

Presented:
2014 LLCs, LPs and Partnerships

July 10 – 11, 2014
Austin, Texas

LLC and Partnership “Pre-Nups”: Drafting Buy-Sell Provisions

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TABLE OF CONTENTS

I. INTRODUCTION..... 1

II. DESIGNING THE AGREEMENT..... 1

III. TRANSFER RESTRICTIONS..... 1

IV. TRIGGER EVENTS..... 2

A. Right of First Refusal..... 2

B. Divorce of an Owner..... 2

C. Death of Owner’s Spouse..... 2

D. Death of an Owner..... 3

E. Retirement of an Owner..... 3

F. Disability of an Owner..... 3

G. Termination of an Owner’s Employment (Other Than Death, Retirement, or Disability)..... 3

V. MANDATORY V. OPTIONAL PURCHASE..... 4

VI. IDENTITY OF THE PURCHASING PARTY..... 4

VII. PURCHASE PRICE..... 4

A. Fair Market Value of the Interest..... 4

B. Enterprise Value of the Interest / Liquidation Value of the Interest..... 5

C. Net Book Value of the Interest..... 5

D. Formula..... 5

E. Pre-Established Value..... 5

F. Other..... 5

VIII. MANNER OF PAYMENT OF PURCHASE PRICE..... 5

IX. MISCELLANEOUS..... 6

APPENDIX A: TRIGGER EVENT CHART

LLC AND PARTNERSHIP “PRE-NUPS”: DRAFTING BUY-SELL PROVISIONS

I. INTRODUCTION.

A Buy-Sell Agreement is an agreement entered into by the owners of a closely-held company that governs the transfer and disposition of the ownership interests (“Interests”) in the company. The goal of a Buy-Sell Agreement is to promote the stability of the company and its owners by providing an agreed-upon framework for the manner in which Interests in the company can be held, transferred, and purchased. Without such an agreement in place, the company and its owners are at risk of unwanted co-owners, disorderly ownership and management succession, and the inability to ever liquidate an investment. While Buy-Sell Agreements typically have common elements, in the world of Buy-Sell Agreements “one-size does not fit all”; the terms of each Buy-Sell Agreement will need to be customized to fit the unique needs and goals of the company and its owners. The Buy-Sell Agreement for a company with two 50/50 owners will likely look quite different from a Buy-Sell Agreement for a company with four owners at 85/5/5/5. Also, as time passes, it may be necessary to have the owners of the company re-evaluate the terms of their existing Buy-Sell Agreement. What made sense 5 or 10 years ago may not make sense anymore such that the Buy-Sell Agreement may need to be modified to fit new circumstances and objectives.

A Buy-Sell Agreement can be used for each type of commonly encountered business organization, including a corporation, limited liability company, limited partnership, and general partnership. For a corporation, the Buy-Sell Agreement is typically a separate, stand-alone agreement executed by the company and the owner or incorporated into a Shareholders Agreement that governs the internal affairs of the corporation. For a limited liability company, limited partnership, or general partnership, the “Buy-Sell Agreement” is often part of the overall company agreement or partnership agreement.

If the controlling owner desires the company to issue a small Interest to one or more key employees, it may be best to have each key employee execute a separate Buy-Sell Agreement with the company. In this situation, the Interest of the controlling owner would not be subject to a Buy-Sell Agreement at all, as he or she would want maximum flexibility to transfer his or her Interest.

It is important to consider and implement the Buy-Sell Agreement at the inception of the company and issuance of the Interests. The “honeymoon” of starting a business can turn sour quickly, and, if appropriate

measures have not been put in place at the beginning, it can be difficult to re-establish order and stability.

II. DESIGNING THE AGREEMENT.

In designing the Buy-Sell Agreement, there are several questions that need to be asked, including:

- a. What are the restrictions on transferring an Interest (whether by sale, pledge, gift, or otherwise)?
- b. What are the events (“Trigger Events”) for which an owner’s Interest will be subject to purchase by the company and/or the other owners?
- c. Will the purchase of an Interest upon the occurrence of a Trigger Event be mandatory or optional?
- d. Who will be the purchaser of the Interest (company and/or other owners)?
- e. What is the purchase price for the Interest on the occurrence of a Trigger Event?
- f. What is the method of payment of the purchase price on the occurrence of a Trigger Event?

III. TRANSFER RESTRICTIONS.

If owners of a closely-held company can freely sell, pledge, gift, or otherwise transfer their Interests, there is a significant risk that at some point down the road an Interest will be transferred to someone that the other owners do not want as a co-owner. An unexpected co-owner can cause havoc to the company and the other owners as he or she will not only have an economic stake in the company, but, in certain cases, may have voting and management rights, rights to inspect the books and records of the company, and rights to re-transfer the Interest to others. Furthermore, such unexpected owner may be looking over the shoulders of management, second guessing many of their decisions, and threatening litigation for mismanagement.

