RBC Wealth Management Services

THE NAVIGATOR

Buy-Sell Agreements – Checklist for Business Owners

Part III – An integral tool to minimize shareholder conflict

This article provides a handy checklist that you can go through with your qualified tax or legal advisor when contemplating a new buy-sell agreement or reviewing an existing one. A well-drafted buy-sell agreement can provide a ready market for company shares, set a price for those shares and provide a stable continuance of the business by avoiding unnecessary disagreements between the shareholders.

Elements of a Buy-Sell Agreement

A buy-sell agreement consists of three common elements: a triggering event, a valuation method and a funding strategy.

Triggering Event

For the most part, buy-sell agreements are activated at the onset of a specific occurrence, called the "triggering event". The most common triggering events are:

- **Death** — In the event of the death of a shareholder, a well-drafted buy-sell agreement ought to consider that the beneficiaries of the deceased may not want to become actively involved in the business, or that the surviving shareholders may not want the beneficiaries to be actively involved in the business.
- **Disability** — Among the things that must be considered in a buy-sell agreement in the event of the disability or critical illness of a shareholder is that the disabled shareholder may want to exit the business and realize the full market value for his or her business interest. Or, due to the disabled shareholder's inability to contribute to the business, the other shareholders may want to purchase his or her interest. The buy-sell should qualify the following:
  - What is the definition of disability under the agreement?
  - What is the duration of the disability before the buy-sell is triggered?
  - How soon after a critical illness diagnosis will the buy-sell be triggered?
- **Living buyout (retirement or dispute)** — In this situation, the terms of the transaction and the appropriate approvals of the other shareholders must be clearly stated in the buy-sell agreement to allow for a smooth transfer of ownership. In certain buy-sell agreements, a "shotgun clause" exists as an exit provision. This clause applies when shareholders no longer agree on the strategy or direction of the corporation such that there is an unresolved impasse. The shotgun clause allows one shareholder to set a specified price at which he/she is prepared to buy the other shareholder's interest in the business or sell his/her own interest. The other shareholder then may choose the option he/she prefers within a specified timeline. The premise behind this clause is to allow a resolution to the impasse at a fair amount.
- **Marital breakdown** — A well-drafted buy-sell agreement must acknowledge that an interest

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in the business is an asset that may be subject to division-of-property regimes under provincial matrimonial law. Provisions should be added in the agreement requiring all shareholders to enter into a marriage agreement with their non-participating spouse which excludes the shares as family property. If this provision is not possible, then provisions should be added to the agreement that give the remaining shareholders the right to buy out the shareholder undergoing a division of property, or the shareholder's spouse should the spouse be awarded shares in the business under the terms of the division of assets.

- **Third Party Offers** – A well-drafted agreement must also contemplate the restrictions, approvals and other provisions regarding third party offers. Some agreements may include a right of first refusal, which typically requires a selling shareholder to present the highest offer received from a third party to the remaining shareholders, who then have the option of approving the transaction or acquiring the shares themselves at the price and terms presented. Other provisions in the buy-sell agreement related to third party offers may include:

  (i) **Right of First Opportunity** – the selling shareholder offers his/her shareholdings to the other shareholders at the price and terms he/she wishes. If none of the other shareholders accepts, the selling shareholder is free to sell his/her shares at the specified price and terms;

  (ii) **Tag-along Provision** – In a situation where a third party offer of the shares of the majority shareholders has been made, this provides the non-selling minority shareholders the opportunity to force a purchaser to acquire their shares as well. This usually provides protection to minority shareholders if the majority shares are being sold to an incompatible third party; and

  (iii) **Drag-along Provision** – In a situation where a third party offer for the shares of the majority shareholders has been made, this provision forces minority shareholders to sell their shares on the same terms and conditions accepted by the majority shareholders. This allows the majority shareholders to negotiate and sell the business as a 100% sale.

- **Bankruptcy** — In the event of the insolvency of one of the shareholders, the buy-sell agreement must consider that the creditors may have the right to encumber or seize his or her shares, and thus be afforded the same rights as the other owners. Additionally, they may be entitled to sell the shares in the open market without prior approval of the other shareholders, or force a liquidating dividend to satisfy claims, leaving the other shareholders powerless to prevent liquidation.

Please note that if the buy/sell agreement gives a shareholder a right to acquire shares as a result of any of the triggering events above other than by death, bankruptcy or permanent disability of the individual, the signing of the buy/sell agreement may cause certain tax deeming rules to apply. These rules deem each shareholder to be in the same position with respect to control of the corporation as if the right or option had been exercised.

