disability or if employment is terminated without cause.

As you can see, Buy/Sell Agreements can become quite complex and this outline is only intended to be a preliminary overview. If you have any questions regarding any of the issues discussed, please do not hesitate to contact me.