

Legacy by Design, LLC

Reviewing a Buy-Sell Agreement

CHECKLIST

Succession Planning

Farmers, Ranchers, & Family Business Owners

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Checklist for Reviewing a Buy-Sell Agreement



LEGACY BY DESIGN, LLC

Client:

Date Prepared :

Prepared by:

Reviewed by:

Purpose: This checklist should be used to help ensure that the relevant points have been included (or at least considered) when a buy-sell agreement is drafted.

Yes No N/A

Identity of Parties

- | | | | |
|---|-------|-------|-------|
| 1. Are all existing owners and the entity itself named or otherwise specifically identified in the agreement? If community property, have spouses been included? | _____ | _____ | _____ |
| 2. Are all individuals holding an option to purchase ownership interests included as parties to the agreement? | _____ | _____ | _____ |
| 3. Is there a provision conditioning future acquisitions of ownership interests on the new owners accepting the agreement's terms and provisions? | _____ | _____ | _____ |
| 4. If spouses are not actual parties to the agreement, have they at least executed a consent to its terms and an acknowledgment of how any disposition of their community property or marital interest in the entity's ownership will be handled? | _____ | _____ | _____ |

Valuation Method Alternatives

- | | | | |
|--|-------|-------|-------|
| 5. If an agreed-upon value is used: | | | |
| a. Is it clear how and when the agreed value will be determined? | _____ | _____ | _____ |
| b. Is an alternate valuation method provided to address situations where the agreed value has not been changed or reviewed for a certain period of years? | _____ | _____ | _____ |
| c. Is there a method to break a stalemate if the owners cannot agree on the value to use in establishing or updating the agreement? | _____ | _____ | _____ |
| d. If the agreed value is directly or indirectly tied to life insurance coverage on the owners, does this same value apply to triggering events other than death? (If so, the client needs to make sure the method of funding the buy out after one of these other events has been addressed because life insurance proceeds won't be available in those circumstances.) | _____ | _____ | _____ |
| 6. If the appraisal method is used: | | | |
| a. Does the agreement specify the qualifications required of the person chosen as appraiser? | _____ | _____ | _____ |
| b. Is the method for selecting an appraiser specified? [For example, it could be based on (1) mutual agreement of the parties, (2) each party selecting an appraiser and the average of the two appraisals used, or (3) each party selecting an appraiser, and the two appraisers then selecting a third appraiser to actually establish the company's value.] | _____ | _____ | _____ |
| c. Is the issue of who pays for the appraisal (perhaps depending on the triggering event) addressed? | _____ | _____ | _____ |

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
7. If a formula approach is used:			
a. Is the formula for valuing the company clearly spelled out in the agreement? [For example, just saying net book value, capitalized earnings, or capitalized net cash flow isn't enough. Such details as the method for determining net book value (GAAP or tax basis, cash or accrual) or the capitalization rate to be used are also important.]	_____	_____	_____
b. If a capitalization method is used, was consideration given to the appropriateness of adding back the owners' salaries and benefits?	_____	_____	_____
c. Does the agreement provide a simple, cost-effective method for resolving disputes about the application of the formula?	_____	_____	_____

Triggering Events

8. Offer by outside Third Party:			
a. Does the company or the shareholders or both have a right of first refusal?	_____	_____	_____
b. If the party with the right of first refusal (company or owners) fails to exercise such right, does the other party then have an option to exercise a right of refusal?	_____	_____	_____
c. If a right of refusal exists, can it be partially exercised, or does the selling owner's entire interest have to be acquired?	_____	_____	_____
d. Is there a provision requiring notice of any offer to be delivered to the company and the other owners within a specified time frame? Must third party offers be in writing?	_____	_____	_____
e. Is there a deadline for when a right of refusal must be exercised?	_____	_____	_____
f. Does the agreement specify the price at which a right of first refusal may be exercised? [For example, (1) the price offered by the third party; (2) a formula, agreed value, or appraisal amount, or (3) either the lesser or greater of (1) or (2).]	_____	_____	_____
g. If a right of refusal is not exercised, is the right to use it triggered again if the third party sale isn't consummated within a specified time period?	_____	_____	_____

