Buy-Sell Agreement Planning Checklist

Sun Life Financial

The Buy-Sell Agreement[1]

Whenever a corporation has more than one shareholder, it is commonly recommended that the shareholders enter into a buy-sell agreement to operate in the event of a shareholder's death, disability, retirement, or conflict with other shareholders or a number of other specific circumstances.

There are numerous objectives for such an agreement. The agreement can provide for a smooth transfer of the business interest, avoiding potential disputes about the need for the sale/purchase, the price and other terms of sale. Most importantly the buy-sell agreement creates a degree of liquidity for the normally illiquid shares of a private corporation.

Failure to facilitate this smooth transfer could jeopardize the financial well being of the departing shareholder and his/her family. It could also jeopardize the financial health or even the viability of the business.

By providing for a sale, the likelihood of a confrontation between the departing and remaining shareholders will be minimized. Employees, customers, suppliers and creditors will be reassured about the continuity of the business. Where appropriate funding has been mandated in the agreement, creditors will also be reassured about the financial health of the business and the remaining shareholders after the buy-out.

Unanimous Shareholder's Agreement

The buy-sell agreement can be a separate document or part of a more comprehensive unanimous shareholder's agreement that governs banking, dividend and various other corporate policies. Recent Income Tax Act changes regarding share redemption and life insurance create the need to review whether the buy-sell agreement or amendments to the buy-sell agreement should be done outside of the remainder of the shareholder's agreement. It is recommended that an experienced tax and legal advisor be consulted in the drafting of such agreements.

This Checklist

This checklist offers a number of issues to consider in the development of a thorough buy-sell agreement. However, it does not in any way reduce the need to review these matters with competent legal and other advisors or to have the buy-sell agreement developed by a competent legal practitioner.

[1] **This document is for discussion purposes only and in no way binds those named parties to an agreement. The buy-sell agreement must be prepared by independent legal counsel of the parties involved.**

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What Should be Included in a Buy-Sell Agreement?

In general

In general, regardless of the triggering event, certain elements should be considered for inclusion:

- **A specific definition of the triggering event**. For example, where disability is the triggering event, a clear, verifiable definition of disability, often coordinated with the definition used in the insurance purchased to fund the buy-out, may be advisable.
- A dollar value or a clear, verifiable **valuation method** arbitrated by a pre-determined third party if necessary.
- A clear definition of the **manner in which the purchase will be financed**. Where financial contracts such as life or disability insurance are to be utilized, the requirement to purchase these contracts and a reference to contract numbers or similar information should be included.

On the death of a shareholder

Among the things to consider in the event of the death of a shareholder are the following:

- The beneficiaries of the deceased shareholder may not want to become actively involved in the business.
- The beneficiaries of the deceased are entitled to the fair market value equivalent of the deceased’s interest in the business.
- The surviving shareholders may not want the beneficiaries to be actively involved in the business.
- The surviving shareholders may need a source of funds with which to purchase the deceased shareholder’s interest.
- The sale of the business interest may create taxes and other expenses for the estate of the deceased shareholder.
- Additional capital may be required to replace lost cash flows, or to train or hire a replacement, if the deceased shareholder was key to the business.

On the long-term disability of a shareholder

Among the things to consider in the event of the long term disability or critical illness of a shareholder are the following:

- The disabled shareholder may no longer be able to make a contribution to the business. The other shareholders may want to purchase his or her interest.
- The disabled shareholder may want to exit the business and realize the full market value for his business interest.
- The other shareholders may need a source of liquidity to purchase the disabled business owner's interest.
- Additional capital may be required to replace lost cash flows, or to train or hire a replacement if the disabled shareholder was key to the business.

Living buy-out (retirement, dispute etc.)

Among the things to consider in the event of the departure of a shareholder due to retirement, dispute or similar reasons are the following:

- In situations where the shareholder(s) are contemplating succession amongst themselves or an involved family member, there should be provisions to allow for a smooth transfer of ownership.
- The terms of the transaction and the appropriate approvals of the other shareholders should be stated.

Marital breakdown

Among the things to consider in the event of the marital breakdown of a shareholder are the following:

- The business interest is an asset that may be subject to division of property regimes under provincial matrimonial law.
- In some circumstances, the particular shareholder may be required to provide an amount equal to a portion of his/her business interest or even of the actual business interest itself to his/her former spouse.
- The end result may be the addition of the former spouse as a shareholder or the imposition of a significant debt upon the shareholder because of the division of assets. In either case, the expectations of this shareholder or former spouse with respect to dividend policy or other business policies may no longer align with those of the other shareholders.
- Provisions can be added to the buy-sell agreement to give the remaining shareholders the entitlement to buy out the shareholder undergoing division of property and/or that shareholder's spouse, should shares in the business be awarded to that person under terms of the division of assets.

