

**CROSS PURCHASE AND BUY-SELL
AGREEMENTS FOR SMALL BUSINESSES**

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Mr. Bourland is the founding shareholder of Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represent individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Bourland was born in Fort Worth, Texas on October 2, 1943. He earned a B.A. from Baylor University and his J.D. from Baylor University School of Law. He earned his LL.M. in Taxation from University of Miami, Florida. Additionally, he was a Captain in JAGC, USAF, 1970-1975.

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CROSS PURCHASE AND BUY-SELL AGREEMENTS FOR SMALL BUSINESS

I. INTRODUCTION.

A Buy-Sell Agreement is an agreement entered into by the owners of a closely-held company that governs the transfer and disposition of the ownership interests (“Interests”) in the company. The goal of a Buy-Sell Agreement is to promote the stability of the company and its owners by providing an agreed-upon framework for the manner in which Interests in the company can be held, transferred, and purchased. Without such an agreement in place, the company and its owners are at risk of unwanted co-owners, disorderly ownership and management succession, and the inability to ever liquidate an investment. While Buy-Sell Agreements typically have common elements, in the world of Buy-Sell Agreements “one-size does not fit all”; the terms of each Buy-Sell Agreement will need to be customized to fit the unique needs and goals of the company and its owners. The Buy-Sell Agreement for a company with two 50/50 owners will likely look quite different from a Buy-Sell Agreement for a company with four owners at 70/10/10/10. Also, as time passes, it may be necessary to have the owners of the company re-evaluate the terms of their existing Buy-Sell Agreement. What made sense 5 or 10 years ago may not make sense anymore such that the Buy-Sell Agreement may need to be modified to fit new circumstances and objectives.

A Buy-Sell Agreement can be used for each type of commonly encountered business organization, including a corporation, limited liability company, limited partnership, and general partnership. For a corporation, the Buy-Sell Agreement is typically a separate, stand-alone agreement executed by the company and the owners. For a limited liability company, limited partnership, or general partnership, the “Buy-Sell Agreement” is often part of the overall company agreement or partnership agreement. (**Note:** If the controlling owner desires the company to issue a small Interest to one or more key employees, it may be best to have each key employee execute a separate Buy-Sell Agreement with the company. In this situation, the Interest of the controlling owner would not be subject to a Buy-Sell Agreement at all as he or she would want maximum flexibility to transfer his or her Interest.)

II. DESIGNING THE AGREEMENT.

In designing the Buy-Sell Agreement, there are six primary questions that need to be asked:

- A. What are the restrictions on transferring an

Interest (whether by sale, pledge, gift, or otherwise)?

- B. What are the events (“Trigger Events”) for which an owner’s Interest will be subject to purchase by the company and/or the other owners?
- C. Will the purchase of an Interest upon the occurrence of a Trigger Event be mandatory or optional?
- D. Who will be the purchaser of the Interest (company and/or other owners)?
- E. What is the purchase price for the Interest on the occurrence of a Trigger Event?
- F. What is the method of payment of the purchase price on the occurrence of a Trigger Event?

III. TRANSFER RESTRICTIONS.

If owners of a closely-held company can freely sell, pledge, gift, or otherwise transfer their Interests, there is a significant risk that at some point down the road, an Interest will be transferred to someone that the other owners do not want as a co-owner. An unexpected co-owner can cause havoc to the company and the other owners as he or she will not only have an economic stake in the company, but may have voting and management rights, rights to inspect the books and records of the company, and rights to re-transfer the Interest to others. Furthermore, such unexpected owner may be looking over the shoulders of management, second guessing many of their decisions, and threatening litigation for mismanagement. To minimize this risk, the Buy-Sell Agreement should include restrictions on the right of an owner (or certain owners) to sell, pledge, gift, or otherwise transfer his or her Interest in the company. (**Note:** With respect to Texas corporations, §21.211 and §21.213 of the Texas Business Organizations Code (the “TBOC”) indicate that the restrictions imposed on the transfer of stock must be reasonable to be enforceable. §21.211 of the TBOC also identifies specific types of transfer restrictions that may be reasonable or are presumed to be reasonable. The TBOC does not contain these “reasonableness” standards in the specific sections of the statute covering limited liability companies and partnerships. In any event, at least for Texas corporations, complete restrictions on the transfer of stock may not be enforceable under the TBOC.)

