

OWNER AGREEMENTS: ESSENTIALS AND CAUTIONARY TALES

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Introduction



What is an Owner Agreement?

- Three friends decide to start a business, which they'll own 1/3 each. It is a bit of a whirlwind to start, so they hop on to Legal Zoom to form an LLC, mention the business to their accountant, and they dive into operations and live happily and profitably for 10 years.



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Over the next few years...

- On the 10th anniversary of the business, Jim approaches Rick and John to let them know that he is making an estate plan and plans for his interest to pass to his wife upon his death.
- On the 11th anniversary of the business, Rick develops a serious medical condition, such that she can no longer functionally participate in decision-making processes for the company but remains an owner of 1/3 of the company's voting power.

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Over the next few years...

- On the 12th anniversary of the business, John sells his entire interest in the company to his sister-in-law (Donna “Sunshine” Smith) who Owners Jim and Rick have met, but don’t always agree with.
- On the 13th anniversary of the business, Jim passes away from Merkel cell carcinoma. Pursuant to Jim’s will, his interest passes equally to his wife and three children: Jane lives out of state, Savannah lives out of the country, Cameron is only 14 years old, and Sarah has passion and drive...for anything but the business.

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Over the next few years...

- On the 14th anniversary of the business, Sunshine is convicted of a drug-related crime. She remains an owner of the business, but the community reacts negatively. Business starts to slow down, given the bad press.
- On the 15th anniversary of the business, Rick personally files for bankruptcy, and Rick’s 1/3 interest in the company is left to the discretion of the bankruptcy courts.

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Over the next few years...

- On the 16th anniversary of the business, the owners can't agree on anything but the decision to liquidate and dissolve.
- **Life happens, but a well-developed owner agreement can provide guidance when addressing difficult decisions and circumstances.**



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What is an Owner Agreement?

- Shareholder agreement
- Operating agreement
- Partnership agreement
- Buy-sell agreement
- Joint real estate owner agreement



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What is an Owner Agreement?

- The agreement should address the following questions (among many others):
 - What happens to my business if my partners and I can't agree anymore?
 - What are my options for getting out of the business, selling my interest, or selling the business in its entirety?
 - What happens to my business if either my partner or I die?
 - Who can I expect to be my future business partners, and how can I control or limit who I will need to work with?
 - How might my business involve my family in the future?
 - How will my business impact my estate planning, my financial future, and my family's financial future?

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The Advisor's Role

- Understanding value and liquidity of business assets
- Ensuring client's expectations regarding the business and their future succession and retirement goals align with reality
- Annual tax planning, and tax planning for the owner's exit from the business



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Comprehensive Planning for the Future



- Not all owner agreements are the same.
- Is the goal to create a document that the parties know at the outset they will need to amend in the future, or to create an agreement that contemplates planning beyond the current generation of ownership?
- Facilitate difficult decision-making before the emotions and conflict arise

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Anticipate Difficult Circumstances and Set Expectations

- Transfer of ownership to family members
- Employment of family members
- Termination of employment and/or ownership status due to conviction of crimes



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Restrictions on Transfer

Rights Associated with Ownership

- Equity vs. Profits Interests
 - Grant of profits interests to employees is a useful way in some circumstances to provide employees with “skin in the game” and a reward for their effort without triggering immediate recognition of taxable income to the extent of the interest’s fair market value.
- Voting vs. Non-Voting Interests
 - Allows owners to signal commitment to a transition in ownership while retaining ultimate governance authority

What are Transfer Restrictions?



- According to the 2023 National State of Owner Readiness Report by the Exit Planning Institute: 80% of business owners have the majority of their wealth tied up in their business.
- Useful in setting expectations regarding future ownership of the business, and how it may impact each owner's estate plan

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Restrictions on Restrictions

- As a matter of public policy, transfer restrictions are not permitted to completely alienate an owner from their ability to separate from a business.
- Generally, conditions may be established for the sale of stock, but outright prohibitions of transfer are not enforceable.
- Must be noted clearly on certificated interests, and must be noted clearly in the owner agreement of uncertificated interest.

