

**CORPORATE SHAREHOLDERS' AGREEMENTS  
AND LLC OPERATING AGREEMENTS**

**“Buy-Sell” Provisions**

**by**

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Fairfield, CT



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DEFINITION OF “FAIR MARKET VALUE” FOR SHAREHOLDERS’  
AGREEMENT – VALUE DETERMINED BY “THREE STOOGES”  
APPRAISAL PROCESS

Section \_\_\_\_ . Definition of “Fair Market Value”.

(a) if the Company has issued Shares in a private offering to one or more investors (other than Shares issued to employees of the Company and “Performance Shares” issued pursuant to one or more Work-for-Equity Agreements) within the preceding twelve (12) months for an aggregate purchase price of \$250,000 or more, the “Purchase Price” shall be the price per Share paid by such investor or investors (or, if more than one such private offering has taken place within such 12 month period, the arithmetic average of such prices);

(b) if the Company has obtained a report from an independent valuation expert within the preceding twelve (12) month period, the “Purchase Price” shall be the price per Share set forth in such report;

(c) if both of the events described in clauses (a) and (b) of this sentence have occurred within the preceding twelve (12) month period (i.e. a valuation report and a private offering of Shares), the “Purchase Price” shall be the greater price per Share determined pursuant to clause (a) or (b) of this sentence;

(d) if neither of the events described in clause (a) or (b) of this sentence has occurred within the preceding twelve (12) month period, the “Purchase Price” shall be determined as follows:

- (i) the Company and the Shareholder shall negotiate in good faith to determine the Purchase Price for a period of ninety (90) days following any event described herein giving rise to the need for such determination;
- (ii) if the Company and the Shareholder shall fail to reach agreement on the Purchase Price during such ninety (90) day period, the “Purchase Price” shall be determined by an independent appraiser or valuation expert selected by the Company and reasonably acceptable to the Shareholder (the “First Appraiser”), such appraisal to take place within thirty (30) days after the appointment of the First Appraiser;
- (iii) the determination of the Purchase Price by the First Appraiser shall be binding and conclusive upon both the Company and the Shareholder unless either party rejects such determination by notice in writing delivered within ten (10) days after such determination;
- (iv) if either the Company or the Shareholder rejects the First Appraiser’s determination of the Purchase Price within such ten (10) day period, the Purchase Price shall be determined by an independent appraiser or valuation expert selected by the Company and reasonably acceptable to the Shareholder (the “Second Appraiser”), such appraisal to take place within thirty (30) days after the appointment of the Second Appraiser; and

- (v) upon the determination of the Purchase Price by the Second Appraiser, the Purchase Price shall be the arithmetic average of the determinations made by the First Appraiser and the Second Appraiser, which determination shall be binding and conclusive upon the Company, the Shareholder, and (in the case of a deceased Shareholder) the Shareholder's estate.

The fees and expenses of the First Appraiser shall be borne equally by the Company and the Shareholder, and the fees and expenses of the Second Appraiser shall be borne exclusively by the party that rejected the determination made by the First Appraiser. The First Appraiser and the Second Appraiser shall each be conclusively presumed to be acceptable to a Shareholder unless such Shareholder objects in writing to the appointment of either the First Appraiser or the Second Appraiser within three (3) days of notice of his, her or its appointment by the Company. All references to a "Shareholder" in this paragraph shall be deemed also to refer to the heir, executor, administrator, or other personal representative of a deceased Shareholder under this Agreement.

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PROVISION FOR LLC OPERATING AGREEMENT – DETERMINATION OF FAIR  
MARKET VALUE OF WITHDRAWING MEMBER’S INTEREST BY MEMBERS

\_\_\_\_. “*Transfer Price*”, for purposes of Article VI of this Agreement, means the fair market value of a withdrawing Member’s or Interest Holder’s Interest, as determined by the Members in good faith.