Often the Buy-Sell Agreement will allow an owner to sell his or her Interest to a third party, subject to a “right of first refusal” in favor of the company and/or the other owners. Under a right of first refusal, if a third party has offered to purchase all or any portion of an owner’s Interest in the company, before that selling owner can sell his or her Interest to the third party, the selling owner must provide the

company and/or the other owners the opportunity to purchase such Interest at the same price and terms as offered by the third party. In other words, the right of first refusal is a mechanism for the company and/or other owners to purchase the selling owner's Interest if the other owners do not want the third party to become an owner of the company.

Another possible exception to the general prohibition on the transfer of an Interest is to allow "estate planning" transfers from the owner to his or her spouse, lineal descendants, trusts for the benefits of the owner, his or her spouse, and lineal descendants, and family controlled entities (i.e., family limited partnership). However, "estate planning" transfers should only be included in the Buy-Sell Agreement if the owners are comfortable with a succession plan that includes an owner's family, including succeeding generations. Such situations might include an owner who is simply a passive investor or a founding owner with a substantial stake in the company who wants to allow the family to continue to own the Interest in the company following his or her death. Allowing estate planning transfers to a key-employee who holds a 2% Interest in the company would not be recommended as most likely the company and other owners will want such 2% owner's Interest purchased on death or employment termination. (**Note:** If the company is an s-corporation for federal income tax purposes, the Buy-Sell Agreement should prohibit transfers to persons who are not eligible to own stock in an s-corporation. If the company is a partnership for federal income tax purposes, it may be prudent for the Buy-Sell Agreement to prohibit transfers of Interests that would cause a termination of the company for federal income tax purposes under §708 of the Internal Revenue Code.)

IV. TRIGGER EVENTS.

Trigger Events are the events affecting an owner that may (or will) give rise to the purchase of such owner's Interest. Commonly used Trigger Events are as follows:

- A. Right of First Refusal;
- B. Divorce (where the former spouse is awarded all or part of the Interest in the company);
- C. Death of the Owner's Spouse (where the spouse does not leave his or her community property interest to surviving Owner);
- D. Death of the Owner;
- E. Retirement of the Owner;
- F. Disability of the Owner; and
- G. Termination of the Owner's Employment (other than Death, Retirement, or Disability).

A. Right of First Refusal.

If an owner receives an offer from a third-party to purchase all or a portion of the owner's Interest, before selling such Interest to the third party, the company and/or the other owners would have the right (but typically not the obligation) to purchase such Interest from the selling owner at the same price and terms as offered by the third party. If the company and/or the owners do not elect to exercise this right of purchase, then the selling owner could proceed to sell his or her Interest to the third party at the same price and terms as communicated to the company and/or other owners. This purchase right in favor of the company and its owners (also known as a "right of first refusal") provides the company and its owners the opportunity to keep "outsiders" from acquiring an ownership stake in the company and at the same time provides the selling owner the opportunity to liquidate his or her investment if a purchaser can be found.

B. Divorce of an Owner.

If an owner divorces and the former spouse (the "Ex-Spouse") is awarded all or a portion of the owner's Interest by the divorce decree, then the divorced Owner, the company, and the other owners would have the right (but typically not the obligation) to purchase the Interest awarded to the Ex-Spouse. Discussion of the purchase price to be paid for the Ex-Spouse's Interest and the manner of paying such purchase price are discussed below in Section VII and Section VIII, respectively. If no one exercises their right to purchase the Interest awarded to the Ex-Spouse in the divorce, the Ex-Spouse would be entitled to retain all of such Interest.

C. Death of Owner's Spouse.

If the spouse of an owner dies, and such deceased spouse (the "Deceased Spouse") does leave his or her community property share of the Interest to the surviving-spouse owner (whether outright or in trust), the surviving-spouse owner, the company, and/or the other owners would have the right (but typically not the obligation) to purchase all of the Deceased Spouse's community property share of the Interest not left to the surviving spouse. If the surviving-spouse owner, the company, and/or the other owners do not exercise their right to purchase such Interest from the estate of the Deceased Spouse, then the heirs and beneficiaries would acquire such Interest. Discussion of the purchase price to be paid for such Interest and the manner of paying such purchase price are discussed below in Section VII and Section VIII, respectively. If no one exercises their option to purchase the Interest, the Deceased Spouse's community property share of the Interest would pass to his or her heirs and beneficiaries.