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Conditions of Transfer



- May require owners to first offer interest to company and/or other owners prior to transferring to a third party
- Transfer conditions and rights may vary among owners for succession planning purposes
- Specific individuals may be named as “eligible transferees”
- Useful in protecting an S Election (if applicable)

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Involuntary vs. Voluntary Transfer

- Conditions of transfer may vary, depending on whether a transfer is voluntary or involuntary
- Voluntary transfers include sales or transfers to third-parties, and without restriction, may result in the remaining owners working with new and unintended business partners.
- Involuntary transfers include situations where an owner is divested of their interest due to obligations to third-parties (i.e. divorce, bankruptcy, encumbrance).

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Involuntary Transfer

- In situations involving divorce proceedings or bankruptcy, the provisions of an owner agreement may be persuasive to the court in determining the value of the interests and the ultimate owner of the interests, but the agreement is not determinative—especially if fair market value as set forth in the agreement is unreasonable or outdated.



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Other Involuntary or Unplanned Exits

- Death
- Disability
- Conviction of a Crime
- Termination of Employment
- Disagreement Among Owners



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Death of an Owner

- If an owner agreement does not specify that the decedent's interest will automatically transfer to the company or other members at closing, they will pass through the estate.
- Alternatively, an owner agreement may specify that the death of an owner is a trigger for a mandatory offer to sell of the decedent's interest to the company, and the transition will be subject to terms agreed upon by the owners in advance.

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Death and Disability

- Death
 - May use TOD designation on ownership interest (different requirements for certificated vs. uncertificated interests)
- Disability
 - The agreement should clearly define what constitutes disability for purposes of triggering a buy-out option

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Bankruptcy

- Bankruptcy itself can not be a trigger for a company/owner option to buy stock at risk of becoming part of a bankruptcy estate.
- Bankruptcy court is an equitable court – owner agreement may be persuasive but is not the sole factor that the court will evaluate.
- Court will consider the intention of the parties (and who the owner agreement was meant to protect in evaluating arguments related to its interpretation).
 - In re Popkin & Stern

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In re Popkin & Stern

- Bankruptcy proceeding involving the issue of whether a Chapter 11 trustee who sought to collect a judgment could the debtor's stock
- Court held: “[r]equirement under shareholder agreements, that any shareholder whose stock was to be sold in any voluntary or involuntary sale had to give notice of such sale to corporation and other shareholders, was meant to protect other shareholders, and not seller, by ensuring that corporation and these other shareholders had opportunity to exercise their contractual rights of first refusal; accordingly, corporation and other shareholders could waive any deficiency in notice, which was given not by seller as specified under agreements but by judgment creditor executing on his stock, and seller lacked standing to raise any such defect as ground for avoiding execution sale.”

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Divorce

- Owner agreement value of ownership is again, persuasive, but is not the sole factor that courts will evaluate in a divorce proceeding involving an interest in a company.
- *Butler v. Butler*: “[f]or equitable distribution purposes, valuation of husband's share in accounting firm was not properly set by shareholder agreement, where shareholder agreement provided that withdrawing partner would receive a fixed amount, the amount for which the stock was purchased at inception of the accounting firm, an amount which had never been reevaluated to determine whether it reflected the company's current financial picture, even though the husband might not ever be able to realize a value based on the going concern value of the accounting firm.”

