§1 Fundamental questions regarding founders’ relations

As discussed below, one of issues that the founders need to consider is the form of legal entity for operation of their new business venture (e.g., corporation, partnership or limited liability company); however, regardless of the form of entity selected the founders need to sit down and carefully discuss the relationship that will exist among the founders with respect to ownership and management of the business before outside investors are brought into the picture. When properly done, the ownership structure will protect the rights of each founder while creating incentives to make the business grow well into the future. The structure should always be flexible enough to adapt to future changes, including new employees and capital-raising from outside investors. Among the questions that need to be asked are the following:

- What percentage of the company will be owned by each founder?
- What rights will each of the founders have with respect to the management and control of the company?
- What tangible contributions (e.g., money, property, contract rights, etc.) will each founder make to the company and how will they be valued?
- How much time will each founder be expected to devote to the business?
- What incentives will be used to motivate each of the founders to remain actively involved with the business of the company?
- What procedures should be followed when a founder dies, becomes disabled, reaches retirement age, or voluntarily leaves the company prior to retirement age?
- What procedures should be followed to expel a founder from the company?
- Are there other persons outside the founding group who are likely to become actively involved in the business of the company?

The founders may be more interested in spending time on developing their new products and services than on dealing with what can often be very difficult and divisive issues. However, if these questions are not addressed at the beginning of the venture, it is likely that trouble will erupt down the road.

§2 --Allocation of ownership interests

In general, ownership determines how profits from the business will be shared and management rights will be exercised. Each form of business entity can be adapted so that certain founders enjoy greater economic rights as opposed to voting rights and vice-versa. In dividing ownership, consideration should be given to all of the actual and potential contributions of the founders to the business. For example, the founders may ascribe value to any or all of the following: cash and property contributed by the founders at the time that the new business is launched, including the costs to the founders of acquiring or
developing the property; the value of anticipated future contributions by the founders, including cash, property, services, business development assistance, and introductions to business partners; and the opportunity costs to the founders of launching the new business. Obviously, it is difficult to value several of these factors, particularly those which are speculative and depend on performance in the future. However, it is important for each founder to believe that his or her contributions have been fairly recognized. Professional advisors working with the founders of an emerging company will likely recommend that weight or credit should be given to discovery or conception of the ideas underlying the business; the time and effort expended in leading and managing efforts to promote those ideas; the level of financial and personal risk assumed in forming and launching the business; the amount of income foregone by forming the company and accepting a nominal or modest salary during the initial development period; the amount of effort spent in writing a formal business plan for the company; the specialized expertise contributed toward the development of new technology and/or products; and the background, training and experience that the founder expects to bring to crucial post-formation activities associated with the actual commercialization of the company’s technology or products.

In some cases, one of the founders of a new business may contribute intangible property and services while the other founders are providing the cash necessary to fund the development and marketing of the products based on the intangibles. Since the founders may reasonably differ as to the value to be placed on the contributions of the non-cash participant, counsel must proceed carefully to make sure that the assets are fairly valued. In that situation, counsel is faced with reconciling the following issues:

- What method(s) should be used to value the intangible property and services be valued for purposes of determining the relative equity ownership of the business?
- What obligations, if any, will be imposed on the parties to make additional capital contributions?
- Who will own the rights to trade secrets, patentable, or copyrightable information? Will the founder retain ownership and license them to the entity, or will the entity own all the rights?
- What obligations will be imposed on the “inventor” with respect to continued development of the intangible property?
- Who will own the rights to the intangible property in the event the company merges or dissolves?

Another issue to keep in mind is the possibility that the relative ownership interests of the founders will be diluted by future events, such as the need to grant an ownership interest to new managers, key employees, and one or more groups of outside investors. For example, a founding group looking for venture capital funding may discover that they will need to set aside 5%-10% of the equity for filling out the management team, 10%-20% of the equity for a pool of incentives for new employees, and 40%-60% of the equity for sale to the venture capitalists.
§3 Transfer restrictions

It is typical for the founders to enter into various agreements that impose restrictions on their ability to free transfer ownership interests in the business. First of all, vesting restrictions may be used to ensure that the founders remain with the company long enough to provide the anticipated value that was implicit in their ownership interest. If an owner should leave the company before an interest has vested, the company and/or the other owners would have the right to acquire the ownership interest on favorable terms (e.g., at cost payable in installments over a period of time). Once a founder’s rights in his or her ownership interest have vested, other restrictions would apply that limit the disbursement of control outside the original founder group while at the same time providing the founders with some opportunity to gain liquidity for their interests in the event they become dissociated with the company.

- A right of first refusal provides the company and/or the owners with the first opportunity to purchase ownership interests that the founder wishes to sell to a third party. Such a provision can prevent the sale of ownership interests to outsiders and generally will substantially limit the transferability of the interests.
- A buy-sell agreement restricts transfers of ownership interests by granting the company and/or the other owners the right to purchase the interest of an owner upon the occurrence of certain events, such as a proposed sale of the ownership interest to a third party, death or disability of the owner, termination of employment, bankruptcy, or divorce. Buy-sell agreements may also provide liquidity by requiring that the company and/or the other owners purchase the interest of the deceased or disabled owner. Procedures for determining the value of an interest upon any required purchase and sale will be included in the agreement.
- Co-sale agreements, which are often used when venture capitalists invest in the company, allow outside investors to sell their ownership interests at the same time that the founders sell their interests. A co-sale right often is coupled with a right of first refusal and thus allows the investors to choose between purchasing the founders’ interests or selling out on the same terms and conditions.