9. Disagreement among the Parties.			
a. Is there a provision allowing any owner to make an offer for the other owners' interests and set the purchase price and terms? (Sometimes called a push-pull or Russian roulette provision, it typically requires the other owners to either sell at the offered price and terms or purchase the offering shareholder's shares at that same price and terms.)	_____	_____	_____
b. If such a provision exists, is there a time frame for responses from both sides?	_____	_____	_____
c. Is there a provision for binding arbitration as a mechanism for resolving disputes among the parties?	_____	_____	_____

10. Death of an Owner.			
a. Is the agreement clear as to whether it is an option or a requirement that the decedent's shares be sold back to the company or other owners?	_____	_____	_____
b. If a sale is optional:			
(1) Does the agreement specify who holds the option (the decedent's heirs or the company/other owners)?	_____	_____	_____
(2) Is there a deadline on the right to exercise the option?	_____	_____	_____
(3) Are the procedures for exercising the option specified (how to give notice, etc)?	_____	_____	_____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
c. Terms of sale.			
(1) If the purchase price is funded by insurance proceeds that prove to be inadequate, is there a provision for determining how the balance is to be paid (all at closing or over a period of time)?	_____	_____	_____
(2) If a portion of the purchase price will be paid over time, are there provisions for determining the payment period, terms of payment, and interest rate?	_____	_____	_____
11. Disability of an Owner.			
a. Is the term disability adequately defined?	_____	_____	_____
b. When disability occurs, is it clear whether a sale is mandatory or optional?	_____	_____	_____
c. If optional, does the agreement specify who holds the option (disabled owner or the company/other owners)?	_____	_____	_____
d. Does the agreement specify the formula for determining the purchase price, the deadline for exercising any option to force or make a sale, and the payment terms?	_____	_____	_____
12. Termination of Employment.			
a. Is it clear whether a sale is mandatory or optional?	_____	_____	_____
b. If optional, does the agreement indicate who holds the option (former employee or the company/other owners), the deadline for exercising it, and how it is to be exercised (notice requirements, etc.)?	_____	_____	_____
c. Does the purchase price vary depending on the reason for termination? (For example, a voluntary termination might command one price, while a termination for cause might result in a lower price.)	_____	_____	_____
d. If the price varies depending on the reason, are the reasons clearly defined? (For example, if termination for cause is a triggering event, the agreement should define cause.)	_____	_____	_____
e. Are the payment terms clearly defined?	_____	_____	_____
13. Involuntary Disposition (bankruptcy or insolvency, etc. of an owner).			
a. Is it clear whether a sale is mandatory or optional?	_____	_____	_____
b. If optional, does the agreement indicate who holds the option (the owner in distress or the company/other owners), the deadline for exercising it, and how it is to be exercised (notice requirements, etc.)?	_____	_____	_____
c. Does the agreement specify the formula for determining the purchase price, the deadline for completing a sale, and the payment terms?	_____	_____	_____
14. Divorce or Death of Non-Owner Spouse.			
a. Does the owner spouse have the option or obligation to purchase the non-owner spouse's community property or marital interest if such interest is not awarded in divorce or doesn't pass under the will?	_____	_____	_____
b. If the purchase option exists, but the owner spouse fails to exercise it, do the other owners or the company have the option to buy the interest?	_____	_____	_____
c. If the owner spouse has the obligation to purchase the non-owner's stock, but has insufficient resources, can the business redeem the non-owner spouse's interest?	_____	_____	_____
d. Does the agreement specify the formula for determining the purchase price, the deadline for completing a sale, notification requirements, and the payment terms?	_____	_____	_____