D. Death of an Owner.

What happens to an owner's Interest on death varies depending on the circumstances and goals of the company and its owners. For an owner holding a minority position in the company, his or her Interest is often subject to either an optional or mandatory purchase by the company and/or other owners because the other owners will not likely want the deceased owner's surviving family involved in the business of the company on a going forward basis. On the other hand, a founding owner who holds a substantial ownership position in the company may want the flexibility of leaving his or her Interest to family members—especially if the decedent has other family members involved in the company or the company would generate a steady income stream for the decedent's spouse or family. However, if the owner's spouse and surviving family have no involvement and interest in the company, then such owner may want the company and/or other owners to be required to purchase his or her Interest on death. Discussion concerning the purchase price to be paid for the deceased owner's Interest and the manner of paying such purchase price are discussed below in [Section VII](#) and [Section VIII](#), respectively. (**Note:** If the purchase of a deceased owner's Interest will be mandatory, to ensure the availability of funds for such purchase, the company or other owners, as applicable, could obtain life insurance on the life of the owner, with the proceeds of such life insurance policy to be used by the company or other owners, as applicable, to purchase the deceased owner's Interest (up to the total purchase price). Any life insurance proceeds in excess of the purchase price for the deceased owner's Interest would be retained by the owner of such policy.)

E. Retirement of an Owner.

The Buy-Sell Agreement may contain a "retirement" Trigger Event which requires the company or other owners to purchase the Interest of a long-time employee-owner who "retires" from the company to allow such owner to liquidate his or her investment. "Retirement" would be a defined term in the Buy-Sell Buy Agreement that often includes both a period of full-time employment requirement (i.e. 15 years) and an age requirement (i.e. 60 years old). Discussion concerning the purchase price and manner of paying the purchase price for the Interest is set forth in [Section VII](#) and [Section VIII](#), respectively. (**Note:** The retirement "Trigger Event" could be an optional purchase by the company or other owners (rather than a mandatory purchase) to provide the company and other owners more flexibility; however, in such event, the loyal employee-owner has no assurance that he or she will be able to monetize his or her investment in the company upon retirement.)

F. Disability of an Owner.

The Buy-Sell Agreement may also contain a "disability" Trigger Event. A "disability" Trigger Event may require the company or the other owners to purchase an employee-owner's Interest on disability in order to provide such disabled owner the opportunity to liquidate his or her investment. Alternatively, the Buy-Sell Agreement could provide the company and the other owners the option to purchase an owner's Interest on disability. From a company / other owners' point of view, the optional purchase is preferred in order to provide the company maximum flexibility. "Disability" would be a defined term in the Buy-Sell Agreement. Sometimes disability is defined in terms of the definition of long-term disability under the disability insurance plan maintained by the company—so if the key-employee owner is disabled under the terms of the disability plan, then he or she is considered disabled under the Buy-Sell Agreement. Alternatively, sometimes disability is defined in terms of the inability of the employee-owner to perform normal employment duties on a full-time basis for a consecutive period of time (i.e. 12 months). Any dispute as to the disability of the employee-owner could be handled by a dispute resolution process involving licensed medical doctors (i.e. a single medical doctor selected by the company whose determination is binding or, alternatively, 2 medical doctors – one selected by the employee-owner and one selected by the company, with any deadlock broken by a third medical doctor jointly selected by the parties). Discussion concerning the purchase price and manner of paying the purchase price for the Interest is set forth below in [Section VII](#) and [Section VIII](#), respectively.

G. Termination of an Owner's Employment (Other Than Death, Retirement, or Disability).

What happens to an owner's Interest on termination of employment with company (other than on account of death, retirement, or disability) varies depending on the circumstances. For an owner who holds a minority ownership position in the company, his or her Interest is usually subject to purchase (either optional or mandatory by the company and/or other owners) on termination of employment. If such owner resigns without cause or is terminated by the company "For Cause" (as defined in the Buy-Sell Agreement), then the company and/or the other owners often have the right (but not the obligation) to purchase his or her Interest. "For Cause" would be defined in the Buy-Sell Agreement as a laundry list of bad acts by the owner such as fraud, theft, conviction of felony, material violation of his or her employment contract (if any) or company policies that remain unremedied after notice and a cure period, gross negligence in performing

duties, etc.). On the other hand, if the owner is terminated by the company without cause, then sometimes the company is required to purchase such owner's Interest to enable such owner to liquidate his or her investment since he or she was not "at-fault" in terminating the employment relationship. For a founding owner with a substantial ownership position in the company, whether or not his or her Interest is subject to purchase on employment termination involves many of the considerations discussed above under the section titled "Death of an Owner"). Such owner may want to the flexibility to retain his or Interest if the company provides a steady income stream to the owners or there is a likelihood that the company may be sold in an acquisition transaction down the road, or he or she may want to be able to leave his or her Interest to family after the owner dies.

