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Contemporary Considerations for Drafting Buy-Sell and Valuation Provisions in Limited Liability Company Operating Agreements



7 Min Read

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Most limited liability company operating agreements contain provisions that address transfers of interests by the LLC members.^[1] In the absence of specific provisions in an operating agreement, statutory defaults will apply. In

privately held companies, transfers are often severely restricted by governing law, and sometimes prohibited altogether. LLC statutes commonly permit transfers of economic interests (*i.e.*, the right to receive allocations and distributions), but not governance rights (*e.g.*, voting, access to information). The bifurcation of LLC interests between economic rights and governance rights can, over time, tend to concentrate management authority in the person(s) who still possess governance rights, even though the person(s) represent only a minority of the economic interests in the LLC at present.

To address this tension, operating agreements often contain so-called “buy-sell” provisions to facilitate orderly transfers of economic interests and ensure a reasonable level of congruity between ownership of economic interests in the LLC and its governance. Sometimes these provisions are designed to mimic an unrestricted market dynamic in which capital can be efficiently deployed and property rights easily alienated. More often than not, however, the provisions contain cumbersome processes and ambiguous legal terms which are far removed from the goal of facilitating transfers at a price “a willing buyer would pay a willing seller.”

There are five key topics that counsel should consider when drafting buy-sell provisions:

- the events which trigger buy-sell rights (including deadlock),
- valuation of the interest,
- the form of transaction and payment terms,
- the means for resolving disputes regarding value, process, or both, and
- tax consequences.

Triggering Events. Triggering events vary greatly based upon the nature of the LLC’s business. For example, service partnerships in which all members agree to devote substantially all of their time and attention typically list buy-sell triggers that include death, disability, resignation, and retirement. On the other hand, an LLC organized solely as a passive real estate holding company under third party

management is likely to have a very limited set of triggering events. Where management authority is divided (either generally or with respect to approval of material transactions) in a manner that could result in deadlock, the parties may choose to include buy-sell provisions as a method for breaking (or superseding) the deadlock.

Valuation of LLC Interests. The basis for valuing LLC interests generally falls into the following three categories: the Market-Based approach, the Income-Based approach, and the Asset-Based approach. Some agreements reference a (seemingly) objective standard such as "fair value," "fair market value," or "book value;" and some go the extra step of describing the person responsible for making the determination (*e.g.*, the company's accountant, a panel of appraisers, or a third-party independent valuation firm).

Other agreements use a detailed formulaic approach based on some multiple of revenues, earnings, or both. Finally, some simply reference the value as determined by an outside expert. Among the issues often neglected in a buy-sell agreement are the impact of changed market conditions and company circumstances, extraordinary events (especially those that result in anomalous operating results), the applicability of valuation discounts (whether at the enterprise or equity owner level), or the relationship of the valuation to the amount of available insurance. For example, in today's context, market conditions, company circumstances and extraordinary events arising from the COVID-19 pandemic and its aftermath may be relevant valuation factors. The parties also should consider the impact of value determinations made in the context of a buy-sell transaction on subsequent equity-based transactions, such as the grant of profits interest or options.

Transaction Structure and Terms. Buy-sell transactions can be structured as cross-purchase transactions between or among equity owners, entity purchase transactions, or a combination of the two. The structure of the transaction not only has important tax implications, but it can also significantly impact ownership ratios and the resulting governance of the LLC. In certain circumstances, transactions can be funded with insurance. In others, a

long-term payout may be required to ensure the soundness of the entity. The agreement must consider release from debt obligations and other liabilities (especially those taken into account in the valuation of the enterprise); and any cash waterfalls or profits interests (with corresponding value hurdles). Finally, the parties may want to address the possibility of a clawback in favor of the selling equity holder in the context of a future sale or other change in control transaction consummated within a defined window following the buy-sell transaction.

Dispute Resolution. Buy-sell transactions often generate disagreement – on value, on terms, on structure, and any other issue that parties can contest. This is particularly true when the transaction has been precipitated by alleged oppressive or other improper conduct. The success of a buy-sell agreement is highly dependent on the parties' (mutual) perception of fairness and willingness to share information which may be perceived to be relevant to value.

To that end, engagement of a competent neutral under well-defined conditions can help ensure a speedy end to potentially intractable disputes – especially if the agreement specifies the requisite background and qualifications of the neutral. If parties agree to a good process up front, they can eliminate (or at least minimize) months- or years-long battles over selection of mediators, arbitrators, appraisers and other experts, access to information, and the allocation of costs of the process itself.

[2]

During the COVID-19 pandemic, courts and counsel have increasingly relied on mediation in civil cases. In fact, a new ABA study comments that for civil cases many "judges, plaintiff attorneys and defense attorneys agree that mediation is the fairest way to resolve cases."^[3] In the context of business valuation disputes, mediation presents an opportunity to implement an innovative (and cost-effective) approach in which an independent valuation expert is jointly retained by the disputing parties to serve as a neutral expert advisor to the mediator.

Tax Implications. A buy-sell transaction is in essence a mini-acquisition, and like any other acquisition, the structure of the transaction will dictate its tax consequences for both the buyer and seller (*e.g.*, whether the buy-out will be funded with pre-tax or post-tax dollars, whether the buyer will get a basis step-up in the entity assets or just its interest in the acquired equity, etc.). Tax consequences depend on both the structure of the transaction and the tax classification of the entity itself. It is possible for the parties to agree up front to standard deal terms – or at least on a process to deviate from those terms so long as the after-tax position of the parties is largely preserved. For entities taxed as partnerships, the agreement must also consider so-called “hot assets”, the impact of release from debt, the availability of Section 754 elections, and the taxation of periodic payments (especially those that are based on the future performance of the company, tied to subsequent employment or service obligations, or are open-ended in amount). Lastly, the “new” partnership audit rules in effect for 2018 and subsequent years must be considered, as standard release language in buy-sell agreements may operate to shift pre-closing tax risks of the seller to the buyer.

Buy-sell agreements are a challenge – especially for clients who resist the reality that nothing ever stays the same. For the alert practitioner, they also present an opportunity to deliver real value, even if its impact may not be realized until well into the future.

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[2] See [Who Decides Disputed Valuation Under LLC Agreement's Buy-Out Provision: Arbitrator or Appraiser?](#) in *New York Business Divorce* (Blog Post, February 15, 2021)

[3] *New ABA Study Explains Why Civil and Criminal Jury Trials are Disappearing*, Jan. 11, 2021: <https://www.americanbar.org/news/abanews/publications/youraba/2021/0111/disappearing-juries> (<https://www.americanbar.org/news/abanews/publications/youraba/2021/0111/disappearing-juries>).

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