\_\_\_\_. *Dispute Resolution*. The Members agree that they will negotiate in good faith and use their best efforts to attempt to reach an amicable adjustment of any dispute or controversy which may arise among them concerning the Company or this Agreement (including but not limited to the determination of the Transfer Price payable to a deceased, disabled or withdrawing Member or Interest Holder). If any controversy or claim arising out of or in any way connected with this Agreement cannot be settled by the parties involved within ninety (90) days after a disputed matter has been raised by a party, then the Company shall be dissolved in accordance with applicable law.



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PROVISION FOR LLC OPERATING AGREEMENT – DETERMINATION  
OF FAIR MARKET VALUE OF WITHDRAWING MEMBER’S INTEREST  
BY INDEPENDENT VALUATION EXPERT APPOINTED BY SOLE MANAGER

\_\_\_\_. “*Transfer Price*”, for purposes of Article VI of this Agreement, means the fair market value of a withdrawing Member’s or Interest Holder’s Interest, as determined by an independent appraiser or valuation expert selected by the Manager in good faith.





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PROVISION FOR LLC OPERATING AGREEMENT – DETERMINATION  
OF FAIR MARKET VALUE OF WITHDRAWING MEMBER’S  
INTEREST BY COMPANY’S INDEPENDENT ACCOUNTANT

\_\_\_\_. “*Transfer Price*”, for purposes of Article VI of this Agreement, means the fair market value of a withdrawing Member’s or Interest Holder’s Interest, as determined by the Company’s independent accountant or accounting firm, which determination shall be conclusive and binding upon the Company, the withdrawing Member or Interest Holder, and all other parties to this Agreement in the absence of manifest arithmetical error.



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PROVISION FOR LLC OPERATING AGREEMENT – DETERMINATION OF FAIR MARKET VALUE OF WITHDRAWING MEMBER’S INTEREST BY PREDETERMINED “FORMULA VALUE”

\_\_\_\_. “*Transfer Price*”, for purposes of Article VI of this Agreement, means the value of a withdrawing Member’s or Interest Holder’s Interest, as determined by the Company’s independent accountant(s) (whose determination shall be conclusive and binding upon the Company, the withdrawing Member or Interest Holder, the estate of a deceased Member or Interest Holder, and all other Members and Interest Holders in the absence of manifest arithmetical error) within ninety (90) days of the Company’s written request to determine the same, which shall be the greater of (i) One Hundred and 00/100 (\$100.00) U.S. Dollars, (ii) the amount in such withdrawing Member’s or Interest Holder’s Capital Account, or (iii) the fair market value of such withdrawing Member’s or Interest Holder’s Interest, which shall be the greater of the amounts derived pursuant to clauses (A) and (B) below, as adjusted pursuant to clauses (C) and (D) below:

(A) two hundred percent (200%) of the arithmetic average of the net profits of the Company (before any income taxes, interest, depreciation and amortization, and computed without any deduction for year-end bonuses, management bonuses, contributions to any 401(K), pension, profit-sharing or similar plan) for each of the five (5) calendar years ending prior to the calendar year in which the withdrawal of the Member or Interest Holder occurs (or the entire period from the formation of the Company to the date of the Member’s or Interest Holder’s withdrawal occurs, if shorter than five (5) full calendar years) shall first be determined; and

(B) fifty percent (50%) of the arithmetic average of the gross revenue of the Company (as such quoted term is defined for purposes of U.S. Generally Accepted Accounting Principles consistently applied) for each of the five (5) calendar years ending prior to the calendar year in which the Member’s or Interest Holder’s withdrawal occurs (or the entire period from the formation of the Company to the date of the Member’s or Interest Holder’s withdrawal if shorter than five (5) full calendar years) shall then be determined; and

(C) the greater of the amounts determined under clauses (A) and (B) above shall be multiplied by a fraction, the numerator of which shall be the withdrawing Member’s or Interest Holder’s Percentage, and the denominator of which shall be one hundred (100); and

(D) (i) to the sum determined under clause (C) above shall be added the aggregate principal amount of any and all indebtedness owed by the Company to the withdrawing Member or Interest Holder, as set forth on the books and records of the Company, together with accrued but unpaid interest to and including the date of the Member’s or Interest Holder’s withdrawal, and (ii) from the sum determined under clause (C) above shall be deducted the aggregate principal amount of any and all indebtedness owed by the withdrawing Member or Interest Holder to the Company, as set forth on the books and records of the Company, together with accrued but unpaid interest to and including the date of the Member’s or Interest Holder’s withdrawal.