Bankruptcy or insolvency

Among the things to consider in the event of the insolvency of a shareholder are the following:

- Will creditors (the new shareholders) have the right to seize or otherwise encumber the shares of a shareholder in the event of that shareholder's insolvency? If so, the creditor becomes the shareholder and is afforded all the same rights.
- The creditors may be entitled to sell the shares in the open market without prior approval of the other shareholders.
- The creditors may force a liquidating dividend in order to satisfy claims. Other shareholders may be powerless to prevent liquidation.

Provisions for an inter vivos sale

The following is a general list of factors that should be considered when planning for the sale of shares of a business[2].

1. Shareholder loans – Loans to the company held by the selling shareholder should be settled prior to the sale closing.

2. Guarantees – The vendor should be released from any guarantees of obligations of the company.

3. Share certificates – The share certificates should be endorsed in blank for transfer and held by an escrow agent pending full payment of the purchase price.

4. Payment schedule – A payment schedule should be created specifying the timing of payments, and should include provisions for prepayment and extensions.

5. Security – The balance of the purchase price may be secured. A promissory note, a pledge of the shares, or a mortgage are typical forms of security.

6. Tax indemnification – The vendor may agree to indemnify the purchasers in respect of any additional tax liability which may arise as a result of a reassessment of the company by Canada Customs and Revenue Agency, C.C.R.A. (formerly Revenue Canada) or any other tax authority for a fiscal period during which the vendor was a shareholder.

7. Resignation – The vendor may be required to resign as an officer, employee and director of the corporation.

8. Restrictive covenant – A restrictive covenant may be prudent to ensure that the vendor does not compete against the business being sold in the same market or geographical location.

[2] Shareholder Agreements – A Tax and Legal Guide, Jack Bernstein, CCH Canadian Limited, 1988

General Information

Legal name of Business _____________________ **Incorporation date __________**

Doing business as _________________________

Ownership

Class_____

Shareholder's name	%	Director (y/n)	Officer (y/n)	Held in Trust (y/n)	Voting (y/n)	Party to the agreement (y/n)

Class ____

Shareholder's name	%	Director (y/n)	Officer (y/n)	Held in Trust (y/n)	Voting (y/n)	Party to the agreement (y/n)

Class ____

Shareholder's name	%	Director (y/n)	Officer (y/n)	Held in Trust (y/n)	Voting (y/n)	Party to the agreement (y/n)

Notes:

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Are there any related or affiliated businesses/companies?

Are there any existing share transfer restrictions in the company's articles, bylaws or other agreements?____

What events may trigger the buy-out?

	Yes	No
Death of the shareholder		
Long-term disability		
Retirement from the business		
Marital breakdown		
Resignation		
Termination		
Bankruptcy of the shareholder		
Desire to sell		

What shares are remaining shareholders required to purchase?

	Class(es)	Yes	No
All shares owned			
Shares of a specific class(es)			
Otherwise (specify)			

What proportion of shares will other shareholders purchase?

(Where other shareholders purchase)

	Yes	No
Pro rata		

Otherwise (specify)

What conditions allow for the sale to an outside purchaser?

	Yes/No	Percent Required
Unanimous shareholder agreement		
Majority shareholder election		
Seller's approval		
Other (state)		

What sales arrangement will be used for each triggering event?

Event	Shotgun	Mandatory	Right of First Refusal	Optional (Put-Call)
Death of the shareholder				
Long-term disability				
Retirement from the business				
Marital breakdown				
Resignation				
Termination				
Bankruptcy of the shareholder				
Desire to sell				

Does the sales arrangement for any event differ by shareholder? ______________________
If so, specify____
____
____
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How will the buy-sell agreement be funded?

What assurances do shareholders have that purchasing shareholders have the liquidity available to purchase their business interests at fair market value, or the agreed upon price?

Event	**Insurance**	**Cash**	**Purchaser Finance**	**Vendor Finance**
Death of the shareholder				
Long-term disability				
Retirement from the business				
Marital breakdown				
Resignation				
Termination				
Bankruptcy of the shareholder				
Desire to sell				

In the event of vendor finance:

Repayment terms ______________________________

Interest rate ______________________________

Security ______________________________

In the event of cash purchase, consider the:

- pattern of savings required to create the capital needed
- financial vehicle in which to invest these savings
- the availability of redundant assets, in the case of corporate share redemption ______________________________
____
____
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Evaluating alternative strategies for funding

It's recommended that the business owner and his/her financial advisors review the quantitative and qualitative aspects of the above alternatives as well as any others not mentioned. The strategy adopted may vary with the business owner's situation and objectives.

Where insurance is in place for funding purposes

Death

	Yes	No
Cross purchase:		
• Personally owned insurance		
• Trusteed ownership of policies		
• Identity of trustee:		
• Corporate owned policies		
Share repurchase or combination (hybrid):		
• Target corporation-owned policies		
• Holding company-owned policies		
• Other		
How will excess insurance proceeds be treated?		
• Excess remains with the beneficiary		
• Excess increases the purchase price		
• Other________________________		

How will a deficiency be satisfied where the life insurance proceeds are less than the sale price?	Yes	No
• Cash		
• Purchase finance		
• Vendor finance		

- Terms of repayment ____________________
- Interest rate ____________________
- Security ____________________

	Yes	No
Will surviving owners have the right to purchase any policy on their own life? (For individually owned policies)		

Purchase price ______________________________________

	Yes	No
Will a departing owner have the right to purchase any policy on their own life?		