V. MANDATORY V. OPTIONAL PURCHASE.

Upon the occurrence of a Trigger Event, the purchase of the Interest by the company and/or other owners could be mandatory or optional. In many instances, the purchase of the Interest is at the option of the company and/or the other owners in order to provide the company and/or the other owners the maximum amount of flexibility in deciding whether or not to purchase the Interest. However, there are certain Trigger Events where the owners may determine that the purchase of an Interest will be required in order to allow the affected owner to liquidate his or her Interest in the company and because the affected owner has not done anything blameworthy. Trigger Event where the purchase by the company or other owners might be mandatory would include death, retirement, or termination of employment by the company without cause.

VI. IDENTITY OF THE PURCHASING PARTY.

The Buy-Sell Agreement should identify who the purchasing party will be upon the occurrence of a Trigger Event. The company could be the purchasing party or one or more of the other owners could be the purchasing party. Furthermore, if the purchase of the Interest is at the option of the purchaser (rather than required), then the Buy-Sell Agreement could be structured to provide both the company and the other owners to right to purchase the Interest. For example, if a Trigger Event occurred and the company did not exercise its option to purchase the subject Interest, then the other owners could then have the option (on a pro rata basis based on ownership) to purchase the subject Interest. A Buy-Sell Agreement structured with the company as the purchasing party is sometimes referred to as "redemption purchase" Buy-Sell Agreement as the company is redeeming ("buying-back") the Interest. On the other hand, if the Buy-Sell Agreement

is structured with the other owners as the purchasing party, the Buy-Sell Agreement is sometimes called a "cross-purchase" Buy-Sell Agreement. Finally, for Trigger Events involving divorce or death of an owner's spouse, the divorced or surviving owner is typically given the first option (ahead of the company and other owners) to purchase the Interest from the former spouse or estate of the deceased spouse, as the case may be, in order to enable the owner to regain his or her full Interest in the company. (**Note:** If the Trigger Event is going to give rise to a mandatory (required) purchase by the purchasing party, then from the remaining owners' point of view, it is often preferable to have the company be the purchasing party in order to avoid personal liability of the owner.)

VII. PURCHASE PRICE.

The purchase price to be paid for the Interest upon the occurrence of a Trigger Event (other than a proposed sale to a third party) can be determined in many ways. Some of the more common methods of determining the purchase price are as follows:

A. Fair Market Value of the Interest.

This is a standard valuation technique that is commonly defined as "the price at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open market and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts." If the Interest constitutes a minority or non-controlling ownership percentage in the company, then valuation discounts are typically applied for lack of control and lack of marketability. These discounts often range from 25% to 40%, collectively.

B. Enterprise Value of the Interest / Liquidation Value of the Interest.

This valuation technique would value the company as a whole (taking into account goodwill and going concern value and all of the liabilities of the company) and then multiply that value by the percentage ownership in the company represented by the Interest—without any valuation discounts for lack of control or lack of marketability.

C. Net Book Value of the Interest.

This valuation technique would subtract the company's liabilities from the company's assets (as reflected on the company balance sheet) and then multiply that number by the percentage ownership in the company represented by the Interest. This valuation technique is typically not reflective of fair market value.

D. Formula.

In some lines of business, there may be an industry standard valuation formula for valuing a business. If this is the case, such valuation formula might be a good starting place for determining the purchase price for an Interest. For example, a company in a particular line of business may typically sell for 5 X EBITDA less debt. Such a formula could be used as a basis for establishing the purchase price for the Interest, with the overall value of the company based on such formula being multiplied by the percentage ownership represented by the Interest to arrive at the purchase price for such Interest. If discounts are desired, the purchase price could then be discounted (25%–40%) to reflect the lack of marketability and lack of control.

E. Pre-Established Value.

Sometime the owners want to establish a per share/unit value in the Buy-Sell Agreement on an annual basis (or other periodic basis) with the purchase price for an Interest being based upon the most recently established share/unit value. The downside of this technique is that the owners may forget to update the value in the Buy-Sell Agreement on a regular basis. If this technique is used, there should be a fallback provision that if the owners have not updated their valuation within a certain period of time (i.e. 2 years) and the owners cannot currently agree on the purchase price for the Interest, then the purchase price will be based on a professional appraisal of the fair market value of the Interest.

