

# Minority Investor Rights in Private Companies: Buy-Sell Agreements, Court-Ordered Buyouts, Breach of Fiduciary Duty

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Today's faculty features:

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# Understanding the Rights of Minority Investors in Private Companies

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## David F. Johnson

David maintains an active trial and appellate practice in the business divorce/closely-held business area and specializes in fiduciary litigation. David routinely represents minority and majority shareholders, partners, and LLC members in disputes and litigation, including breach of governance documents, breach of fiduciary duty, and derivative actions. David is one of twenty attorneys in Texas (of the 75,000 licensed) that is triple board certified by the Texas Board of Legal Specialization, including Civil Trial Law and Civil Appellate law.

David is the primary author of the Winstead Business Divorce blog ([www.winsteadbusinessdivorce.com](http://www.winsteadbusinessdivorce.com)) and also has the Texas Fiduciary Litigator blog ([www.txfiduciaryliterator.com](http://www.txfiduciaryliterator.com)), both of which report on business divorce/closely-held business issues and legal cases impacting the fiduciary field in Texas. David has written over 20 law review articles and written and presented over 400 CLE articles on various issues, including business-divorce topics.



## Peter A. Mahler

Peter A. Mahler concentrates his litigation practice on business divorce cases involving dissolution and other disputes among co-owners of closely held business entities, such as limited liability companies, corporations, and partnerships. He has decades of litigation experience prosecuting and defending business divorce cases at the trial and appellate levels, as well as in mediation and arbitration proceedings. He also works closely with appraisers involved in the valuation of business interests in appraisal contests, such as elective buy-outs in dissolution proceedings and dissenting shareholder appraisals following cash-out mergers.

For over 10 years, Peter has published a widely followed blog called New York Business Divorce, which has well over 500 articles covering all aspects of dissolution and dissenting shareholder proceedings, involving limited liability companies, corporations, and partnerships, business valuation, and more. He also produces the podcast Business Divorce Roundtable, on which he interviews experts in the field of business divorce, including lawyers, law professors, and business appraisers.



## Peter J. Sluka

Peter J. Sluka represents a broad range of individuals and entities in all phases of complex commercial litigation, with a particular focus on disputes among co-owners of closely held businesses. Peter has successfully represented prominent businesses and individuals from all industries in cases involving directors' fiduciary duties, valuation of businesses and assets, material misrepresentations, and shareholders' rights.

Peter is a regular contributor to the New York Business Divorce Blog, publishing articles on all aspects of dissolutions, buyouts, valuation, fiduciary duties, and corporate governance.





# Program Overview

- Types of Closely-Held Business Entities, Statutory Regimes
- Rights of Minority Owners
  - Vote on Company Action / Participate in Management
  - Inspect Books and Records
  - Purchase Shares to Avoid Dilution
  - Bring Derivative Actions
  - Petition for Dissolution
  - Receiverships
- Limitations on the Rights of Minority Owners
  - Expulsion, Dilution, Transfer Limitations
  - Freeze Out Merger
- Buy-Sell Agreements
  - Purpose/Types
  - Considerations and Best Practices

# Types of Closely-Held Business Entities – Statutory Regimes

## ➤ Corporations

- Model Business Corporation Act (FL, AZ, GA, NH, NC)
- NY Business Corporation Law
- Delaware General Corporation Law
- Texas Business Organizations Code

## ➤ Limited Liability Companies

- Revised Uniform LLC Act (AL, NJ, CA, FL, CT)
- NY Limited Liability Company Law
- Delaware LLC Act
- Texas Business Organizations Code

