Buy-sell agreements: a checklist for business owners

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.

An integral tool to minimize shareholder conflict.

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 events

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 should address an instance where 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.
- **Illness**. 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 of their 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.
- **Living buy-out (retirement or dispute).** In these situations 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.
- **Marital breakdown.** A well-drafted buy-sell agreement must acknowledge that an interest in a business is an asset that may be subject to division of property regimes under provincial matrimonial law. Provisions should be added to the agreement to allow the remaining shareholders the entitlement to buy out the shareholder undergoing division of property, or the shareholder's spouse, should he or she be awarded shares in the business under the terms of the division of assets.

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- **Bankruptcy.** In the event of the insolvency of one of the shareholders, the buy-sell agreement must address the fact that the creditors may have the right to encumber or seize his or her shares, affording the creditors the same rights as the other shareholders. 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.

Valuation method

Business valuation is approached in various ways in buy-sell agreements. Some agreements attempt to set a price 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 overlook 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 approach to a business valuation. Most formulas will start with the book value and make adjustments for the appraised value of specified hard assets (e.g. real estate, equipment, fixtures) and goodwill.

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. For this reason, a vast number of buy-sell agreements call for an independent business valuation.

Funding strategy

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 requires that the departing shareholder 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 extended terms of payment or the shareholder receives a reduced valuation of his or her shares if the shareholder departs voluntarily before normal retirement age.

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Insurance funding

Issues to consider:

- Will the policy be corporate 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?
- 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?

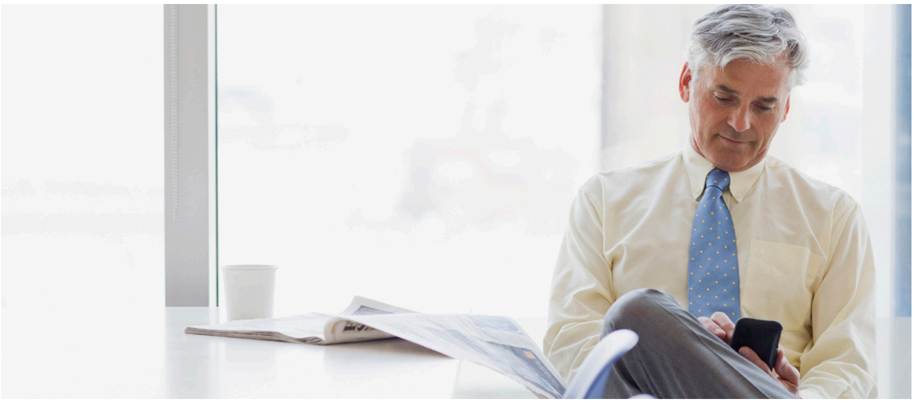
Alternative funding strategies include:

- The shareholders establish a sinking fund.
- The shareholders get a loan to pay for the shares.
- The company purchases shares by making installment payments to the shareholder.

Selling the shares

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

- **Shareholder loans.** All loans to and from the company held by the selling shareholder should be satisfied prior to the sale.
- **Resignation.** The shareholder may be required to resign as an officer, employee and director of the corporation.
- **Restrictive covenant.** A restrictive covenant provides limitations to an employee as to future conduct, following the termination of employment. A restrictive covenant may be necessary to ensure that the departing shareholder does not compete against the company in the same market or geographical location.
- **Payment schedule.** A payment schedule should be created to specify the timing of the payments and their duration, and should include provisions for prepayment and extensions.



For more information about buy-sell agreements, please contact us.

- **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 with the company are different than the tax issues when the departing shareholder sells 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?
- Should a departing shareholder have outstanding obligations to the company? If so, how will they 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?

Clients should consult their own professional advisors when planning to implement a strategy. This will ensure that individual circumstances have been properly considered and that action is taken on the latest available information.