Yes No N/A

Funding and Security for Buyout Payments

15. In the case of a cross-purchase agreement (where the other owners, rather than the company, are responsible for acquiring the selling owner's interest):
- a. If the agreement is funded with insurance, has a trust or partnership been established to hold the insurance, and then receive and distribute the proceeds? (When there are more than two or three shareholders, such an arrangement is normally more convenient because the alternative is for each owner to hold a policy on every other owner.) _____
 - b. If a trust or partnership is not used, is there some provision for ensuring that the owners keep the insurance policy in force? _____
 - c. Are the insurance policies properly owned, and appropriate beneficiary designations in place, to match up with the buy-sell document? _____
16. If the ownership interest will be purchased on an installment basis:
- a. Will a security interest in the stock, partnership interest, etc. be granted to the selling owner? (If yes, the seller normally retains the shares until the note is paid, even though the ownership interest is transferred on the company's books.) _____
 - b. Does the agreement specify who votes the ownership interest and receives the benefits of ownership (dividends, distributions, etc.) during the installment payment period? _____
 - c. If an escrow agent will be used instead of a security agreement:
 - (1) Is the agent a party to the agreement? _____
 - (2) Is the agent's compensation, if any, determined by the agreement? _____
 - (3) Does the agreement specify whether the agent will be indemnified, and if so, by whom? _____
 - (4) Is there a mechanism for unblocking the log jam in the event the escrow agent refuses to act? _____
17. In the case of a redemption agreement (where the company, rather than the other owners, is responsible for acquiring the selling owner's interest):
- a. Are all of the insurance policy proceeds required to be used to purchase the ownership interest? _____
 - b. Can part of the proceeds be used to help the company recover from the loss of the owner? _____
 - c. Can whole life insurance policies with cash values be transferred to a retiring or terminating owner? _____

Other Issues and Miscellaneous Provisions

18. Will the agreement be respected for estate tax purposes? _____
- a. If not, has client been informed in writing about possible adverse consequences (i.e., estate tax valuation in excess of amount received for the business under terms of the buy-sell agreement)? _____
19. Does the agreement or some other document (such as a corporation's by-laws) require that the stock certificates or other evidence of ownership carry restrictive language to make third parties aware of the existence of a buy-sell agreement? _____

	<u>Yes</u>	<u>No</u>	<u>N/A</u>
20. Has applicable state law been reviewed to determine that the agreement is within any limitations that exist on the right to restrict transfers of the entity's ownership interest?	_____	_____	_____
21. Should a provision be included to restrict the issuance of additional ownership interests by the entity?	_____	_____	_____
22. If an S corporation, partnership, or LLC, is there a provision requiring mandatory distributions at least sufficient to cover the owners' tax liabilities related to the entity?	_____	_____	_____
23. If an S corporation, is there a provision specifying how the entity's income or loss is to be allocated in the year an owner withdraws? [The income can be allocated based on the "per share, per day method" or, if all shareholders who hold stock at anytime during the year agree, based on the corporation's actual books and records]	_____	_____	_____
24. If an S corporation, are transfers to ineligible shareholders restricted?	_____	_____	_____
25. If an S corporation, are other shareholders indemnified against federal and state taxes, penalties, interest, and other expenses that arise from another shareholder causing termination of S status in violation of the agreement?	_____	_____	_____
26. If an S corporation, has agreement been reviewed to ensure it does not create a second class of stock?	_____	_____	_____
27. If a partnership or LLC, is there a provision specifying how the entity's income or loss is to be allocated in the year a less-than-50% owner withdraws?	_____	_____	_____
28. If a partnership or LLC, is there a provision specifying whether the entity must make a Section 754 election to step up (or step down) a transferee partner's share of basis in partnership property?	_____	_____	_____
29. Does the agreement provide addresses for notices and the method for giving notice to the parties involved?	_____	_____	_____
30. Is there a provision that automatically severs any invalid, illegal, or unenforceable provision from the agreement?	_____	_____	_____
31. Is there a provision making the agreement binding not only on the parties involved, but also their heirs and legal representatives?	_____	_____	_____
32. Is there a provision establishing the state under whose law the agreement is governed?	_____	_____	_____
33. Is there a provision stating that this is the entire agreement and that it cannot be amended or revoked except in writing by all parties to the agreement?	_____	_____	_____
34. Is the disposition of loans between a departing owner and the company provided for?	_____	_____	_____