F. Other.

A different method for determining purchase price can be used for different Trigger Events. For example, the price for an Interest being purchased as a result of the death, retirement, or disability of an owner could utilize a higher valuation methodology (i.e. a formula based methodology or Enterprise Value/Liquidation Value of the Interest where there are no discounts) than if the owner voluntarily resigns his employment or is terminated by the company “For Cause” (i.e. Net Book Value of the Interest or Fair Market Value of the Interest where there is typically valuation discounts if the Interest constitutes a minority ownership percentage). Also, depending on the situation, it may be advisable to have the purchase price vary depending on whether the departing owner signs a non-compete and/or release of claims with the company in connection with the purchase of his or her Interest. The company wants to avoid a situation where an owner can leave the company and begin competing against the company while being paid a significant price for his or her Interest which can be used to finance the competing enterprise. In this situation, the

purchase price otherwise payable to the resigning owner could be discounted by a certain percentage (i.e. 50%) unless the departing owner signs a reasonable non-compete and release of claims.

VIII. MANNER OF PAYMENT OF PURCHASE PRICE.

The Buy-Sell Agreement should not only clearly define the method of determining the purchase, but also clearly describe the manner of paying the purchase price. Will the entire purchase price be paid in a single lump sum payment up-front or will it be paid in installments over a period of time? Often times, a portion of the purchase price is paid up-front and the remainder is paid in installments over a period of time. It is important to structure the manner of payment in a way that will not financially hamstring the purchasing party. Also, the manner of paying the purchase price may vary depending upon the particular Trigger Event giving rise to the purchase of the Interest. For example, a shorter payment period may be used if the Trigger Event is retirement or death of the owner while a longer period may be used if the Trigger Event is resignation by the owner, termination of the owner “For Cause”, or divorce or death of spouse (as outlined above). Furthermore, if the Trigger Event is the death of the owner and there is life insurance available to fund the purchase, it is common that the entire life insurance proceeds (up to the total purchase price amount) be immediately applied to the purchase of the Interest.

If the purchase price will be paid in installments, consideration needs to be given as to whether interest will be paid in addition to the normal purchase price installments and at what rate of interest. In addition, if the purchase price will be paid in installments, consideration should be given as to whether the payment obligation will be secured or unsecured. Sometimes the Interest being purchased is pledged as collateral to secure the payment of the purchase price.

IX. MISCELLANEOUS.

- A. The owner’s spouse should sign the Buy-Sell Agreement (or a separate Consent Form) acknowledging his or her agreement to be bound by the terms and conditions of the Buy-Sell Agreement.
- B. If life insurance is being obtained to fund the purchase of an owner’s Interest on death, it is important that the owners evaluate the sufficiency of the policy amount from time to time. As the company increases in value, additional insurance may need to be obtained so that the purchaser does not have to tap into other funds to purchase the Interest.

- C. If the company is a pass-through entity for federal income tax purposes and the company ordinarily makes regular tax distributions to the owners, the parties may want to include a tax distribution provision in the Buy-Sell Agreement for certain Trigger Events (i.e. death or retirement) so that the owner whose Interest is being purchased receives a tax distribution for the current year flow-through income (in addition to the purchase price for his or her Interest).
- D. If the company has a credit facility with a lender, the company should make sure that payments to an owner under a Buy-Sell Agreement will not violate any loan covenants.
- E. With respect to Texas corporations, §21.213 of the TBOC describes the method for putting the holder of the stock and third parties on notice concerning the existence of stock transfer restrictions (for both certificated and uncertificated stock).
- F. With respect to Texas corporations, §21.210 of the TBOC requires the corporation to maintain a copy of the agreement restricting the transfer of its stock at the corporation's principal place of business or registered office. Furthermore, a copy of such agreement is subject to the same right of examination by the shareholder as the books and records of the corporation.

APPENDIX A: TRIGGER EVENT CHART

	<u>Trigger Event</u>	<u>Optional v. Mandatory Purchase</u>	<u>Identity of Purchaser</u>	<u>Purchase Price</u>	<u>Payment Terms</u>
1.	Right of First Refusal				
2.	Divorce of Owner where Owner’s ex-spouse is awarded all/part of the Interest				
3.	Death of Owner’s Spouse (where deceased spouse does not leave community property share of the Interest to the surviving Owner)				
4.	Death of Owner				
5.	Retirement of Owner				
6.	Disability of Owner				
7.	Termination of Employment (other than Retirement or Death)				
	a. By Owner without cause (i.e. resignation)				
	b. By company without cause				
	c. By company “For Cause”				