## ➤ Partnerships, Professional Corporations, Limited Partnerships

# Types of Closely-Held Business Entities – Statutory Regimes

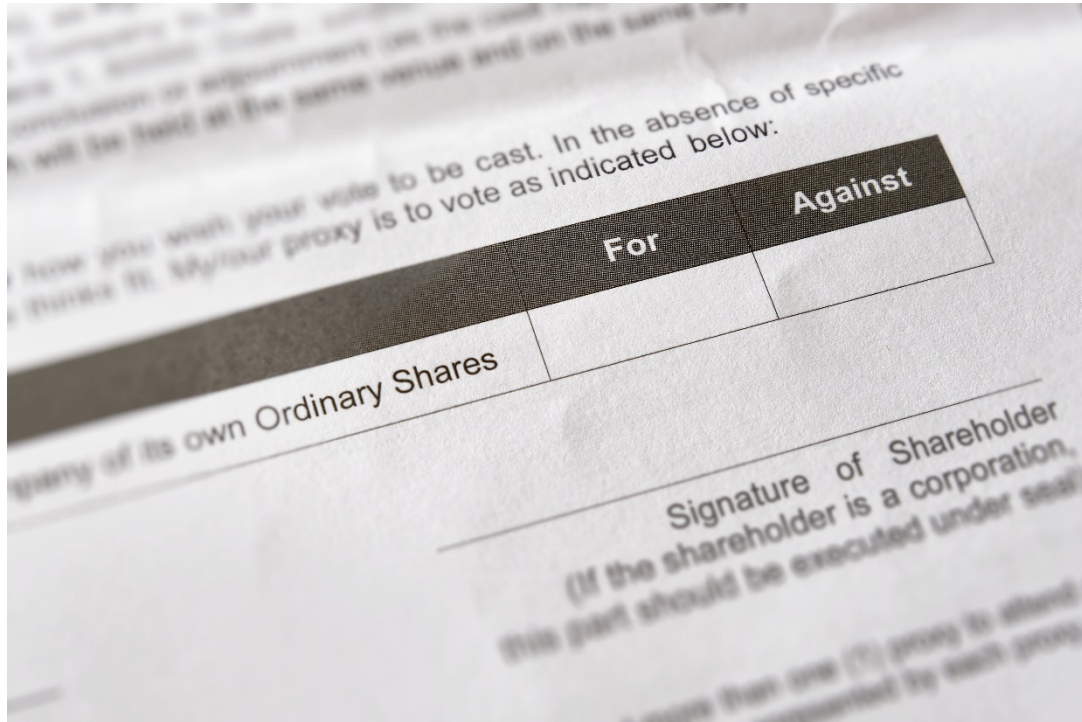
- Beware the applicable statutory regime.
- In many cases, the applicable law is set forth in the ownership documents.
- If not specified in the ownership documents, the law of the state of organization generally governs.
- Statutory regimes contain both **mandatory** and **default** rules.
  - Default Rules apply unless an agreement of the parties specifies some other rule.
  - Mandatory Rules apply regardless of attempts to modify or override them.

# Rights of Minority Owners

- Vote on Company Action / Participate in Management
- Inspect Books and Records
- Preemptive Rights
- Derivative Actions
- Receiverships
- Petition for Dissolution



# Rights of Minority Owners – Vote / Participate in Management (Corporations)



- Minority Shareholders Can:
  - Vote to elect the Board of Directors (NY BCL 614; Tex. Bus. Org. C. 21.359)
  - Vote on a merger or consolidation (NY BCL 903; Tex. Bus. Org. C. 21.452)
  - Vote on amendment to Certificate of Incorporation (NY BCL 803; Tex. Bus. Org. C. 21.054)
  - Vote on items requiring shareholder approval in the shareholders' agreement.
- Minority shareholders do not have a right to be involved in the day-to-day operations of the business.

## Rights of Minority Owners – Vote / Participate in Management (LLCs)

- Member-Managed LLC vs. Manager-Managed LLC
  - Member-Managed LLCs: The members are vested with the right and ability to run the company.
  - Manager-Managed LLCs: Members have authority to elect the managers, but day-to-day decisions are made by the managers
- Many state statutes provide a default rule: unless the articles of organization provide otherwise, an LLC is a member-managed LLC (e.g., NY LLCL 401, Tex. Bus. Org. C. 101.251).
- Note: In NY, all members in a member-managed LLC owe fiduciary duties, regardless of how “active” or “passive” they are (*Marcus v Antell*, 2018 NY Slip Op 32527(U) [Sup Ct NY County Oct. 5, 2018]). It is unclear in TX what duties members have.

# Rights of Minority Owners – Vote / Participate in Management

- Owner agreements often give minority owners additional management rights, including:
  - The right to employment within the company;
  - Management authority over a particular division or product; or
  - Preferential voting rights based on share classes.