§4 Management of the new business

Regardless of the consideration they provide for their ownership interests, the founders must consider potentially contentious matters relating to control of the business. For example, decisions must be made regarding the voting rights of each of the founders and their power to control membership of the board of directors or other management body. The key issues to be considered include the following:

- What voice will each founder have in the election of the members of the managing body, such as the board of directors?
- Who will be responsible for the day-to-day operations of the business (e.g., officers of the corporation)?
• What level of consensus among the founding group will be required for major transaction, such as sale or merger of the company, major debt financings, and issuances of securities?
• What are to be the terms of any employment agreements between the company and the founders, including the amount of salary and other benefits to be paid to owners who are to be active in the business?
• What procedures should be used to resolve any disputes among the members of the founding group?
• How are the members of the founding group going to participate in the profits generated by the business?
• What restrictions should be placed on the outside activities of the founder, as well as their ability to transfer their ownership interests in the company?

The founders will often turn to an attorney to assist them in considering these issues and documenting their decisions. Counsel needs to be aware that the negotiation and drafting of an owners’ agreement will often lead to conflicts of interest such that the attorney cannot represent the founders concurrently. Even if all sides are properly informed of potential conflicts and grant the appropriate waivers, counsel still walks a fine line since it may be impossible to anticipate all the conflicts that might ultimately arise in the future. Accordingly, the attorney should be ready to prepare some form of disclosure letter and obtain a waiver of potential conflicts from each of the founders. If the founders are unwilling to waive the conflicts, separate counsel should be retained.

The members of the founding group should enter into an agreement among themselves as to how the company will be operated. In the corporate context, such an agreement is generally referred to as a pre-incorporation or shareholders' agreement. In the case of a partnership or an LLC, the matters are typically covered in a separate part of the partnership agreement or operating agreement, respectively. In some cases, the founders will address these issues before the entity is formed in some type of pre-formation agreement. This can be a useful exercise since it can give the founders a good idea of whether they will be able to live and work with each other before they incur the additional expense of actually forming the entity. Voting agreements are often used to establish procedures for making decisions regarding important matters relating to the business. In the case of a corporation, voting procedures may be laid out in a separate shareholders’ or voting agreement. Voting provisions for partnership and limited liability companies are set out in the partnership or operating agreement, respectively. The founders may elect to cover a variety of matters in the voting agreement, including the vote required to elect the managers of the company and approve fundamental changes in the business, including a sale of the company or its assets, significant borrowings, and admission of new owners. Transactions between the company and one of the owners may also be subject to special approval procedures. Whenever an owners’ agreement is implemented, an evidence of an ownership interest (e.g., a share certificate) should include a legend that notifies third parties of the existence of a restriction on the rights of the owners with respect to transfers or exercise of economic or control rights.
§5  Employment agreements

Some or all of the members of the founding group may also enter into employment agreements with the company that describe their duties and responsibilities with the company, the terms of compensation for their services and, perhaps most importantly, the rights and obligations of the company and the founder upon termination of the founder’s employment relationship with the company. Employment agreements are often valuable to founders who hold a minority ownership interest in the equity of the company who seek protection against the possibility that they will be discharged by some concerted action of the majority owners. In addition, however, employment agreements can serve a number of purposes beyond merely providing protection to minority owners and setting forth the terms of compensation. Employment agreements that contain noncompetition provisions serve to protect the other founder in the event that the employee-founder leaves the enterprise and attempts to start a competing business. The employment agreement also settles issues regarding the ownership and use of intellectual property rights acquired by the entity.

§6  Shareholders’ agreements

The answers to the fundamental questions regarding founders’ relations discussed above will normally provide the basis for drafting various contractual agreements among the founders in their roles as shareholders with respect to corporate governance and their duties and responsibilities to the corporation and one another. These “shareholders agreements”, which complement and supplement the provisions in the articles of incorporation and bylaws that will generally govern the operation and management of the corporation, can include an “agreement to incorporation”, which is actually entered into before the corporation is formally formed and organized; voting agreements; and buy-sell agreements. In some cases, the founders may opt for a comprehensive shareholders’ agreement which covers a wide array of governance issues beyond the election of directors, including designation of officers; voting requirements for fundamental corporate changes, such as mergers, the sale of all of the corporate assets and the issuance of a significant number of new shares; dividend policies; and alternative dispute resolution procedures. In addition to governance issues, a “hybrid” shareholders’ agreement often covers issues normally addressed in stock purchase agreements, employment agreements, intellectual property agreements, non-competition agreements and buy-sell agreements. Finally, founders wishing to create a detailed set of guidelines regarding management and operation of the corporation may include provisions relating to investment of corporate funds, maintenance of books and records, indemnification of directors and officers and inspection and auditing of corporate records. See Table 2 for a comprehensive list of questions to consider during the negotiation and drafting of an agreement among the owners of a new corporation.

§7  Agreements to form a new corporation

An agreement to form a new corporation, sometimes called an “agreement to incorporate”, should be considered as a valuable opportunity to reduce to writing the
understanding of the founders regarding the general terms and conditions associated with the formation and initial organization of the new corporation (see Table 1). The content of an agreement to incorporate will vary depending upon the circumstances; however, the matters commonly covered in such an agreement include the names and addresses of the parties; the proposed name of the corporation and a description of the procedures that will be followed to check the availability of the name and reserve it for future use on behalf of the corporation; a description of the proposed purpose and activities of the corporation; a summary of the place or places where it is anticipated that the corporation will conduct its business, including a statement of the procedures that will be followed in order to qualify the corporation as a foreign corporation; a description of the proposed capitalization of the corporation, including subscriptions by the founders; a list of the incorporators, initial directors and officers of the corporation; and a description of the terms of engagement of any persons required to assist in the incorporation process, such as lawyers, accountants or appraisers.