Purchase price ______________________________________

Disability

How will disability be defined?	Yes	No
• According to the terms of the insurance contract purchased to fund the buy-out?		
• Other definition?		

What duration of disability will be required before the buy-sell will be triggered?	Yes	No
• 6 months		
• 12 months		
• 24 months		
• Other		

Will remaining shareholders have the right to acquire from the disabled shareholder any interests in disability insurance policies on their lives?	Yes	No
• Optional		
• Mandatory		

How will the shares of the company be valued?

Event	Fair Market Value	Pre-Determined Price	By Formula
Death of the shareholder			
Long-term disability			
Retirement from the business			
Marital breakdown			
Resignation			
Termination			
Bankruptcy of the shareholder			
Desire to sell			

Minority interests
Will valuation be pro-rata or factor in minority interest discounts or control premiums?

Life Insurance
Will the receipt of life insurance proceeds affect the value of the business interest for the purposes of the buy-sell agreement? Yes ☐ No ☐

Periodic review of the buy-sell agreement

If the price is pre-determined, does it properly reflect the value of the business?
Yes ☐ No ☐

The pre-determined price will be reviewed: (Please check one)

Monthly		Bi-annually (min. recommended)	
Quarterly		Tri-annually	
Semi-annually		Every five years	
Annually (recommended)		Other (specify)	

In the event of a significant change to the operations of the business, such as selling a significant income-generating asset or a wind down and liquidating dividend, the buy-sell agreement should be updated immediately.

A pre-determined price valuation should default to a formula or valuation should the parties fail to update the valuation at the specified times.

Formula-driven purchase price

Factors to consider:

- **Unanimous agreement of the shareholders required to determine or amend the purchase price formula**
    - There are many factors which could make the purchase price formula obsolete. A mechanism should be in place for its periodic review and modification based on shareholder approval.

- **Approval of the majority of shareholders**
    - Does modification of the purchase price formula require a simple majority, a specified percentage of votes, or unanimous shareholder approval? This requirement should be specified in writing in the shareholders' or buy-sell agreement.

- **Accepted industry practices**
    - Each industry typically has a set of generally accepted practices, whether formal or informal. One practice is generally a valuation or a "quick and dirty" method of determining what operating assets are worth at different levels of industry output. This may not be suitable for diversified business or one which holds assets not involved in operations.

- **Standard valuation practices**
    - Valuing a business on a multiple of adjusted average earnings, or on the value of its assets adjusted for fair market value changes are generally methods used by professional valuators. These methods are reasonable for use in the buy-sell agreement, depending on the nature of the company. Care should be taken in choosing a multiplier. Its best to seek the advice of a chartered business valuator in selecting a multiplier or in using these methods.

- **Comparison to the value of comparable businesses and/or sale amounts of these entities**
    - Independent, third-party buyers may ultimately use this method to assess the value of the business. It may not however be the most appropriate method to have in a buy-sell agreement. It may also be difficult to obtain current relevant information to match to company profile. This may present a problem, given the importance and urgency of accurate and objective information in a buy-out situation.

- **Price for shares vs price for assets**
    - Generally the sale is for shares in a multiple shareholder company. However, if it is contemplated that the company may be divided, a formula should be determined that values each operating segment separately, as well as the company as a whole.

Fair market value purchase price

Factors to consider:

- Independent chartered business valuators, chartered accountants, or appraisers all do valuations. Someone with a "Chartered Business Valuator" designation should be considered.
- In assessing the value of a business, a number of quantitative and qualitative factors should be considered:

  Quantitative

  - The revenues of the business
  - The assets used to earn income
  - The value of redundant assets
  - The net earnings adjusted for owner/manager compensation and unusual items over a number of years
  - The return of investment generated by the business
  - Growth in earnings
  - Gross margins and profit margins
  - Debt
  - Recurring cash flows
  - Discounts negotiated with suppliers

  Qualitative

  - Position in the market place
  - Rate of growth
  - Unrecorded assets such as contracts, patents, key customer relationships
  - Unrecorded liabilities such as claims & contingencies against the business, or warranties and guarantees extended to customers.
  - Industry
  - Competition
  - Customer loyalty and goodwill
  - Key employees
  - Workforce
  - Distribution channels
  - Brand recognition
  - Corporate alliances formed

Other considerations

How will amounts owing by the business to the departing partner be dealt with?

How will amounts owing to the business by the departing partner be dealt with?

Are the wills of the owners consistent with the terms of the agreement?

Do owners have marital contracts and, if so, are they consistent with the terms of the agreement?

Termination provisions

Under what circumstances will the agreement be terminated?

	Yes	**No**
Bankruptcy of the business		
Winding up the business		
Agreement by all parties		
Death of all owners in common disaster		
Other		

Notes