## Rights of Minority Owners – Inspect Books and Records

### ➤ As Permitted by Ownership Agreement

### ➤ As Required by Applicable Statutes:

- NY BCL 624 provides for statutory inspection rights of (i) a record of shareholders and minutes of shareholder meetings and (ii) annual balance sheets and income statements.
- NY LLC Law 1102 allows for inspection of member information, articles of organization, tax returns.
- Tex. Bus. Org. C. 3.151, 3.153 provides for statutory inspection rights of (i) books and records of accounts, (ii) minutes of proceedings, (iii) records of owners of entity, and (iv) other books and records required to be kept by statute. Must be a written demand stating a proper purpose. Court can grant greater relief.
- RULLCA: “A member may inspect and copy full information regarding the activities, affairs, financial condition and other circumstances of the company as is just and reasonable if: (A) The member seeks the information for a purpose reasonably related to the member’s interest as a member; (B) the member makes a demand in a record received by the company, describing with reasonable particularity the information sought and the purpose for seeking the information; and (C) the information sought is directly connected to the member’s purpose.”
- Delaware LLC Act 305 allows inspection for “any purpose reasonably related to the member’s interest as a member of the [LLC].”



# Rights of Minority Owners – Inspect Books and Records

## ➤ Common Law Inspection Rights

- Generally broader than statutory rights.
  - New York Courts have held that the common law right of inspection includes access to a company’s tax returns, account books, and records of subsidiaries.
- “Proper Purpose” Required, Subject to the Courts Discretion
  - Investigating alleged misconduct by management and obtaining information that may aid legitimate litigation (*Retirement Plan for Gen. Employees of City of N. Miami Beach v McGraw-Hill Companies, Inc.*, 120 AD3d 1052, 1056 [1st Dept 2014])
  - To determine the value of the minority owner’s interest;
  - In aid of a lawful challenge to management policy.
- Improper purpose
  - To discover business secrets to aid a competitor of the corporation, to secure prospects for personal business;
  - To find technical defects in corporate transactions to institute “strike suits;”
  - To locate information to pursue one's own social or political goals.

## Rights of Minority Owners – Preemptive Rights

- In a corporation, minority owners may have the right to purchase additional stock to avoid dilution of their interest.
- Preemptive rights vary by state:
  - New York: no preemptive rights for post-1997 companies; in pre-1997 companies, BCL 619 provides for preemptive rights when a proposed issuance of stock would “adversely effect” the voting or distribution rights of the owner.
  - Texas: No preemptive rights unless the governing documents provide for them. If preemptive rights are granted, then the owner has a restricted period of time to file suit to enforce those rights, otherwise, they are waived.

## Rights of Minority Owners – Preemptive Rights

- In most states, LLC members do not have preemptive rights unless the governing documents provide for them.
- Example:
  - (a) Issuance of Additional Membership Interests. The Company hereby grants each Member the right to purchase its pro rata share of any new Membership Interest that the Company may from time to time propose to issue or sell to any party.

## Rights of Minority Owners – Derivative Actions

- In certain circumstances, minority owners can prosecute legal claims for *injury to the company*:
  - In New York:
    - Shareholder derivative suits are authorized by statute: BCL 626
    - LLC Members' common law rights to sue derivatively were recognized in *Tzolis v. Wolff*, 884 N.E.2d 1005 (2008).
  - In Texas:
    - Shareholder derivative suits are authorized by statute: Tex. Bus. Org. C. 21.551-600.
    - LLC members also have statutory rights to sue derivatively: Tex. Bus. Org. C. 101.451-500.

## Rights of Minority Owners – Derivative Actions

- Test for whether a claim should be pled derivatively or directly: 1) who suffered the alleged harm (the corporation or the stockholders); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders individually)
  - Claim against management for waste, misuse of company funds;
  - Claim against management for self-dealing, breach of fiduciary duty;
  - Excess salary of managers;
  - Claims that company wrongly advanced legal fees.
- A suit that mixes or confuses direct and derivative claims is likely to be dismissed.

## Rights of Minority Owners – Derivative Actions

- Types of actions that impact a minority owner that may justify a derivative action:
  - Misapplying corporate funds and assets;
  - Diverting corporate opportunities;
  - Terminating key employees;
  - Improperly withholding or failing to declare dividends; and
  - Manipulation of the value of the corporation's stock for the improper purpose of buy-sell obligations.
- *See Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

# Rights of Minority Owners – Derivative Actions

- Derivative Actions Are Limited:
  - Standing requirements
    - Particularized pre-suit demand, ownership throughout litigation, qualifications
  - Recovery is on behalf of the company. Many times, the economics of a derivative suit weigh against minority owners.
    - *But see* BCL 626(e): a fee-sharing provision: a successful derivative plaintiff may be able to recover the attorneys' fees spent litigating that claims.
    - Tex. Bus. Org. C. 21.451(b) allows a court to award fees to the winning party, so the shareholder may to a judgment against it if it loses.
  - Other creditors may have superior claims
  - No right to a jury trial
  - Asymmetry of information, evidence makes derivative claims difficult to win.
- Texas relaxes requirements for closely-held entities, and allows award of damages directly to the shareholder. Tex. Bus. Org. C. 21.563.