Other matters which might be covered in an agreement to incorporate are listed in Table 1 and include a description of the terms of any proposed employment relationship between the new corporation and any of the founders; the general terms of any share transfer restrictions and/or buy-sell arrangements among the corporation and its future shareholders; a description of any proposed purchase of assets by the new corporation, which will be relevant whenever the new corporation is going to take over the operations of a going concern; and a description of the procedures that will be followed in offering shares to persons not otherwise affiliated with the founding group, including the preparation of an offering document, engagement of finders and payment of the fees and expenses associated with complying with any securities law requirements.

The agreement to incorporate is also the place to address specific tax and regulatory issues associated with the formation and operation of the new corporation. For example, if the new corporation is being formed in the US and the founders wish to have it treated as a Subchapter S corporation for federal income tax purposes, the agreement should contain various covenants regarding the steps that will be taken to perfect and maintain Subchapter S status. In the case of regulated businesses it will be necessary to ensure that the corporation can obtain the appropriate license or permit. Compliance with securities laws should also be addressed if shares will be offered to outside parties. Finally, if an existing legal entity, such as a partnership, is being converted to a corporation, agreement should be reached on the assets that will be transferred to the new corporation and the number of shares that the owners of the old entity will receive in exchange and attention must be paid to ensuring that they achieve the tax treatment they are expecting with respect to the conversion.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Matters to Consider in Drafting an Agreement to Incorporate</th>
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<tr>
<td>1. Names and addresses of the parties;</td>
<td></td>
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<tr>
<td>2. The proposed name of the corporation and a description of the procedures that will be followed to check the availability of the name and reserve it for future use on behalf of the corporation;</td>
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3. A description of the proposed purpose and activities of the corporation;
4. A summary of the place or places where it is anticipated that the corporation will conduct its business, including a statement of the procedures that will be followed in order to qualify the corporation as a foreign corporation;
5. A description of the proposed capitalization of the corporation, including subscriptions by the parties;
6. A list of the incorporators, initial directors and officers of the corporation;
7. A description of the terms of engagement of any persons required to assist in the incorporation process, such as lawyer, accountants or appraisers;
8. A description of the terms of any proposed employment relationship between the new corporation and any of its organizers and/or promoters;
9. The general terms of any buy-sell arrangements among the corporation and its future shareholders;
10. If the principals wish to have the corporation treated as a Subchapter S corporation for tax purposes, the agreement may contain various covenants regarding the steps that will be taken to perfect and maintain Subchapter S status;
11. A description of any proposed purchase of assets by the new corporation, which will be relevant whenever the new corporation is going to take over the operations of a going concern;
12. When subscriptions will be sought from persons not otherwise affiliated with the founding group, a description of the procedures that will be followed in making the offering, including the preparation of an offering document, engagement of investment bankers and payment of the fees and expenses associated with complying with any securities law requirements; and
13. If an existing business will be incorporated, a description of the assets that will be transferred to the new corporation, the shares that will be issued in exchange for each proprietor's interest and a summary of the tax elections that will be made in connection with the incorporation.

§8 --Shareholders’ voting arrangements

Probably the most common reason for entering into a shareholders’ agreement is to set out the terms of any special arrangements among the founders regarding voting of their shares once they become shareholders. The power to elect the members of the board of directors of a corporation is held by the shareholders, and the power to elect all or a majority of the directors is held by those shareholders who own a majority of the outstanding stock of the corporation. Under certain circumstances, however, the shareholders may wish to allocate voting rights in some manner other than based on the ownership of shares. For example, a special arrangement might be used when all of the shareholders in a closely held corporation want to ensure they will serve on the board of directors. Another situation is when a shareholder wishes to reduce his or her ownership interest in the corporation for estate planning purposes while retaining the voting control, at least while the shareholder remains actively involved in the management of the business. Finally, a minority shareholder may be unwilling to invest needed capital without assurances that he or she will have some ability to participate on the board.

Voting arrangements may take a variety of forms, including voting trusts; irrevocable proxies; and voting or “pooling” agreements. Under a voting trust, which is authorized by statute, one or more shareholders transfer record title to their shares to designated individuals who act as voting trustees in accordance with the terms of the voting trust agreement entered into by the participating shareholders, which terms include directions as to how shares held in the trust will be voted. Voting trusts can operate as an easy and self-executing means for ensuring that the votes are cast in the manner specified. However, voting trusts can be somewhat costly to create and maintain; although

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simplified versions of such an agreement can be drafted to meet the needs of closely held corporations. When using a voting trust reference must be made to the guidelines included in the applicable state corporation laws. An irrevocable proxy is an arrangement whereby one or more shareholders irrevocably grant to another person or persons, who need not be shareholders, the right to vote the shares owned by the granting shareholders for the duration and to the extent described in the proxy. Certain statutory procedures must be followed in order to ensure that a proxy is irrevocable.

