



Mary Hanson



About the Business Advisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for 27 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

GETTING BOUGHT OUT: Selling your share of the business to another shareholder.

by Mary Hanson

Most co-owners of a business will split up before making it to the 10th anniversary of the business. Typically, one of the original owners buys out the other owner(s). And typically, the purchase is not based on a shareholder agreement. Even where a detailed shareholder agreement is in place, there is most likely no event triggering a right to buy out shares under the agreement. No bankruptcy, death, disability, attempted transfer of stock, or failure to perform has triggered the right of one shareholder to buy out another. The parties merely desire to end the co-ownership for reasons not covered in a shareholder agreement.

Because this is a voluntary, negotiable purchase and sale of stock, there are no rules that must be followed. There is no obligation to follow any of the provisions of the shareholder agreement in this situation, on purchase price, down payment, payment terms, or any other provision of the agreement. Each party must be prepared to negotiate the terms that cover his or her concerns.

The concerns of the buyer and the concerns of the seller are quite different. It is important for the owner being bought out to recognize some of the key objectives from his or her standpoint.

Since most businesses owned by two or more people are operated as a corporation, this article looks at the issues that need to be considered when one shareholder sells his or her stock in a corporation to another shareholder or to the corporation.

The format of the purchase and sale is similar to the purchase and sale of an entire business as the purchase and sale of corporate stock. The key issues are purchase price, terms of payment, collateral to assure payment, and agreement regarding liabilities.

The Buyer

Will the purchaser of the shares be the corporation or another shareholder – or both? Probably the biggest concern for the seller of stock is getting paid. Consequently, the most desirable buyer of the stock is the party with the most money. In a new business the deeper pocket may be another shareholder. When a corporation is well-established and profitable, it may be the corporation.

In any event, it's best to get both the corporation and the other shareholder bound to cover the payment obligations, through the use of guarantees.

Purchase price

The most common method of determining a purchase price is by

▼

“The purchase price should not be negotiated without considering how payments will be made and where the money will come from.”

negotiation and agreement, without any formal appraisal. Since the existence of an appraisal does not require or persuade the buyer to offer the appraised value to the seller, any appraisal is of limited benefit. An appraisal may or may not provide meaningful guidance or information for the buyout of a shareholder’s stock.

Keep in mind that any price determination, formula, or requirement of an appraisal in a shareholder agreement most often does not apply. The parties may consider, discuss, or argue the applicability of the method of valuation set out in the shareholder agreement. But the seller has no power to make the buyer offer or pay the amount established in that agreement. Without an event triggering an option or obligation to buy under the the shareholder agreement, the negotiations for the sale of stock are voluntary, and all issues are negotiable.

The advice of the corporation’s accountant should be valuable, even if he or she doesn’t do “business valuations.” The accountant can assist the owners in reviewing the financial statements, cash flow, debt, liquidity of assets, growth trends of the business, profit trends, etc. along with the tax consequences of the buyout.

The purchase price should not be negotiated without considering how payments will be made and where the money will come from. The buyer of the stock will hope to be able to make the payments with the money saved by not paying the selling shareholder a salary, bonus,

dividends, insurance payments, a car allowance, and other benefits.

The seller should endeavor to get more than that out of the buyer.

Both the buyer and seller need to understand the impact of the purchase and sale of corporate stock. Whether the buyer is the corporation or the other shareholder, the selling shareholder does not ordinarily get any assets of the business. It is not a split of assets, but a purchase and sale of corporate shares for cash payments. This issue comes up often regarding the “shareholder’s truck” and similar property that actually belongs to the corporation. Memorabilia, artwork, and personal items also may create issues to be addressed.

The accountant can be helpful on this issue, first in determining what items are on the corporation’s books (vs. personal items that may have been used at the business but not purchased by the corporation), and to identify alternatives for getting corporate assets out of the corporation and into the hands of the departing shareholder. This can’t be a dividend or S corporation distribution – which must be made to all shareholders in accordance with their stock ownership percentages. It may be possible to treat the distribution of certain property as a bonus or as a separate purchase by the seller or as part of the payment for stock, if the buyer of the stock is the corporation.