# Rights of Minority Owners – Petition for Dissolution (Corporations)

- Deadlock
  - BCL 1104 allows a 50% owner or owners to petition for dissolution on the grounds of:
    - director deadlock precluding board action;
    - shareholder deadlock precluding an election of directors; or
    - that “there is internal dissension and two or more factions of shareholders are so divided that dissolution would be beneficial to the shareholders.”
- BCL 1104 requires coordination among minority shareholders to reach the 50% requirement





# Rights of Minority Owners – Petition for Dissolution (Corporations)

## ➤ Shareholder Oppression

- BCL 1104-a allows a 20% owner or owners to petition for dissolution when:
  - The directors or those in control of the corporation have been guilty of illegal, fraudulent or oppressive actions toward the complaining shareholders;
  - The property or assets of the corporation are being looted, wasted, or diverted for non-corporate purposes by its directors, officers or those in control of the corporation.
- There is no statutory or common-law shareholder oppression claim in Texas. Minority owners must pursue other remedies.

## Rights of Minority Owners – Petition for Dissolution (Corporations)

- What is Shareholder Oppression?
- “Majority conduct [that] substantially defeats expectations that, objectively viewed, were both reasonable under the circumstances and were central to the petitioner’s decision to join the venture.”
- This may include: terminating the minority shareholder as an employee and ending compensation, failing to disclose company information, refusing to allow minority shareholder to make management decisions, refusing to make distributions or dividends, refusing to buy back a minority shareholder’s interests and locking them in or trapping them, offering less than fair value for the interests, refusing to let the minority shareholder transfer his or her interests, taking actions that devalue the interests, etc.

# Rights of Minority Owners – Petition for Dissolution (Corporations)

## ➤ Remedies in a Shareholder Oppression Case

➤ Dissolution

➤ Money Damages

➤ Forced buyout?

- Some jurisdictions hold that majority owners owe duties to minority shareholders, and that there was a claim for shareholder oppression that requires a majority shareholder to buy-out a minority shareholder at a fair price.
- *Ritchie v. Rupe*, however, the Texas Supreme Court held that there was no such claim in Texas. 443 S.W.3d 856 (Tex. 2014).
- Several New York Cases have forced a buyout of the oppressed shareholder under BCL 1104-a, see *Matter of Clever Innovations, Inc.*, 2012 NY Slip Op 02536 [3d Dept 2012], but there is no consensus among courts.

# Rights of Minority Owners – Petition for Dissolution (Corporations)

- In New York, a petition for dissolution under BCL 1104-a gives the majority owners the right to purchase the petitioning shareholder's shares:
  - BCL 1118
  - Even after a finding of oppression, "Every order of dissolution, however, must be conditioned on permitting any shareholder of the corporation to elect to purchase the complaining shareholder's stock at fair value."



## Rights of Minority Owners – Petition for Dissolution (LLCs)

➤ New York’s standard for judicial dissolution of an LLC:

“On application by or for a member, the supreme court in the judicial district in which the office of the limited liability company is located may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with the articles of organization or operating agreement.”

➤ *LLC Law 702; Matter of 1545 Ocean Avenue, LLC, 72 AD3d 121 (2d Dept Jan. 26, 2010)*

## Rights of Minority Owners – Petition for Dissolution (LLCs)

- In New York, neither minority member oppression nor deadlock is, standing alone, sufficient to meet the high standard for dissolution of an LLC.
- As long as the company is operating in accordance with its stated purpose, dissolution of an LLC is difficult to obtain.
- Many LLCs have in their governing documents a broad purpose clause, “The Company is formed for any valid business purpose.”
  - *Lazar v Attena LLC*, 2020 NY Slip Op 33003(U) [Sup Ct NY County Sept. 9, 2020]

## Rights of Minority Owners – Petition for Dissolution (LLCs)

- In Texas, upon the application of an owner in a partnership or LLC, a court may order the termination of the entity if the court determines that:
  - (1) the economic purpose of the entity is likely to be unreasonably frustrated;
  - (2) another owner has engaged in conduct relating to the entity's business that makes it not reasonably practicable to carry on the business with that owner; or
  - (3) it is not reasonably practicable to carry on the entity's business in conformity with its governing documents.
- Tex. Bus. Org. C. 11.314.