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FORM OF "GOLDEN RULE" BUYOUT CLAUSE FOR  
LLC OPERATING AGREEMENT

5. "Golden Rule" Buyout.

5.1 Notwithstanding any other provision in this Agreement, in the event any Member or Interest Holder (the "Offeror") desires to purchase the Membership Interest of any other Member or the Economic Interest of an Interest Holder who is not also a Member (such other Member or Interest Holder being hereinafter referred to as the "Offeree"), then and in such event the Offeror may at any time offer, by written notice to the Offeree with a duplicate copy to all other Members and Interest Holders, to purchase the Offeree's entire interest in the Company for the "Purchase Price" of the Offeree's interest in the Company (as such quoted term is defined in Article I of this Agreement).

5.2. Upon receipt of such written offer (the "Offeror's Proposal"), the Offeree shall have thirty (30) days to accept or reject the Offeror's Proposal by written notice delivered to the Offeror (the "Offer Period"). In the event the Offeree accepts the Offeror's Proposal, then the conveyance of the Offeree's interest in the Company shall be made to the Offeror within thirty (30) days of the expiration of the Offer Period, and the purchase price set forth in the Offeror's Proposal shall be paid upon such conveyance. In the event the Offeree rejects the Offeror's Proposal, the Offeree shall so notify the Offeror in writing before the expiration of the Offer Period, which notice shall constitute an offer to purchase the Offeror's entire interest in the Company at the "Transfer Price" of the Offeror's interest in the Company (as such quoted term is defined in Section 1 of this Agreement), within thirty (30) days after the earlier of (x) the expiration of the Offer Period and (y) the date of the Offeree's notice rejecting the Offeror's Proposal. In the event the Offeree rejects the Offeror's Proposal as aforesaid, then the conveyance of the Offeror's Membership Interest shall be made to the Offeree within thirty (30) days of the date of the Offeree's written notice rejecting the Offeror's Proposal.

5.3 In the event of the failure of the Offeree to accept or reject the Offeror's Proposal within the Offer Period, then the Offeree shall be conclusively presumed to have accepted the Offeror's Proposal upon the terms and conditions herein set forth.

5.4 In the event the Offeror's Proposal is rejected by the Offeree but the parties fail to consummate the purchase of the Offeror's interest in the Company within ninety (90) days after delivery of the Offeror's Proposal, then (i) both the Offeror's Proposal and the Offeree's election to purchase the Offeror's interest in the Company shall be deemed withdrawn and no sale or purchase of either the

Offeror's interest in the Company or the Offeree's interest in the Company shall be deemed to have taken place, (ii) the Offeror shall, promptly upon demand, reimburse the Offeree for any and all costs and expenses, including but not limited to reasonable attorney's fees and expenses, incurred by the Offeree in connection with the transactions described in this Section \_\_5, and (iii) the Offeror shall, promptly upon demand, pay to the Offeree the amount of Ten Thousand and 00/100 (\$10,000) U.S. Dollars as liquidated damages for breach of this Section \_\_5 and not as a penalty.

THE FINER POINTS OF "BUY-SELL" AGREEMENTS  
FOR THE STARTUP VENTURE

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## What Are “Buy-Sell” Provisions?

- Owners of closely-held businesses want to keep ownership of business “in the family”, with no ownership by “outsiders” who don’t add value
- When an owner dies, his/her shares may be transferred to an “outsider”
- When an owner withdraws from the business (or is forced out), he/she becomes an “outsider”
- When an owner divorces or files for bankruptcy, his/her shares may be transferred to an “outsider” by operation of law

## Your Goals in Drafting “Buy-Sell” Provisions

- Provide for a repurchase of shares/equity by the company and/or the other owners when an owner dies or otherwise withdraws (voluntarily or involuntarily) from the business;
- At a price that is fair to both the company and the withdrawing owner; and
- In a way that ensures that any dispute about the value of a shareholder’s/member’s shares is resolved cleanly and quickly, so the remaining owners can get on with their business



## The Bad News

“It is virtually impossible to draft a buy-sell agreement that will satisfy all three of these goals.

