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Making legal matters easy and economical for your business

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Newsletter, May 2010: Buy-Sell Agreements

In this article I explain buy-sell agreements. Buy-sell protects a business from its owners, specifically their deaths, disabilities, divorces, disputes, bankruptcies and creditors.

Freeloaders and Malcontents. Your company needs a buy-sell agreement because change is constant, and your relationship with your fellow shareholders will change. Shareholders bicker, lose interest in the business, go away, die, get divorced, get run over by trucks, etc.

Sometimes a shareholder gets a better job and stops putting time into your company. He's now a freeloader, and you don't want him to enjoy the benefits of your hard work in building up the business. Sometimes a shareholder is such a malcontent that you must be rid of him. Or a shareholder might get divorced, in which case you don't want his spouse to take over his shares and become your partner. Or a shareholder might go bankrupt, and you need to protect the business from his creditors. In all these cases and other cases, the company needs a structure for the orderly and fair removal of shareholders.

The Economic Divorce. Enter the buy-sell agreement. When changes among the shareholders put your company in danger, the buy-sell agreement forces a fair resolution. I call this the economic divorce – if the company cannot survive a particular shareholder, the buy-sell agreement gets you a divorce on terms that are fair to everyone.

4 D's & 2 B's. Traditional buy-sell involves what I call the 4 D's– death, disability, divorce and dispute. I add a couple B's to the mix – bankruptcy and bad transfers.

- *Death.* If a shareholder dies, the company buys his shares from his estate. This is fair to the surviving family because they usually want money, not shares in an illiquid small business. This is fair to the company because you don't want the deceased shareholder's spouse or son to show up and announce himself as your new partner. Usually you pay a death buy-back in one lump-sum using the proceeds of life insurance.
- *Disability.* Similar to death (except without the finality) if a shareholder becomes disabled, the company buys his shares. The company can pay a disability buy-back using a promissory note.
- *Divorce.* The divorcing shareholder buys out his spouse's entire community property interest in the company's shares. This is done in the divorce proceedings.

- *Disputes.* Sometimes two shareholders just can't get along. To deal with this situation, you use "shotgun" procedures. This means that, between the two warring shareholders, the first shareholder offers to buy out the second shareholder, and the second shareholder has the choice, either be bought out or turn around and buy out the first shareholder on identical terms (i.e. I cut, you choose). Either way, a price is fixed for the buy-out, and one of the warring shareholders leaves the business.
- *Bankruptcy; Bad Transfers.* If a shareholder transfers shares in violation of the shareholders agreement or goes bankrupt, the company can purchase all of his shares to keep the shares away from his creditors. This serves an asset-protection function.

Buy-out Price. The buy-out price is crucial. A high buy-out price gives the exiting shareholder a windfall. A low buy-out price is unfair and leads to litigation. The trick is finding a procedure that ensures a fair price – for example, using a neutral appraisal process to fix a price.

Variation for a Real Estate Venture. As a final note, for some businesses, instead of a traditional buy-sell, it's easier just to liquidate the entire business. This can be true where a business does not have goodwill. For example, the value in most real estate ventures is the real estate. There is neither goodwill value in the venture nor sentimental value in the real estate. With this in mind, if the shareholders can't get along, it's easy to liquidate the assets, distribute the profits and let the shareholders go their separate ways. This is pure economic divorce.

I've tried to make buy-sell easy in this article. But that doesn't mean you can do it yourself. Get a competent business attorney to help you for two reasons: first, I need the money, and second, if you did it yourself you'd screw it up.

Marriage

Love is an ideal thing, marriage a real thing. A confusion of the real with the ideal never goes unpunished. ~Goethe

It is not a lack of love, but a lack of friendship that makes unhappy marriages. ~Nietzsche

Marriage is our last, best chance to grow up. ~Joseph Barth

If you want to sacrifice the admiration of many men for the criticism of one, go ahead, get married. ~Katharine Hepburn

I never knew what real happiness was until I got married. And by then it was too late. ~Max Kauffman

Funny Papers