Voting arrangements may be used with, or in lieu of, other mechanisms for allocating control over a corporation. For example, different shareholder groups may be provided with the ability to elect directors by issuing various classes of stock. Similarly, issuing one class of stock with full voting rights and another class of stock with no voting rights can have the same effect as a contractual voting arrangement. Of course, voting arrangements are not self-executing, and the existence of a voting arrangement does not mean that the corporation must dispense with the legal formalities of shareholder action, such as meetings or actions by written consent.

§9 Voting or pooling agreements

A voting agreement, which is often referred to as a “pooling” agreement, is often entered into by two or more shareholders to provide for the manner in which each of them will vote their shares. Voting agreements are authorized by statute and specifically enforceable. A voting agreement is often preferred over voting trusts and irrevocable proxies because it can be specifically tailored to the needs of the parties. For example, a voting agreement might be limited to votes taken for the election of directors, leaving the parties free to vote their shares as they see fit on any other matters. Voting agreements are also much easier to implement than voting trusts.

A voting agreement may provide that shares will be voted to elect specified directors or voted in the manner directed by a majority of the members of the pool. For example, the shareholders of a closely held corporation might agree to elect one another to the board of directors under a voting agreement. Another situation where a voting agreement may be used is when the founders of a corporation seek to guarantee control over the composition of the board by requiring other holders of common stock, particularly employees, to become parties to a voting agreement that grants the founders the right to vote the shares of the employees for the nominees chosen by the founders. This allows the founders to create economic incentives and rewards for the employees based on success of the business, and appreciation of the value of their common shares, while retaining control over management and the composition of the board.

Voting agreements may continue are not limited in duration, unlike voting trusts, and thus may continue indefinitely. If new parties are to be added to a voting agreement, provision should be made for use of a formal accession agreement that includes a specific acknowledgement by the new party that he, she, or it must be bound by the agreement. Title to the shares subject to the pooling agreement remains in the shareholders who are parties to the agreement and this means, of course, that the agreement is not self-
executing. Each party is obligated to vote his or her shares as provided for in the agreement, but a vote breaching the agreement is not void and in the case of a breach the other parties must bring an action seeking specific performance or damages.

Shareholders’ agreements relating to corporate governance should be drafted in light of the resolution of broader issues relating to management and control of the corporation. Close corporation statutes, and general business corporation statutes in a few states, permit the shareholders to enter agreements to substantially reduce the powers of, or even eliminate, the board, and vest control of the corporation directly in the shareholders. If the board is eliminated, the shareholders will still provide for the election of officers to manage the day-to-day affairs of the corporation. If the board is retained, consideration should be given to having the shareholders’ agreement address the election of directors and supermajority shareholder quorum and voting requirements. For example, the parties to a shareholders’ agreement sometimes provide for supermajority requirements at the board level, which require consensus among the directors and generally protect minority shareholders, or restrictions on the discretion and powers of directors and officers which force more decisions back up to the shareholder level.

§10 Shareholders’ agreements and election of directors

As a general rule, shareholders voting in the election of directors will follow the principles of “one share-one vote,” unless some other provision as to the election of directors is included in the articles and bylaws or in a separate shareholders’ agreement. Some, but not all, states automatically provide for cumulative voting in the election of directors, thereby assuring that holders of less than a majority of the voting shares will be able to elect some representatives to the board of directors. In other states, cumulative voting with respect to the election of directors is only available if it is actually provided for in the articles.

A voting agreement may be used to deviate from the “one share-one vote” rule by providing that the parties will pool their shares to elect directors in accordance with the terms of the agreement. In addition to the examples discussed above, these types of provisions may be used in situations where the shareholder group consists of both founders and employees on the one hand and outside investors on the other hand. For example, the parties may provide that the outside investors will initially have the right to designate a specified number of directors and that the remaining directors will be designated by the founders and other members of the management group. Another option is for the investors and management to be given the right to designate an equal number of directors and require that the remaining director or directors must be agreed upon by both groups of shareholders.

In deciding whether to utilize one of the alternative procedures for the election of directors, consideration must be given to the objectives of the investors, the relationship that exists between the investors and the founders and other members of the management group and the anticipated future financing requirements of the company. For example, in situations where the investors are purchasing a majority interest in the company, they
may, as a result of the operation of statutory voting provision, have the right to elect all of the directors. However, recognizing that it is probably desirable to take a balanced approach to board representation, the investors may agree to an alternative voting scheme which assures them of the right to retain control of the board while allowing one or more members of management to also serve as directors. In any case, the procedures regarding representation on the board will always be heatedly negotiated when the company raises additional funds in future equity financings.

If the investors are not initially given the right to designate a majority of the directors, they may bargain for ability to assume control of the board upon the occurrence of certain events specified in the agreement. The triggers for these “vote switch” provisions, which are referred to by that name since they effectively switch control over the company's affairs from the management group to the investors, are always the subject of intense negotiations. In some cases, changes in control may be limited to situations in which the company fails to make a required redemption, defaults its obligations to make a dividend payment, or becomes involved in insolvency or bankruptcy proceedings. However, the parties may specify additional events, including a default by the company under any covenants made to the investors or the company's failure to satisfy specific financial tests.

