Perspectives on Buy-Sell Agreements

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ABSTRACT

Most buy-sell agreements have provisions that are based on underlying assumptions designed to protect the buyer or the seller. What are those provisions, and how are they structured to favor the buyer or the seller? This column summarizes how specific terms of a buy-sell agreement may be designed to operate when certain contingencies pertain.

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A business interest is often the principal asset of its owner's estate. Consequently, the possible disposition of a business interest during the lifetime or upon the death of its owner is a key aspect of that individual's estate planning. A buy-sell agreement can map out the possible transfers of an interest that may occur if a triggering event occurs that causes one owner to sell his or her interest to another owner.

Let's suppose you are advising two shareholders of an S corporation who are each 50 percent owners of a business. They plan to execute a buy-sell agreement that will address the sale of each owner's interest during their lifetimes, or in the event of either of their deaths. As it stands, neither of them expects to buy the other's shares or to sell his or her shares in the near future. So, the fact that neither expects that a transaction between them is imminent tends to minimize conflicts that might occur if they anticipated that one of them would sell, and the other would buy, sometime soon. However, despite that neutrality, if one of them does proceed to sell his shares to the other, they may wind up with changed perspectives after the agreement terms are activated. Most buy-sell agreements have provisions based on underlying assumptions designed to protect the buyer or the seller. What are those provisions, and how are they structured to favor the buyer or the seller? The following is a summary of how specific terms of a buy-sell agreement may be designed to operate when certain contingencies pertain.

Lifetime Sale: Protect the Buyer, Preserve the Business

When typical terms of a buy-sell agreement are subject to close scrutiny, it becomes evident that some provisions favor the buyer and others favor the seller. Very often, the terms that work in the buyer's interest do so because the buyer remains rooted in the business and subject to its financial viability. For example, consider the payment terms that are often used when a lifetime sale of shares occurs and the buyer has no external financing. The purchaser in the lifetime scenario is most likely dependent on financing the purchase from distributions of profits from the business, or from after-tax dollars received from compensation. While the shareholder who sells is entitled to the regular payments of a fair price, neither party will succeed if the price and terms create an unsupportable financial burden for the business. So, the payments are probably made over several years at a minimal interest rate. Very often, the interest rate for the remaining payments is the applicable federal rate announced by the IRS on a monthly basis. After all, it is usually the case that the objective of the agreement is not to enrich the departing shareholder, but to permit that shareholder to be fairly paid and to allow the business to adjust and prosper over time.

In contrast, if a shareholder dies, having sufficient life insurance in place to complete the purchase of the shares by the surviving shareholder avoids the uncertainty presented by a lifetime buyout. Of course, the key word is "sufficient." If the coverage lags behind the price specified in the agreement, the surviving shareholder must complete the purchase of the decedent's shares under the same terms of a promissory note that a lifetime sale would require.

The Disability Conundrum

If a shareholder in our example dies, the other shareholder is usually required to purchase the decedent's interest. The buyout is mandatory, unlike lifetime events in which the remaining shareholder may have an option, but not an obligation, to purchase. When a shareholder's disability is the triggering event that constitutes an offer to the other shareholder, the purchase may be mandatory or optional according to the circumstances of the business and the preferences of its owners. If the sentiment of the owners is to require a buyout in the event of disability, they may wish to explore purchasing disability buyout insurance on each other. If the purchase is optional, the remaining shareholder may choose to buy the disabled owner's share or may decline to buy the shares.

Typically, defining the disability of a shareholder as a triggering event does not occur until it is clear that the shareholder will no longer be active in the business. A waiting period of 2 years from the onset of the disability is a typical duration. In keeping the agreement on an even keel of neutrality, the owners should recognize that the business may well have lost value during the 2-year waiting period before the disability becomes a triggering event that may cause a sale of shares. By the same token, the buyer may be hard pressed to fulfill the terms of the sale if the other shareholder's disability has reduced the value of the business and required the hiring of a replacement.

Payment Means the Entire Price, No Excuses

When a lifetime sale occurs, or if life insurance funds only a portion of a sale upon death, payments by the buyer are usually made according to the terms of a promissory note in favor of the seller. If circumstances of the business change over time, the purchaser may be tempted to pay less than the full price required for a variety of reasons. Perhaps the price seems unfair, in retrospect. Or perhaps the business is actually worth a lot less at the end of the payment period than it had been worth at the beginning. The drop in value, real or perceived, may be attributable to an economic downturn or to the buyer's management deficiencies in running the business as a sole owner. Whatever the reason, the solution to ensuring full payment is to have the seller's shares held in escrow until the final payment is made. If a default

by the buyer occurs, the seller will have the right to reacquire the shares and to keep all of the payments that were made. Of course, the seller could decline to reacquire the shares and simply sue the buyer to collect the remainder of the debt.

Subsequent Sale by Buyer

Let's suppose that the buyer is in the midst of completing the installment payments to the seller when he enters into an agreement with a third party to sell all of the corporation's assets. The agreement should specify that a sale of the stock or assets of the corporation should cause an acceleration of the remaining payments owed by the buyer to the seller to be due immediately. As a matter of fairness, if the buyer is paid, the seller should be also. Even if the buyer is also paid by the third party in installments over time, the seller's security interest in the stock is compromised if a subsequent sale of the stock or the corporate assets occurs.

Suppose instead that the buyer decides to sell the business a year after buying the seller's stock. One view of that decision would be that the parties made their deal, and, for better or worse, the buyer can do what he or she will with the business. If that is how both parties would have it, no additional provision is needed in the agreement. However, if the value received by the buyer in the subsequent sale is greater than the price of the stock sold between the parties, the seller might believe that he or she should have received half of the additional value. In that case, the buyer and the seller constituted a market for the stock that turns out to have undervalued the corporation. The seller might rightfully argue that the buyer capitalized on the goodwill that the seller had also created over a long period of time. A clawback provision can specify that a subsequent sale by the buyer will entitle the seller to half of the additional value realized in the subsequent transaction. The clawback provision is often limited in time as to when a subsequent transaction merits a sharing of the additional price.

In other words, if the buyer were to capitalize on the value of the enterprise by a sale to a third party within, say, 2 or 3 years, the seller may have a legitimate claim to a share of the proceeds of that sale. If that sale occurs 10 years later, the seller would probably be out of luck, and rightfully so. Where the parties decide to draw the line for a clawback provision, as to both a time limit and a percentage of sharing, is a matter of negotiation. For some owners, including the clawback provision in a buy-sell agreement will be a nonstarter. The buyer becomes the owner, and that's that. They may recognize that a subsequent sale is not an easy transaction to arrange, and if the buyer can engender a favorable outcome, more power to him or her.

On the other hand, both parties may have contemplated a sale to a third party as a favorable exit strategy that may have been feasible for both of them. Imagine that the owners had regarded a sale of the entire business as commanding a premium compared with the price in their buy-sell agreement, and that a triggering event occurs in which one owner bought the shares of the other at that lesser price. If the remaining shareholder manages to sell the business to a third party for a substantially greater price per share not long after, the seller would likely feel that he or she had created a portion of the value that the buyer then realized in the subsequent transaction. A clawback provision can rectify the situation if both parties believe it to be warranted in their particular situation. ■

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