To minimize this risk, the Buy-Sell Agreement should include broad restrictions on the right of an owner (or certain owners) to sell, pledge, gift, or otherwise transfer his or her Interest in the company. (**Note:** With respect to Texas corporations, §21.211 and §21.213 of the Texas Business Organizations Code (the “TBOC”) indicate that the restrictions imposed on the transfer of stock must be reasonable to be enforceable. §21.211 of the TBOC also identifies specific types of transfer restrictions that may be reasonable or are presumed to be reasonable. The TBOC does not contain these “reasonableness” standards in the specific sections of the statute covering limited liability companies and partnerships. In any event, at least for Texas corporations, complete restrictions on the transfer of stock may not be enforceable under the TBOC.)

As an except to the general restriction on the transfer of Interests in the company, often the Buy-Sell

Agreement will allow an owner to sell his or her Interest to a third party, subject to a “right of first refusal” in favor of the company and/or the other owners. Under a right of first refusal, if a third party has offered to purchase all or any portion of an owner’s Interest in the company, before that selling owner can sell his or her Interest to the third party, the selling owner must provide the company and/or the other owners the opportunity to purchase such Interest at the same price and terms as offered by the third party. In other words, the right of first refusal is a mechanism for the company and/or other owners to purchase the selling owner’s Interest if the other owners do not want the third party to become an owner of the company.

Another possible exception to the general prohibition on the transfer of an Interest is to allow “estate planning” transfers from the owner to his or her spouse, lineal descendants, trusts for the benefit of the owner, his or her spouse, and lineal descendants, and family controlled entities (i.e., family limited partnership). However, “estate planning” transfers should only be included in the Buy-Sell Agreement if the owners are comfortable with a succession plan that includes an owner’s family, including succeeding generations. Such situations might include an owner who is simply a passive investor or a founding owner with a substantial stake in the company who wants to allow the family to continue to own the Interest in the company following his or her death. Allowing estate planning transfers to a key-employee who holds a small Interest in the company would not be recommended as most likely the company and other owners will want such owner’s Interest purchased on death or employment termination.

Note: If the company is an S-corporation for federal income tax purposes, the Buy-Sell Agreement should prohibit transfers to persons who are not eligible to own stock in an S-corporation. If the company is a partnership for federal income tax purposes, it may be prudent for the Buy-Sell Agreement to prohibit transfers of Interests that would cause a termination of the company for federal income tax purposes under §708 of the Internal Revenue Code.

IV. TRIGGER EVENTS.

Trigger Events are the events affecting an owner that may (or will) give rise to the purchase of such owner’s Interest in the company. Commonly used Trigger Events are as follows:

- a. Right of First Refusal;
- b. Divorce (where the former spouse of an Owner is awarded all or part of the Interest in the company);
- c. Death of an Owner’s Spouse (where the spouse does not leave his or her community property interest to

the surviving Owner);

- d. Death of the Owner;
- e. Retirement of the Owner;
- f. Disability of the Owner; and
- g. Termination of the Owner’s Employment (other than on account of Death, Retirement, or Disability).

A. Right of First Refusal.

If an owner receives an offer from a third-party to purchase all or a portion of the owner’s Interest, before selling such Interest to the third party, the company and/or the other owners would have the right (but not the obligation) to purchase such Interest from the selling owner at the same price and terms as offered by the third party. If the company and/or the owners do not elect to exercise this right of purchase, then the selling owner could proceed to sell his or her Interest to the third party at the same price and terms as communicated to the company and/or other owners. This purchase right in favor of the company and its owners (also known as a “right of first refusal”) provides the company and its owners the opportunity to keep “outsiders” from acquiring an ownership stake in the company and at the same time provides the selling owner the opportunity to liquidate his or her investment if a purchaser can be found.

B. Divorce of an Owner.

If an owner divorces and the former spouse (the “Ex-Spouse”) is awarded all or a portion of the owner’s Interest by the divorce decree, then the divorced Owner, the company, and the other owners would have the right (but not the obligation) to purchase the Interest awarded to the Ex-Spouse. Discussion of the purchase price to be paid for the Ex-Spouse’s Interest and the manner of paying such purchase price are discussed below in Section VII and Section VIII, respectively. If no one exercises their right to purchase the Interest awarded to the Ex-Spouse in the divorce, the Ex-Spouse would be entitled to retain all of such Interest.

C. Death of Owner’s Spouse.

If the spouse of an owner dies and such deceased spouse (the “Deceased Spouse”) does not leave his or her community property share of the Interest to the surviving-spouse owner (whether outright or in trust), the surviving-spouse owner, the company, and/or the other owners would have the right (but not the obligation) to purchase all of the Deceased Spouse’s community property share of the Interest not left to the surviving spouse. If the surviving-spouse owner, the company, and/or the other owners do not exercise their right to purchase such Interest from the estate of the Deceased Spouse, then the heirs and beneficiaries would acquire such Interest. Discussion of the purchase price