Drafting Buy-Sell Provisions in Shareholder Agreement

Can We "Insure" Compliance?

As published in American Bar Association's Business Law Today
Volume 19, Number 5
May/June 2010

Prepared by:
Mark High 313.223.3650
mhigh@dickinsonwright.com

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The rule is simple—every closely held corporation with more than one shareholder needs a shareholder agreement. Companies with two or more owners should address at least a couple fundamental issues, such as providing for what is to happen upon the death or disability of individual shareholders. (Operating agreements generally address the same issues among limited liability company members. Much of the following discussion easily translates into the LLC context.)

Shareholder agreements can serve many other functions. These agreements can address sales to third parties, supermajority voting requirements, composition of the officers and board of directors, the dispute resolution process, noncompete provisions, antidilution provisions, "tag-along" or "drag-along" rights, or specific valuation procedures. Even registration rights are fair game.

The heart of most shareholder agreements, however, is the right or obligation of one shareholder to buy the shares of another shareholder when certain events occur. This article will review some of the most common provisions included in the buy-sell portion of a shareholder agreement, and describe how the parties can use insurance products to help get a company past a shareholder's death.

A Variety of Options

A company and its shareholders should anticipate and plan for any special event that could alter the shareholder group. Death, disability, retirement, and employee terminations are all events that a company might address. While the list of events may be relatively fixed and routine, each company will have its own way of approaching the situation, and the approaches may vary based on the event or the shareholder affected by it.

The company also can craft different approaches to different situations. Some agreements provide for mandatory purchases by the company. Some give the company the option to purchase. Sometimes the affected shareholder is given the option of offering his or her shares to the company, which the company may or may not have to honor. In some instances, the company is the purchaser; in others, the remaining shareholders are. In some cases, the

spouse of a deceased shareholder can succeed to the shares; in others, the estate of a deceased shareholder must sell his or her shares back to the company. And sometimes, all of the above are incorporated in a single agreement, depending on the situation at hand.

Be prepared to spend a lot of time on these topics. After some initial queasiness ("What do you mean, 'When I die'?"), businesspeople can get intrigued by the subject and discuss options and alternatives for days or weeks. Counsel can make suggestions and share prior experiences, but the decisions need to come from the parties. Also, be prepared to address the conflicts issues arising from the multiple interested parties involved (the company and two or more shareholders) before diving into this area.

What Triggers a Purchase?

If an event would cause the shareholders to want to reconsider their arrangement, it is ripe to be discussed and planned for. Certainly death and disability are commonly covered. Where the shareholders are employees, a change in their employment status may prompt a change in their equity status. Voluntary and involuntary terminations can be covered, with different results sometimes flowing from a termination voluntarily or with cause, rather than without cause.

Defining the events is critical, too. While death is relatively straightforward (even for an attorney), disability is especially tricky. There is almost a different definition in each agreement. One approach is to tie it to the disability definition in the company's disability insurance policy.

Early retirements also can get complex, especially in professional corporations where losing a productive fee-earner in a rare specialty can leave a hole in the practice. Often, a formula of age and length of service, combined with long periods (6 to 12 months) of advance notice, can provide a measuring stick for who can leave, and with what consequences.

Who Buys?

Once a situation is identified, the company needs to decide what it wants to do with the affected party's shares. Mandatory purchases, mandatory sales, options to purchase, and options to sell are each a justifiable outcome.

Purchases can be made by the company itself (redemptions) or by the other shareholders. Often, the company is given the first right to purchase, with the shareholders available to step in

if the company cannot or does not do so. Generally, the shareholders split up the available shares in proportion to their holdings among themselves. If one person decides to not purchase, the remaining shares are often split up among the purchasing shareholders, but this will cause a change in the shareholders' relative holdings.

It is generally good to require all of a shareholder's shares to be purchased, rather than only a part, so (1) the affected shareholder is not stuck holding a very small piece of the company with no further connection and no practical way to get out and (2) the remaining shareholders do not get an opportunity to perhaps vindictively force an exiting shareholder into a minority position.

This decision regarding the purchaser raises several factors to consider. First is the funding issue-——who can pay? Second is a tax concern, as redemptions are sometimes treated as capital gains, but also can be given deemed distribution (i.e., dividend) treatment, resulting in an unfavorable event for the selling shareholder. Third is the effect on the company's control structure, as indicated above. Fourth, keep in mind the statutory limitations on a corporation's ability to make distributions that would render the company insolvent (although many buy-sell agreements allow payments to be deferred without causing a default if they would not be allowed under the governing law). Fifth, check the company's loan documents to see if there are any limitations on payments to shareholders or changes in control.

What Price Will Be Paid?