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If these deemed ownership rules apply, there may be unintended adverse tax implications depending on the facts and circumstances, such as the corporations being deemed associated with one another when they otherwise may not be, the loss of Canadian-controlled private corporation (CCPC) status and the loss of the small business deduction. The Canada Revenue Agency has taken the administrative position that the deeming rules do not apply in certain situations where the shareholder has the contingent right, such as under a right of first refusal or a shotgun arrangement. You should consult a qualified tax advisor when drafting the buy/sell agreement to ensure that unintended adverse tax consequences are not triggered.

Valuation

Business valuation is approached in various ways within buy-sell agreements. Some agreements attempt to value the company annually, with each owner signing off on the agreed annual valuation. While this assures that a current and realistic business value is used, it is easy to forget to update this annual price setting and before long, the figure may become outdated.

Alternatively, many agreements either mandate an independent valuation or attempt to define a formula or rule-of-thumb approach to a business valuation. Some formulas will start with the book value and make adjustments for the appraised fair market values of specific assets — such as real estate, equipment and fixtures — and goodwill. Other formulas may determine the value of a business by applying a specified multiplier to either revenues or earnings. One of the disadvantages of the formula approach is that what seems to apply best at one point in time may be inadequate or inapplicable when the time to apply the formula occurs and as a result may provide a figure that doesn't represent the true value of the business. For this reason, a vast number of buy-sell agreements call for an independent valuator to determine the fair market value of the business.

Funding

As discussed in part 1 of this series, insurance is the preferred funding option in a majority of buy-sell agreements.

What about when a shareholder retires or has an early departure for other reasons where insurance cannot be used?

For these types of situations, the buy-sell agreement should provide for terms of payment. This means that the agreement may require the departing shareholder to accept payment over a number of years at some specified interest rate to ensure that the business is able to meet its obligations. Generally, buy-sell agreements provide for extended terms of payment or a reduced valuation of the shareholder's shares if the shareholder departs voluntarily before the normal retirement age. It should be noted that in certain circumstances, a purchase of shares at a price less than the fair market value could have adverse effects from a tax perspective for both the buyer and the seller. Speak to a qualified tax advisor for details.

Alternative funding strategies include the following:

- The shareholders can establish a sinking fund.
- They can get a loan.
- The company can purchase the shares by making instalment payments to the shareholder.

Insurance funding

When insurance is used to fund a buy-sell agreement, consider the following issues:

- Will the policy be corporately or personally owned?
- How will the excess insurance proceeds be treated?
- Where the life insurance proceeds are less than the sale price, how will the deficiency be satisfied?

Selling the Shares

When a departing shareholder is selling his or her shares, the following factors should be addressed:

- **Shareholder loans —** All loans to the company held by the selling shareholder should be satisfied prior to the sale, or should be contemplated in the selling price.
- **Resignation —** The shareholder may be required to resign as an officer, employee and director of the corporation.
- **Restrictive covenant —** A restrictive covenant may be added to the agreement to protect the company from the departing shareholder/employee. A covenant may ensure that the employee does not compete against the company in the same market or geographical location (i.e. a non-competition agreement).
- **Payment schedule —** A payment schedule should be created to specify the timing of the payment, duration, interest rate and should include provisions for prepayment and extensions.
- **Guarantees —** The departing shareholder should be released from any guarantees of obligations of the company.
- **Tax implications —** The tax issues surrounding a shareholder redeeming his or her shares in the company are different than those surrounding a departing shareholder selling his or her shares to other shareholders. Speak to a qualified tax advisor for details.

Other Considerations

- Does the agreement allow for the sale of shares to an outside purchaser? If yes, under what conditions?
- Do the shareholders have marital contracts in place? If yes, are they consistent with the terms of the agreement?
- How will a departing shareholder's outstanding obligations to the company be handled?
- How will any amounts owing by the company to the departing shareholder be dealt with?
- Under what circumstances will the agreement be terminated?
- Will there be a periodic review of the buy-sell agreement?

If you have any questions or require clarification on any of the issues discussed in this document, you should discuss these with a qualified tax advisor. You should obtain professional advice before acting on any of the information in this article. This will ensure that your own circumstances have been considered properly and that action is taken on the latest information available.

Please contact us for more information.

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