This is one of the many reasons you carry malpractice insurance.”

--- Clifford R. Ennico  
November 18, 2016

## For “Personal” Businesses

- See my presentation from last year’s “Representing the Startup Venture” symposium [included in your course materials]
- Build a relationship with local valuation firms

## Suggestions for Further Reading

- “Forms for Small Business Entities” by Cliff Ennico (ThomsonReuters/West);
- “Closely Held Corporations: Forms and Checklists” by Cliff Ennico (ThomsonReuters/West);
- Business/Corporate and Banking Law and Practice 2015-2016 (NYSBA)
- Limited Liability Companies 2015-2016 (NYSBA)

## Thank You!



## Questions and Answers



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THE FINER POINTS OF "BUY-SELL" AGREEMENTS  
FOR LLCs AND CORPORATIONS

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--- Clifford R. Ennico  
November 17, 2015

## The Four Parts of a “Buy-Sell” Agreement

- Defining the “Triggering Events” for a Buyout
- Will the Buy-Sell Mechanism Be “Mandatory” or “Permissive”?
- Stating Who Will Buy What, When and How When a “Triggering Event” Occurs
- Specifying the Purchase Price, or Providing a Mechanism for Determining Same When a Triggering Event Occurs

## Defining the “Triggering Events”

- Death and Disability
- Voluntary Transfer [sometimes]
- Involuntary Transfers
  - Bankruptcy/Insolvency
  - Dissolution/Liquidation [if shareholder/member is an entity]
- Withdrawal of Shareholder/Member
  - “Termination of Employment”
  - Repeated refusal of owner to obey management directives
  - Nonparticipation in Business/Disappearance
  - Expulsion as manager, director or officer [with or without cause]
- Divorce/Marital Separation
- Management Deadlock [50/50 Situations]

## Must They Sell? Must They Buy?

- “Mandatory” vs. “Permissive” Clauses
- “Seller Must Sell, and Buyer Must Buy”
- “Seller Must Sell, But Buyer May Refuse to Buy If It Can’t Do So”
- “Seller May Sell, But If It Does Buyer Must Buy”
- “Seller May Sell, And Buyer May Buy If It Feels Like Doing So”



## Who Buys, What, When and How?

- Who Buys?
  - The Corporation
  - The Other Shareholder/Members
  - “Onesie/Twoisie” Provisions
- What Do They Buy?
  - All of the Departing Shareholder/Member’s Shares?
  - Only Some of Them?
- When Do They Buy?
  - Only when legally permissible to do so
  - The mechanics of sale, with deadlines for closing, must be set forth in the Agreement!
- How Do They Buy?
  - All cash, vs. payment in installments via promissory note

## Specifying the Purchase Price

- Right of First Refusal [for voluntary transfers only]
- “Certificate of Agreed Value” [not recommended]
- Formula Value [recommended for “personal” businesses]
- “Punting” [specifying a method for determining value]
  - Determination by a single “expert” [accountant, appraiser, valuation expert], whose finding is “binding and conclusive”
  - Determination by “Three Stooges” appraisal
    - Corporation/LLC picks an expert, departing shareholder/member picks an expert
    - If they disagree by less than 10%, “split the baby”
    - If they disagree by 10% or more, they pick a third expert who mediates the dispute
    - Looks beautiful on paper, but can be difficult to administer in practice and may prolong the buyout process indefinitely