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Owner Disagreements

- Mediation
- Put rights and call rights
- Dissolution
- Texas Shoot-Out/Slice of the Pie



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Buy-Out Price and Terms



Potential Funding Sources for Buy-Out

- If Company is the buyer, money may be set aside for purposes of funding the buy-out, but owners will need to consider potential tax on accumulated earnings (as applicable)
- Company and/or owners may seek bank financing, but should ensure that agreement provides adequate time for securing such
- Life insurance policies on owners to fund buy-out



Connelly v. United States (2024)

- Two brothers were shareholders of a corporation, which held key-man life insurance policies on each brother for purposes of redeeming shares upon the death of a shareholder. Upon one brother's death, IRS asserted that the fair market value of his shares included the life insurance proceeds for purposes of evaluating federal estate tax.
- A corporation's contractual obligation to redeem shares is not necessarily a liability that reduces a corporation's value for purposes of the federal estate tax.
- The deceased shareholder's shares must be valued just prior to death, before the buyback occurs, not after. At that point, the life insurance proceeds are still a company asset that increases share value.
- These notes on valuation are only applicable to redemption, and can be avoided in a cross-purchase arrangement.

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Tax Consequences to Buyer and Seller

- Potential installment sale – requires at least one payment toward purchase price to be received after tax year of the sale
 - Installment sale treatment not available if sale results in a loss
- Different implications for buyer may be based on management or entity structure
 - In a limited partnership, general partners' basis may include both recourse and nonrecourse debt, whereas the limited partner's basis may only include nonrecourse debt
 - Due to limited liability of an LLC's members, they may only be able to include nonrecourse debt in their basis to the extent that they bear an economic risk of loss (such as personally guarantying or pledging personal assets)

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Buy-Out Price

- Fixed Price
- Agreement among parties, subject to periodic revaluation (internal valuation)
- Formal valuation
- Based on calculation associated with the company's financials at the time of the sale (book value, EBITDA, etc.)



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Pricing Considerations and IRS Risks

- Arm's-length agreement between related parties
- Transfers below fair market value (part-gift arrangements)
- Estate and gift tax implications – what will the IRS consider in determining fair market value of an interest that was purchase pursuant to an option triggered by death of a member?



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Additional Buy-Out Terms

- Cash at closing, or payment over a term
 - How much flexibility will the respective buyer need to complete the buy-out?
 - If the company is the buyer, what term will appropriately balance the financial strain of the buy-out?
- Appropriate interest rate
 - Imputed income risk
 - Loan between company and owner: interest treated as dividend or distribution
 - Loan between company and employee: interest treated as compensation with income tax implications

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Puts and Calls

- Put Right
 - Selling owner has the ability to obligate a buy-out of their interest.
 - Useful for liquidity and tax planning purposes, as the owner has significant control over the timing of the sale.
- Call Right
 - Other owners have the ability to force an owner to sell.
 - Useful for retirement and succession planning purposes, to have a firm expectation or timeline for a generational ownership transition.

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Other Considerations



Restrictive Covenants

- Non-Competition
 - Must be:
 - (1) ancillary to an employment contract or to a contract for the sale of goodwill or other subject property (such as an owner agreement and sale of interests in a company),
 - (2) supported by adequate consideration,
 - (3) reasonably necessary to protect legitimate interests of the purchaser and
 - (4) reasonable.
- Non-Solicitation
 - Customers, clients, patients
 - Employees



Amendment and Termination of Agreement

- Unanimous approval or majority approval of amendment?
 - Majority shareholders owe fiduciary duties to the company must protect the interests of minority shareholders, such that they are limited in their ability to amend the agreement to the detriment of the minority.
- Termination
 - Perpetual existence of agreement vs. limited term
 - Joinder of new owners

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Sale of Business

- Threshold for approval of sale
- Drag-Along Rights
 - The owner agreement may specify approval processes and thresholds required for agreeing to a sale of the company (majority, unanimous).
- Tag-Along Rights
 - If a majority owner intends to sell their interest in the company, tag-along rights empower the minority shareholder to be included in the majority owner's sale.
- Sale following an owner's exit (potential earn-out provisions or adjustment to agreement price)

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The Role of the Advisor



The Role of the Advisor



- 83% of businesses operate without a written transition plan
- Pay attention to your client's plans for the future, and how they may differ from reality
 - Retirement planning and expectations
 - Estate planning and expectations
 - Business ownership, operations, and value
 - Involving family in the business



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Thank You!

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