§11 ----Supermajority shareholder quorum and voting requirements

The matters normally requiring shareholder approval, and the vote required to approve such matters, are set out in the applicable state corporation statutes. While many matters concerning the operations for the corporation can be dealt with by majority rule, there are generally some actions which should not be taken by a closely-held corporation without obtaining the consent of all of the shareholders, or some percentage-in-interest of the shares that is well in excess of a simple majority vote. These “supermajority” voting requirements are often covered in the articles and bylaws; however, they are also a proper topic for shareholders’ agreements. It is important not to unnecessarily bog down day-to-day activities by requiring that every decision be placed in front of all of the shareholders but it is not uncommon to require “supermajority” approval of operating plans and budgets; issuances of additional shares; sales of significant assets of the corporation; execution of contracts which impose material financial obligations from the corporation; significant increases in salaries; mergers and consolidations; changes in the business of the corporation; and activities which specifically contradict the terms of the shareholders’ agreement. Supermajority shareholder quorum and voting requirements are often used as a means for protecting the interests of minority shareholders. There are, of course, other strategies that can be used to achieve a fair result for all parties without running the risk of a deadlock due to a minority shareholder unreasonably withholding his or her consent. For example, minority shareholders may be convinced to allow the used “majority rule” to apply to a proposed sale of the company provided that the transaction yields all shareholders at least a specified minimum amount per share.

§12 ----Dispute resolution procedures

A shareholders' agreement is a great place to set out procedures for resolving disputes
among the shareholders in a manner that avoids a forced dissolution of the corporation. For example, it is not uncommon for the agreement to provide that in the event that the board is unable to reach a decision on any matter an independent “provisional director” will be designated who will serve solely for the purpose of resolving the particular dispute. If a provisional director procedure is used, the parties should agree to indemnify the designee for acts taken while serving as a director.

Arbitration clauses may also be included in the shareholders’ agreement. Arbitration is ordinarily quicker and cheaper than litigation and may be an efficient solution to dissension and deadlock. In addition, it is more flexible than litigation in dealing with the complex problems encountered by the close corporation and in devising remedies for those problems. If other means of resolving the conflict fail, the shareholders’ agreement might include a “put” or “call” in favor of one or more of the shareholders, which will allow for an orderly withdrawal of members of the shareholder group without dissolving the corporation and disrupting the business. However, any such provision must be carefully drafted and used in a way which does not amount to a violation of the fiduciary obligations of the controlling shareholders.

§13 --Buy-sell agreements

A buy-sell agreement is strongly recommended for clients involved in establishing and operating a closely-held business, regardless of whether the business is operated as a corporation, partnership or limited liability company. The subject matter of a buy-sell agreement can usefully be broken down into two areas: transfer restrictions and buy-sell provisions. While ownership interests in business entities, such as the shares of a corporation, are considered to be personal property which the owner has the absolute right to sell and transfer, there are a number of reasons why the owners of a closely held business are generally willing to accept various restrictions on transfers of such interests, such as:

- The owners want to retain the power to choose their future associates and co-workers;
- The owners want to prevent the business from falling under the control of competitors;
- The owners wish to ensure that all of them are actively involved in the business and avoid conflicts that may arise between active and passive investors;
- Restrictions are required in order to comply with federal and state securities laws;
- The owners want to ensure that the balance of control over the business is not upset by one owner purchasing the interests of the other owners; and
- Restrictions are necessary in order to ensure the eligibility of a corporation for, and/or status as, an “S corporation” for income tax purposes.

In addition, the owners often wish to provide mechanisms by which they might be able to obtain liquidity for their interests, and will often supplement transfer restrictions with “buy-sell” provisions, which provide for the sale of an interest by an owner to the entity and/or the other owners upon the occurrence of certain events—for example, the death of
termination of employment of the owner—on terms and conditions agreed to in advance. Like transfer restrictions, buy-sell provisions serve a number of purposes for the closely held business and its owners, such as:

- Regulating ownership and control of the business and, in some cases, ensuring that ownership is confined to persons active in the business;
- Preserving the balance of ownership and control among the owners;
- Preventing disputes if an owner wishes, or is compelled by circumstances beyond his or her control, to terminate his or her relationship with the business;
- Establishing a mechanism for dealing with disputes which might arise among the owners and for protecting the interests of minority owners;
- Establishing a mechanism for valuing the business and establishing a price at which ownership interests may be transferred within the ownership group; and
- Establishing a fixed value of the ownership interests for estate tax purposes and ensuring liquidity for the interest of a deceased owner.

§14 ----Negotiation considerations

The most cost-effective, although not necessarily the easiest, way to negotiate a buy-sell agreement is for all of the owners to meet with an experienced attorney, keeping in mind the necessity for the attorney to avoid conflicts of interest, and attempt to reach agreement on the basic points to be covered in the agreement. The key issues which must be discussed among the parties include:

- Restrictions on lifetime transfers;
- Procedures for dealing with involuntary lifetime transfers, such as transfers by operation of law upon divorce of one of the owners;
- Buy-sell arrangements on death of owners;
- Buy-sell arrangements on the occurrence of other events, such as termination of employment or deadlock;
- Determination of the purchase price and selection of valuation procedures;
- Manner of payment;
- Funding strategies, including the use of life insurance proceeds to pay for the interest of a deceased owner; and
- Whether or not the agreement should cover other issues relating to management of the business, including selection of directors and officers, the required consensus for approval of certain actions and other topics usually covered in a shareholders’ agreement.

Each of these “issues” has its own sub-set of decisions. For example, as to each buy-sell arrangement, consideration should be given to whether there will be “optional” or “mandatory” purchases and sales and, in the case of options, which parties (i.e., the prospective seller or purchaser(s)) will have the option.