## Dealing with Insurance Upon an Owner's Death or Disability

- Will either the company or the remaining owners be required to buy life or disability "buyout" insurance?
- If so, upon the death or disability of an owner, will the purchase price be the greater, or the lesser, of the insurance proceeds or the "fair market value" of the departing owner's shares
- A tough decision:
  - If "greater," the company could be deprived of much-needed funds to replace the departing owner;
  - If "lesser," the departing owner could be cheated out of a fair price for his/her shares
- Who will the beneficiary be?
  - Consider an "insurance trust" with third party beneficiary
  - If the company is the beneficiary, be sure the company is OBLIGATED to pay the withdrawing owner (or his estate)

## Finding the Right "Formula Value": A Practical Approach [Part 1]

- Talk to your client's accountant or investment banker [if any]
- If your client is a franchise, talk to the franchise's CFO and ask how "resales" are normally priced
- Check out the case law under Section 1118 of the NY Business Corporation Law

## Finding the Right “Formula Value”: A Practical Approach [Part 2]

- When all else fails, use the “greatest of W, X, Y and Z” where:
  - **W is 200% or 300% of the company’s EBITDA (earnings before income taxes, depreciation, and amortization), averaged over a three year period;**
  - **X is 50% or 100% of the company’s sales or revenue, averaged over a three year period;**
  - **Y is the departing owner’s capital account [for a partnership or LLC]; and**
  - **Z is \$100 or another nominal value (where the company has neither EBITDA or sales).**
- “As determined by the company’s independent accountant, whose determination shall be binding and conclusive in the absence of manifest arithmetical error.”

## Valuation by “Punting”

- Resolution of value by a single “expert” must be “conclusively binding” barring arithmetical error
- If you absolutely **MUST** use a “Three Stooges” appraisal clause:
  - Set very strict deadlines for each of the following:
    - Selection of experts by each party
    - Resolution of value by first two experts
    - Appointment of third expert
    - Resolution of value by three experts
    - Severe penalty (dissolution) if value not determined within X days
  - Make it very clear who bears the cost!

## The “Golden Rule” Buyout

- Very useful in “deadlock” (50/50) situations
- “Do Unto Others As You Would Have Them Do Unto You”
- The Mechanics:
  - Shareholder/member # 1 offers to buy the other out for a specified price (can be any amount)
  - Shareholder/member # 2 has 30 days to either (1) accept the offer or (2) buy the first shareholder/member out for the same price (adjusted for differences in percentage ownership)
  - If shareholder/member # 2 refuses to respond to buyout offer one way or the other within 30 days, is deemed to accept
  - If shareholder/member # 2 offers to buy # 1 out for the same price offered by # 1 and # 1 doesn't respond within 30 days, then either:
    - **corporation/LLC is dissolved; or**
    - **no buyout takes place but # 1 pays a penalty (make it hurt!)**

## Cliff's “Buy-Sell” Prejudices

- Mandatory rather than permissive buyouts (corporation first, then shareholder/members pro rata if corporation cannot purchase);
- Upon an owner's death or disability, the purchase price for his/her shares should be the “greater” of insurance proceeds or FMV;
- For “personal” businesses, formula values based on the greater of 2 times annual EBITDA (earnings before taxes, depreciation, and amortization) or ½ annual sales averaged over 3 to 5 years;
- For tech startups, “punting” with a single expert or “Three Stooges” valuation with precise deadlines and penalty for failure;
- Nominal value (\$100) ONLY if corporation/LLC has no EBITDA or sales/revenue [company is basically worthless];
- Be your client's “bad cop” and strongly recommend spousal consent forms;
- Use a “Golden rule” buyout clause in all 50/50 ownership situations (or where there is an even # of owners).

## Suggestions for Further Reading

- “Forms for Small Business Entities” by Cliff Ennico (ThomsonReuters/West);
- “Closely Held Corporations: Forms and Checklists” by Cliff Ennico (ThomsonReuters/West);
- Business/Corporate Law and Practice 2015 (NYSBA)
- Limited Liability Companies 2015 (NYSBA)

Thank You!

### THE LEGAL JOB INTERVIEW

WINNING THE LAW-RELATED JOB IN TODAY'S MARKET



CLIFFORD R. ENNICO Esq.

### THE PARTNER TRACK

SUCCESSING IN ANY LAW FIRM



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