Tax issues

The seller of shares needs tax advice before agreeing to a buyout. The

GETTING BOUGHT OUT: Selling your share of the business to another shareholder.

transaction can be structured a number of ways to reduce taxes or change the tax impact on the buyer or the seller. For example, a buyer of stock may offer the seller a package that provides compensation for consulting or other services (deductible to the corporation) rather than for payment of stock (non-deductible to the buyer). In contrast, the seller of stock will probably benefit from the capital gains treatment on the sale of stock and wish to avoid personal income taxes resulting from employment or consulting services.

Consider whether there is any basis for commissions or rental income from equipment or real property. It is good to consider all the possible bases for a transfer of funds, and consider whether the tax impact is lighter. The seller also has to make sure he or she doesn't give up a well-collateralized promissory note for something less secure, such as a mere promise of employment.

Payment terms

Like any other purchase, the typical payment terms are a down payment at the time of closing, and payments made over a number of years. The amount of the down payment is negotiable. The less confidence you have that the buyer will be able to run the business profitably, the higher that down payment should be.

As the seller, you want the amount to be paid over time reflected in a promissory note. From a legal standpoint, the promissory note is superior to a commitment to payments set out in the purchase agreement. Ideally, a seller wants to

be able to sue on the note alone in the event of non-payment. The drafting and content of the note makes all the difference of whether the note will stand on its own in court or be regarded as just one part of the whole transaction.

Guarantees

If stock is purchased by the corporation, the seller should get a personal guarantee from the other shareholder(s). If the purchaser is another shareholder (especially where that shareholder will then own 100% of the corporation), the corporation should be a guarantor of payments on the note.

Collateral

One of the benefits of having both the shareholder and the corporation on the hook (through the promissory note and also a guarantee) is the ability to get both personal and corporate assets as collateral behind those obligations.

The three most common types of collateral securing the promissory note are the personal real estate of the shareholder who is either the buyer or a guarantor, the pledge of the stock owned by the shareholder who is either the buyer or a guarantor, and the assets of the corporation (either as the buyer and therefore payor on the note or as the guarantor of the buying shareholder's obligations).

Liability

Typically the selling shareholder wants to be relieved of as much liability as possible. The many



“Without an event triggering an option or obligation to buy under the shareholder agreement, the negotiations for the sale of stock are voluntary, and all issues are negotiable.”



Business Advisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

Publisher's Note

I encourage the buyout of a co-owner at the earliest indication of discord, dysfunction, or diverging goals. A business is almost always better off with one owner than with a number of owners – especially if there is any type of conflict or disagreement. A business needs to have one vision and one business plan – not numerous plans and conflicting leadership.

One owner should buy out the other before the problems have a chance to impact the business. Do it when there are still profits, employees, customers, etc.

If a buyout is effected before the disagreement takes its toll, there may be enough cash, cash flow, and borrowing power to conclude an amicable and financially satisfactory resolution. When partners wait until the business is a shambles, there is little to divide or salvage.

Mary Hanson
Attorney/Publisher

different types of liability must be considered.

One category of liability to be addressed is the personal guarantee. The seller may have given personal guarantees to the bank on bank lines of credit, to the landlord on a lease, and to certain vendors. The **ONLY** way to be released from these obligations is through a release from the creditor (landlord, bank, vendor, etc.). After you have left the business, you no longer have the ability to make sure obligations are paid. There is no good substitute for a release from all guarantees.

Other sources of liability include claims from customers, suppliers, and other parties.

The selling shareholder should get the buyer's commitment to pay all

corporate obligations, to maintain insurance, and to indemnify the selling shareholder (if a third party **DOES** sue the departing shareholder, the buyer will cover and reimburse the seller's expenses).

The departing shareholder needs to have his or her name removed from the records of the State Board of Equalization and Employment Development Department in order to limit liability to those agencies. These agencies rely on the Statement of Information filed with the Secretary of State. Therefore the selling shareholder has a compelling reason to make sure that form is amended showing that the seller is no longer a director or officer of the corporation. **BA**

Business Advisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

PRSR STD
US POSTAGE
PAID
TORRANCE CA
PERMIT #43

RETURN SERVICE REQUESTED