## Rights of Minority Owners – Petition for Dissolution (LLCs)

### ➤ RULLCA (AL, NJ, CA, FL, CT) 701(a)(4)(C):

Allows a minority owner to petition for dissolution where the managers or those members in control of the company:

(i) have acted, are acting, or will act in a manner that is illegal or fraudulent; or

(ii) have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the applicant.

### ➤ **In a proceeding brought under subsection (a)(4)(C), the court may order a remedy other than dissolution.**



## Rights of Minority Owners – Receiverships

- Minority shareholders should investigate whether they can obtain a receivership to take the company out of the hands of an oppressive majority.
- Need to look to the applicable jurisdiction's statutory or common law.
- In Texas, the Texas Supreme Court looked to the receivership statutes to justify holding that there is no common-law shareholder oppression claim. *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

## Rights of Minority Owners – Receiverships

- Generally, there are three types of receiverships.
- The first type is a receiver that takes possession and control over specific property.
- The second type of receivership involves a receiver managing an entity to rehabilitate it for the period of time.
- The third type of receivership is a receivership to liquidate an entity.

## Rights of Minority Owners – Receiverships

- For example, a court may appoint a receiver to rehabilitate if it is established that:
  - (A) the entity is insolvent or in imminent danger of insolvency;
  - (B) the governing persons of the entity are deadlocked in the management of the entity's affairs, the owners or members of the entity are unable to break the deadlock, and irreparable injury to the entity is being suffered or is threatened because of the deadlock;
  - (C) the actions of the governing persons of the entity are illegal, oppressive, or fraudulent;
  - (D) the property of the entity is being misapplied or wasted; or
  - (E) with respect to a for-profit corporation, the shareholders of the entity are deadlocked in voting power and have failed, for a period of at least two years, to elect successors to the governing persons of the entity whose terms have expired or would have expired on the election and qualification of their successors.
- Tex. Bus. Org. C. §11.404.

## Rights of Minority Owners – Receiverships

- The Texas Supreme Court held that directors or managers engage in oppressive actions when they abuse their authority over the corporation with the intent to harm shareholder interests, in a manner that does not comport with the honest exercise of their business judgment, and by doing so create a serious risk of harm to the corporation. *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).
- Absent such evidence, directors do not act oppressively in refusing to meet with potential buyers of a minority shareholder's stock. *Id.*

## Limitations on Minority Owners' Rights – Dilution

- Absent a minority owner's having preemptive rights as discussed above, a minority owner has limited power to prevent the dilution of his ownership interest by share issuances or capital raises.
- Percentage ownership matters:
  - 20% required to petition for dissolution on the grounds of shareholder oppression, 50% for deadlock;
  - Economics of potential derivative claims.
- To dilute the minority's interest, the majority need only show a "bona fide business purpose" *Dingle v. Xtenit, Inc.*, 20 Misc 3d 1123(A) (Sup Ct NY Co 2008).

## Limitations on Minority Owners' Rights – Transfer Limitations

- A minority owner may want to exit a business by simply selling their interest to a third party.
- This is rarely a viable option, however.
  - First, independent third parties would rarely want to pay adequate consideration to enter into a business when they have few management rights.
  - Second, even if such a third party could be found, there are normally restrictions in the governing documents that preclude an owner from selling his or her interest to a third party without the consent of the other owners.
- If done correctly, transfer limitations are enforceable. Tex. Bus. Orgs. Code § 3.202, 21.210-213.

# Limitations on Minority Owners' Rights – Expulsion

- LLC Members Can Be Expelled:
  - If the operating agreement provides for member expulsion (for example, upon a vote of majority of members)
  - In states adopting the Revised Uniform LLC Act, a court may expel a member based upon a finding of:
    - Wrongful conduct;
    - Willful and persistent breach of the operating agreement;
    - That it is not reasonably practicable to continue the LLC with that member.
  - Other states, such as NY, have no statutory provision for LLC member expulsion.
- Texas does not allow the expulsion of an LLC member. Tex. Bus. Org. C. 101.107.