§15 ----Ethical and professional considerations
When the founders ask the attorney who has been assisting them in forming and organizing their new corporation to take on drafting a buy-sell agreement he or she is placed in the uncomfortable position of providing legal advice to all of them, a situation that is immediately problematic given that there are a number of areas where the interests of the owners may differ. The possibility of a conflict among the owners is particularly high when there are differences in age, personal wealth and expectations regarding the type and duration of activities of the owners with respect to the corporation and its business. Before counsel attempts to prepare a buy-sell agreement for multiple shareholders and the corporation, reference should be made to the relevant state rules of professional conduct and ethics. In addition to the concerns about conflicts of interest, counsel must be sure that he or she is competent to advise the owners regarding certain substantive legal issues relating to the decisions made about the procedures in a buy-sell agreement. One area that immediately comes to mind is tax, both income and estate, since the tax consequences to the founders may vary significantly depending on how the purchase and sale of an ownership interest in the corporation is structured. Counsel should always obtain a written acknowledgment from all of the owners regarding potential conflicts and their consent to such representation and the attorney should also be sure that the founders all realize that they can and should seek the advice of their own counsel with respect to the terms of the buy-sell agreement.

§16 ---- Voluntary lifetime transfers

In most cases, the fundamental purpose of a buy-sell agreement will be to control voluntary transfers of ownership interests in the corporation, including sales of interests and gifts. While it is possible to attempt to impose outright restrictions on such transfers, it is more common to include provisions such as:

- Conditioning transfers on the consent of the corporation, the other shareholders, or another person, and/or compliance with various procedural requirements;
- Prohibiting transfers to designated persons or classes of persons, such as competitors;
- Restricting transfers other than to designated persons, a group usually referred to in the agreement as “qualified purchasers”;
- A “right of first offer”, which obligates the shareholder to offer the corporation or the other shareholders an opportunity to acquire the restricted interest before the shareholder attempts to find an outside buyer;
- A “right of first refusal”, which gives the corporation or the other shareholders the right to purchase the restricted interest on the same terms as contained in any bona fide offer that the shareholder has obtained from a third party;
- An obligation on the corporation or other persons to either purchase the restricted interest on terms established in the agreement or liquidate the business; or
- Providing the other shareholders with the opportunity to participate in the sale through the use of "tag-along" or "co-sale" rights.
Of course, combinations of various provisions can, and often are, used, such as creating a class of “qualified purchasers” and also requiring that transfers to anyone not meeting the definition of a “qualified purchaser” must be approved by the other shareholders.

§17 ----Forms of buy-sell arrangements

While transfer restrictions are directed at regulating transfers of shares outside of the initial shareholder group, buy-sell arrangements contemplate either repurchase of interests by the corporation or transfer of interests within the initial shareholder group upon the occurrence of certain events. As with restrictions on transfers, there are a number of different general forms of buy-sell arrangements, such as:

- An "option to purchase," under which the corporation and/or the other shareholders are given the option to buy an shareholder's interest upon the occurrence of specified events as to the shareholder;
- A mandatory obligation, referred to as a "buy-out," under which the interest of the shareholder must be sold to, and purchased by, the corporation and/or the other shareholders upon specified events as to the shareholder;
- A "put" right, under which an shareholder may demand that the corporation and/or the other shareholders purchase the shareholder’s interest upon the occurrence of specified events;
- A "call" right, under which the corporation and/or the other shareholders may demand that an shareholder sell his or her interest upon the occurrence of specified events.

Two or more buy-sell arrangements may be used in one agreement, and the parties may use different arrangements depending on the particular event. The parties may also include various methods for inducing parties to take certain actions, such as providing for dissolution if an option to purchase is not exercised.

§18 ----Selecting the purchaser

A key decision in structuring any buy-sell arrangement is selecting the parties who will have either the option or the obligation to purchase a shareholder’s ownership interest upon the occurrence of certain events. The first option is the so-called “redemption agreement”, which provides the corporation with either the option or the obligation to purchase the interest of a shareholder upon the occurrence of certain specified events. In most situations, the redemption agreement will apply to proposed lifetime transfers and will require that an shareholder who wishes to sell his or her interest to a person who is not already an shareholder must first offer the interest to the corporation either at a price and terms that are fixed in advance in the agreement or at a price and terms similar to that already offered by the outside buyer. The redemption agreement usually also comes into play on the death of the shareholder, at which time the estate of decedent will be required to offer his interest for sale to the corporation on terms and at a price set in the agreement.
The second option is a “cross-purchase agreement” which provides each shareholder with either the option or the obligation to purchase the interest of the other shareholders upon the occurrence of certain specified events. For example, if a shareholder wishes to sell his or her interest to a person who is not already a shareholder, he or she must first offer to sell it to the other shareholders in the same manner described above for a redemption agreement. A cross-purchase agreement usually also comes into play on the death of an shareholder, at which time the estate of decedent will be required to offer the decedent’s interest for sale to the surviving shareholders on terms and at a price set in the agreement. Whenever the shareholders have an option or obligation to purchase the interest of another shareholder under a cross-purchase agreement, the rights and burdens will generally be distributed pro rata among them in proportion to their share ownership; however, it is also possible to establish various priorities within the shareholder group.

The third option is a “hybrid agreement”, which combines the elements of redemption and cross-purchase agreements. In a hybrid agreement, each shareholder agrees to offer his interest for sale to the corporation and to the other shareholders upon the occurrence of certain specified events, and to have his or her estate offer it for sale to both the corporation and the other shareholders at death. There are a number of ways in which the rights and burdens can be allocated between the corporation and the other shareholders, such as successive options to the corporation and then the other shareholders, or vice versa, or options in the other shareholders coupled with the corporation’s obligation to purchase any remaining interest.

