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## THE ART OF THE BUY-SELL

**Structure your LLC so that breaking up isn't hard to do.**

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Although limited liability companies (LLC) are formed with success in mind, wise business people plan for uncertainty and include one or more dispute-resolution mechanisms and/or exit strategies in their LLC documentation. Buy-sell agreements are often used to achieve these goals.

During these challenging economic times, venturers have become more litigious in nature. As a result, buy-sell agreements are being triggered with greater frequency. It's important to know the general structure of a buy-sell agreement for an LLC that is formed to acquire real property and issues that need to be addressed in connection with the implementation of such agreements, with a special emphasis on California law.

A buy-sell agreement is a contractual agreement between the members. In a two-member LLC, either member can generally implement the buy-sell by delivering notice that requests the other elect to (i) sell its LLC interest to the initiating member or (ii) purchase the initiating member's interest. Depending upon the applicable buy-sell, it can be implemented at anytime or only after the expiration of a pre-agreed upon lock-out period (e.g., 2 years after the LLC's formation).

The initiating member is generally required to set (i) the price that the non-initiating member will pay for the initiating member's interest if the non-initiating member elects to buy and (ii) the amount that the non-initiating member will receive if it elects to sell its interest to the initiating member. As a result, the initiating member is incentivized to set a fair price for the interests since it does not know whether it will be the buyer or the seller. If the price is set too low, then the non-initiating member may perceive this as a bargain and elect to purchase. If the price is set too high, then the non-initiating member is likely to sell since it will perceive that it is selling at a premium. This logic breaks down if the initiating member is certain that the non-initiating member is unable to purchase for financial or other reasons. In such event, the initiating member may try to "low ball" the non-initiating member.

Within a set number of days after implementation, the non-initiating member is required to deliver notice to the initiating member electing to be the buyer or seller. Once the identities of the parties are established, the buyer is required to purchase the seller's interest within 30 to 60 days after such determination. At the closing, the seller is required to transfer its entire interest to the buyer. At such time, the seller will cease to be a member of the LLC.

Before electing to implement or respond to any buy-sell, the following steps should be undertaken and issues analyzed:

1. Review Buy-Sell Provisions: Before electing to invoke the buy-sell, it is essential that the initiating member thoroughly review and understand the LLC agreement. There are generally time periods in which certain elections need to be made and notices delivered. There are also various obligations that need to be fulfilled by each of the parties. Likewise, the non-initiating member must also review and understand the provisions of the LLC agreement. The failure of either member to timely make elections, deliver notices or fulfill other obligations may prejudice such member's rights under the buy-sell agreement.

2. Setting the Purchase Price: In setting the purchase price, contingent liabilities of the



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venture and costs that will eventually be incurred by the LLC in connection with the sale of its assets need to be taken into account. For example, if the LLC owns real estate, then brokers' commissions and other costs that will be incurred in connection with the eventual sale of the property need to be considered since they affect asset value.

3. Property Tax Reassessment and Documentary Transfer Tax: In California, and notwithstanding the current economic downturn, many ventures have property tax base years that are below their current values. A transfer of an interest in any business entity that owns California real property can cause a reassessment. Any reassessment will result in an increased operating expense to the LLC. In certain instances, the restructure can be achieved without a reassessment. If it cannot, then the increased taxes need to be taken into account in determining the value of the property. Likewise, the transfer of an interest in any business entity that owns real property in California may cause a documentary transfer tax to be imposed. However, in certain instances, the transfer can be structured to avoid such a tax. Any documentary transfer tax that will be imposed also needs to be considered in determining the purchase price.

4. Loans and Other Agreements: Real estate projects are often encumbered by third-party financing. In such event, the loan documents need to be reviewed to determine whether there are any restrictions on the transfer of interests. If there are, then negotiations with the lender need to commence immediately. Assuming no restrictions exist, if the selling party is a guarantor with respect to any such financing, it will want to be released from all liability. Such releases can be time consuming and difficult to obtain. As a result, the dialogue with the lender should also start immediately. If the parties are unable to obtain a release, then the buy-sell agreement usually requires the buyer to indemnify the seller for any losses that may arise in connection with such guaranty. The seller should conduct the proper due diligence to ensure that the indemnitor has assets sufficient to satisfy any claims it may have with respect to such indemnity. Likewise, other contractual obligations of the LLC (e.g. leases, franchise agreements, etc.) should be reviewed to ensure that the consummation of the buy-sell transaction does not require notice to be given to or require the LLC to obtain the consent of any third party.

5. Title Insurance: The member purchasing the interest of the seller should review any existing owner's title insurance policy to verify that the transfer of the seller's interest will not invalidate the policy. If there is an issue, the LLC can usually obtain an endorsement to prevent the denial of coverage.

The issues above are just a summary of some of the items that need to be analyzed before electing to implement or respond to any buy-sell agreement.

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