## Limitations on Minority Owners' Rights – Freeze Out Merger

- Freeze Out Merger: a combination of transactions in which the majority owners cause the entity, through a written agreement or plan of merger, to merge with and into a new entity, with a minority owner of the original entity receiving no ownership interest in the new entity, and his or her ownership interest being extinguished and exchanged for cash.
- In a Corporation, a minority shareholder can seek to challenge the merger for alleged fraud or illegality in the procurement of the merger, including if the proposed merger is a breach of fiduciary duty to the minority shareholder.



# Limitations on Minority Owners' Rights – Freeze Out Merger



- **Minority Challenges to a Freeze Out Merger:**
  - In a corporation, a minority shareholder can seek to challenge the merger for alleged fraud or illegality in the procurement of the merger, including if the proposed merger is a breach of fiduciary duty to the minority shareholder.
  - In a New York LLC, a minority member has no ability to challenge a freeze-out merger.
  
- Absent a basis to enjoin the merger, the minority's sole remedy is a proceeding to determine the fair value of the minority's cashed out interest (see BCL 626).

## Rights of Minority Owners – Summary

### Minority Owners Can:

- Vote on certain actions, participate in the management of the company to the extent set forth in the governing documents;
- Inspect books and records;
- Potentially preserve their percentage interest from dilution;
- Commence a derivative action in the name of the company; and
- Petition for dissolution.

Minority owners are subject to dilution, expulsion, and freeze outs

***None of these options provide a minority shareholder with a reliable path to liquidate their interests in the Company. Minority owners must preserve their rights to liquidate ex ante, in a buy-sell agreement***

## Buy-Sell Agreements

- A contract (or provision in the governing documents) specifying how a member's interest may be liquidated.
- Well-drafted buy-sell agreements should specify:
  - Triggers activating a buy-sell right;
  - A method for determining price;
  - Payment terms and conditions;
  - Restrictive covenants; and
  - Remedies for non-performance.



## Buy-Sell Agreements - Triggers

- The Buy-Sell Agreement should specify when a minority member or the company may exercise its rights under the buy-sell provision
- Common Triggers:
  - Pure Option;
  - Death/Disability;
  - A Minority Owner's Petition for Dissolution;
  - Deadlock;
  - A Minority Owner's Voluntary or Involuntary Alienation of her Interest;
  - Retirement, Termination of Employment; and
  - An Offer to Purchase all or Part of the Company.

# Buy-Sell Agreements – Method for Determining Price



- Formula-Based Buy-Sell Agreements
- Certificate of Value Buy-Sell Agreements
- Appraisal-Based Buy-Sell Agreements
- Shotgun Buy-Sell Agreements
- Insurance-Funded Agreements
- Right of First Refusal, with or without a discount

## Buy-Sell Agreements – Additional Terms

- A well-drafted buy-sell provision specifies additional terms material to the transfer of ownership interests.
  - Payment terms and conditions
  - Financing, earn-out options
  - Buyer's assumption of loans and liabilities
  - Indemnification
  - Confidentiality
  - Restrictive covenants on Seller
  - Employees and Board Members
  - Remedies for non-performance

## Buy-Sell Agreements – Best Practices

- Select a buy-sell agreement that addresses specific concerns of the owners.
  - Deadlock, Retirement, Outside Ownership, Dissolution
- Know where the money is coming from.
  - Financing, Payment Terms, Insurance Proceeds



## Buy-Sell Agreements – Best Practices

- Account for changes and potential changes in the Company.
  - A fair valuation method in year 1 may not be fair in year 15.
- Specify material terms and conditions other than price.
- Beware of complications caused by family ties, personal relationships





## Buy-Sell Agreements – Best Practices



- Get to a lawyer before problems arise.
- Prepare a comprehensive Owners Agreement.
- A good lawyer can help safeguard a company and its members from disputes between the minority and majority owners without costly litigation or a material impact on the business.

## Questions – Additional Resources

- Texas Business Divorce ([www.winsteadbusinessdivorce.com](http://www.winsteadbusinessdivorce.com))
- Texas Fiduciary Litigator ([www.txfiduciarylitigator.com](http://www.txfiduciarylitigator.com))
- New York Business Divorce ([nybusinessdivorce.com](http://nybusinessdivorce.com))

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# Q&A

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