A number of tax and nontax factors should be considered in selecting the purchaser or purchasers in any buy-sell agreement, including the sources available for funding the purchase of the interest; the number of shareholders of the business; and the ages and proportionate ownership interests of the shareholders.

§19 ----Buy-sell events

The parties must carefully consider which events may come within the scope of the buy-sell agreement and trigger a right or obligation to sell or purchase the shares of the shareholder to which the event pertains. Buy-sell agreements can cover a wide range of events which may occur in the personal and professional lives of the shareholders. The most common "trigger events" are proposed lifetime sales to outsiders and the death of a shareholder; however, buy-sell provisions may be made applicable in a number of other situations such gifts, transfers to family members or other shareholders, involuntary lifetime transfers, termination of employment for various reasons (e.g., voluntary retirement, discharge and/or disability), change-in-control transactions, deadlocks and a desire to terminate the business relationship with other shareholders.

Transfers at death, along with restrictions on voluntary lifetime transfers, receive the most attention in any buy-sell agreement. The most common provision for transfers at death is the mandatory offer, under which the estate of the deceased shareholder must offer to sell the decedent’s interest to the corporation, the other shareholders or both, depending on the type of agreement that has been selected. This type of mandatory offer
is required to fix estate tax valuation. However, it is not necessary for the other parties to be obligated to buy the offered interest, although it is customary to provide for the mandatory buy-out of the interest funded through life insurance. If the agreement is not being used to fix estate tax values, it may restrict the class of permissible transferees at death, generally to other parties to the agreement or to specified family members of the deceased. The agreement should include provisions designed to ensure that the decedent's executor and legal representative adhere to the terms of the agreement, and that any heirs, successors or assignees will remain bound by the agreement.

When the success of a closely held business depends on the continued active involvement of the shareholders as employees, it is not surprising that many buy-sell agreements include options in favor of the corporation and/or the other shareholders to purchase the interest of a shareholder who ceases to be employed in the business. While many agreements simply refer generally to terminations, without regard to the particular circumstances, it often makes sense to explicitly distinguish among the events listed on the slide and establish different buy-sell arrangements for each form of termination. For example, repurchase at “fair value” in an “all cash” deal payable at closing may be required when an shareholder is terminated without “cause” or retires at or after a specified retirement age while shareholders who are terminated “for cause” or retire early may have no right to have their interests purchased or may only be offered an amount equal to their cost for the interest which would be payable in installments over several years under the terms of a promissory note.

The ability to purchase the interest of a departed shareholder-employee can be quite advantageous for the business and the other shareholders. For example, the repurchased interest can be used to recruit a replacement for the departing shareholder. Also, the other shareholders can be freed from the burdens of continuing to comply with the rights otherwise given to minority shareholders, such as inspection and voting rights. The departed shareholder-employee may also be eager to sell a minority interest, since it is unlikely that he or she will ever be able to again exercise any meaningful influence over the ongoing operation of the business.

### Table 2
**Questions for Preparation of Owners’ Agreement**

#### Background
- What general subjects should be covered by the terms of the agreement? Consider regulation of future issuances of ownership interests; management and control of the business; establishment of employment relationships; and buy-sell arrangements.
- What is the term of the agreement? Consider having the agreement remain in effect for a fixed term or until terminated by a vote of all or a specified percentage-in-interest of the parties.
- What procedures should be included for amendment or modification of the agreement (e.g., vote or consent of all parties)?

#### Ownership Interests
- What percentage of the ownership interests will be held by each founder? Will it be necessary to
commission a valuation of non-cash assets which the founders might contribute to the business?

- Should the agreement provide for preemptive rights for the founders with respect to future issuances of ownership interests?

Management and Control

- What procedures should be included for insuring that the founders will cooperate regarding the election of the managers of the business? Issues to be considered include the number of persons serving on the managing board of the entity; persons to be elected as members of the managing board; functions of managing board; resolution of disputes among members of the managing board; persons to be elected as officers (including titles); and managers' and owners' meetings. A detailed description of officers’ duties may also be included.
- What instructions should be included regarding protection and disbursements of the fund of the business? Consider language regarding location of bank accounts and signature requirements for checks.
- How will the founders select accountants and auditors for the business? What financial reports should be prepared for the owners?
- What matters should require the consent of all the founders? Consider issuances of additional ownership interests; sales of significant assets; execution of contracts which impose material financial obligations from the business; significant increases in salaries; mergers and consolidations; and/or changes in the business of the entity.
- Should the agreement include provisions regarding the payment of dividends or other distributions of profits? Consider either allowing the directors to determine the timing of dividends or requiring payment of some minimum dividend amount (subject to any restrictions on dividends or distributions included in applicable state law).
- What books and records should be maintained by the business? Note the need to comply with minimum requirements established by applicable statutes and related regulations.

Employment Matters

- Should the agreement include provisions relating to employment of the founders by the business? If so, consider the following issues: duties of each founder in his or her capacity as an employee and the amount of time that each founder will spend on the activities of the business; the amount of compensation to be paid to each employee-founder (including benefits); and the circumstances under which employment of a founder may be terminated.
- Should the agreement include restrictions on the ability of the founders to engage in competitive activities?
- Should the entity be required to purchase health and/or life insurance and/or disability insurance with respect to any of the founders?
- What types of obligations should be imposed on the founders regarding protection of the confidential information of the business? A definition of confidential information should be included in the text of the agreement. The agreement should also provide for assignment of the founders’ business-related inventions to the entity.

Buy-Sell Provisions

- Should the agreement include restrictions on transfers of ownership interests? In many cases, the transfer of interests may be subject to a right of first offer or refusal in favor of the entity and/or the other owners. Transfers should be broadly defined to include all possible voluntary and involuntary means of transfer including gift, pledge, hypothecation, operation of law (e.g., dissolution of marriage), and intestate succession. Restriction should apply to the founders, personal representatives of deceased or incompetent founders, founders’ spouses, and permitted transferees.
- Should the agreement grant one or more of the founders the right to compel the entity to purchase the interests of other specified founders? Such a provision may be helpful in the case of a deadlock among

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<table>
<thead>
<tr>
<th>Founders’ Relationships and Agreements</th>
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<tbody>
<tr>
<td>Should the agreement provide for optional or mandatory purchase of ownership interests upon disability of a founder? If so, how should disability be defined?</td>
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<tr>
<td>Should the agreement provide for optional or mandatory purchase of ownership interests upon the termination of employment of a founder? If so, what events should constitute termination of employment?</td>
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<tr>
<td>Should the agreement provide for mandatory purchase of the ownership interests of a deceased founder?</td>
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<tr>
<td>Should the agreement provide for optional or mandatory purchase of ownership interests which become subject to transfer to a third party in an involuntary transfer (e.g., a transfer pursuant to a judicial order or enforcement of pledge)?</td>
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<tr>
<td>How is the purchase price for ownership interests subject to buy-sell provisions to be determined? For example, the parties may agree that the value of the interests will be the sum of the book value of the interests as reflected in the financial statements of the entity plus an amount equal to the value of the goodwill associated with the interests. The price may vary depending on the event that triggers the buy-sell provision, such as when interests subject to involuntary transfers are purchased at the lower of the price determined pursuant to the above formula or the price actually paid by the third party for the interests.</td>
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<tr>
<td>What provisions should be included for payment of the purchase price for ownership interests bought and sold under the buy-sell agreement? For example, a portion of the price may be paid immediately in cash and the balance may be paid out in installment payments under a promissory note. Consider the need to purchase insurance to finance purchases.</td>
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**Note:** In the case of a corporation, the owner’s agreement would take the form of a shareholder's agreement that would cover a variety of matters, including the allocation of ownership interests, voting rights, and restrictions on transfers of shares. In the case of a partnership or limited liability company, the provisions might be incorporated into the partnership or operating agreement, respectively. Regardless of the form of documentation used, it is important for the founders to consider all of the issues raised above before proceeding with the actual formation of the new entity.
About the Author

This chapter was written by Alan S. Gutterman, whose prolific output of practical guidance and tools for legal and financial professionals, managers, entrepreneurs and investors has made him one of the best-selling individual authors in the global legal publishing marketplace. His cornerstone work, Business Transactions Solution, is an online-only product available and featured on Thomson Reuters’ Westlaw, the world’s largest legal content platform, which includes almost 200 book-length modules covering the entire lifecycle of a business. Alan has also authored or edited over 90 books on sustainable entrepreneurship, leadership and management, business law and transactions, international law and business and technology management for a number of publishers including Thomson Reuters, Practical Law, Kluwer, Aspatore, Oxford, Quorum, ABA Press, Aspen, Sweet & Maxwell, Euromoney, Business Expert Press, Harvard Business Publishing, CCH and BNA. Alan is currently a partner of GCA Law Partners LLP in Mountain View CA (www.gcalaw.com) and has extensive experience as a partner and senior counsel with internationally recognized law firms counseling small and large business enterprises in the areas of general corporate and securities matters, venture capital, mergers and acquisitions, international law and transactions, strategic business alliances, technology transfers and intellectual property, and has also held senior management positions with several technology-based businesses including service as the chief legal officer of a leading international distributor of IT products headquarterd in Silicon Valley and as the chief operating officer of an emerging broadband media company. He has been an adjunct faculty member at several colleges and universities, including Berkeley Law, Golden Gate University, Hastings College of Law, Santa Clara University and the University of San Francisco, teaching classes on corporate finance, venture capital, corporate governance, Japanese business law and law and economic development. He has also launched and oversees projects relating to sustainable entrepreneurship and ageism. He received his A.B., M.B.A., and J.D. from the University of California at Berkeley, a D.B.A. from Golden Gate University, and a Ph. D. from the University of Cambridge. For more information about Alan and his activities, and the services he provides through GCA Law Partners LLP, please contact him directly at alangutterman@gmail.com, follow him on LinkedIn (https://www.linkedin.com/in/alangutterman/) and visit his website at alangutterman.com.

About the Project

The Sustainable Entrepreneurship Project (www.seproject.org) was launched by Alan Gutterman to teach and support individuals and companies, both startups and mature firms, seeking to create and build sustainable businesses based on purpose, innovation, shared value and respect for people and planet. The Project is a California nonprofit public benefit corporation with tax exempt status under section 501(c)(3) of the Internal Revenue Code dedicated to furthering and promoting sustainable entrepreneurship through education and awareness and supporting entrepreneurs in their efforts to launch and scale innovative sustainable enterprises that will have a material positive environmental or social impact on society as a whole.

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