When working with internal purchases among the company and its shareholders, the parties need to establish a price for the shares to be transferred. In a third-party outsider purchase, this is established by the outsider's offer, which is, almost by definition, a market price. The standard buy/sell agreement, however, will establish its own procedure for valuing the company and arriving at a fair purchase price. When done correctly, these can go a long way toward fixing value for IRS purposes, which can be a concern in family-owned entities.

Companies use annual outside appraisals, periodic outside appraisals, internal agreed-upon values, values based on book value, sales, EBIT, EBITDA, asset values (with or without intangible assets), a formula special to their industry, and some combination of the above. Appraisals may seem expensive but can provide the most supportable valuation if the company anticipates a challenge or objection. Be careful about relying on the shareholders to sign an

annual valuation certificate; it is always prudent to put in a backup appraisal procedure if the last signed certificate gets too stale, generally at about the 18-month point.

The next issue is what you do with the enterprise value, regardless of how you get it. Since the parties do not know whether they will be the buyer or the seller when the procedure is designed, everyone usually plays nice and tries to establish a fair mechanism. Sometimes, however, minority discounts are taken. Parties also may try to punish a bad actor, or at least provide incentives for a valued contributor to stay in place. The possibilities are almost endless. For example, an employee terminated without cause might have his or her shares repurchased at their full value, but a voluntary early retirement or a termination for cause may result in a substantial discount to full value, or a delayed payout, or both. Be wary of requiring a deep discount or even complete forfeiture of ownership interests, which seems vulnerable to attack as overreaching and unreasonable. Also, remember to coordinate those employment and shareholder agreement provisions, clarifying that shareholder status does not guarantee employment.

How Is the Price Paid?

Once the price is established, the next issue is to provide how it will be paid. It is hard to estimate the effect of a purchase obligation on the company that will occur at some point in the future, at a price that is not going to be known before then, and with no way of gauging what the company's financial situation will be like. Nevertheless, that is the task at hand.

From the company's standpoint, it does not want to subject itself to a large lump-sum payment obligation out of the blue, or saddle itself with onerous periodic payments. Even worse would be to have several shareholders being bought out at the same time, which can happen at smaller professional firms in the midst of a generational change. This can suck up any free cash flow the company may be generating, leaving the remaining workers in a cash-poor situation and harboring at least some degree of resentment toward their former partners.

For the shareholder, this introduces an element of credit risk to an already complex and uncertain situation. If the shareholder is counting on this major investment providing substantial assets for a spouse upon death, or cash flow for him- or herself at retirement, then this will be a major pressure point.

The procedure is often the same whether the ultimate buyer is the company or one or more of the shareholders. Again, in most situations, the parties are unsure as to what side they will be on when the issue comes up, and this helps push them toward a middle ground. This does not mean they are easy negotiations, but it can be a great service to the company to establish a buyout procedure that at least gives it a map to navigate through a critical transition.

Buyer-Financed Buyout

There are few rules that are universal. Here is one that approaches that standard: Sellers like cash at closing. In most shareholder settings, that is not a practical alternative. A lump-sum buyout can be a burden, and it is the rare company that sets up a sinking fund to cover its future buyout obligations. Not only does that tie up cash that could be used as working capital or currently paid out to the other owners, but, for C corporations, it can result in accumulated earnings problems on the tax side.

The other way that sellers can be paid out is through the company (or purchasing shareholders) borrowing the purchase price under its credit line with the bank. This puts the funding cost fully on the borrowing company in the form of interest payments and reduced credit availability to fund the business. Banks are also very reluctant to allow even healthy companies to take borrowed funds and send them upstream to reduce someone's equity position. They will talk about fraudulent conveyances, preference payments, and the like, but fundamentally, it just seems to violate a law of nature for them.

Seller-Financed Buyout

More common is a deferred purchase price, one paid over time. Certainly, it spreads out the buyer's pain, but this also can provide the seller with deferred tax liabilities. Often, there will be a significant down payment at closing, with the company issuing a promissory note to evidence the remaining payment obligation. Often, the note is subordinated to the company's senior credit facilities. The selling shareholder is entitled to interest at a rate that reflects the circumstances and credit risk involved. The sale is generally effective at closing, and the former shareholder assigns its shares to the buyer, for cancellation or transfer, as appropriate.

The seller may want to impose covenants on the company's actions to protect his or her payment stream, such as restricting dividends to other shareholders while he or she is still owed money, or at least if his or her payments are in default. A shareholder may ask for security on

the payment obligation. Depending on the circumstances, these can be reasonable requests, although the company needs to check its lending covenants to see if they would require the consent of its bank. Sometimes, the shareholder agreement anticipates these issues, but they can come up at the time a purchase is contemplated. Often, a pledge of the purchased stock is provided as security. Although not perfect, it is certainly preferable from the company's standpoint to the alternative procedure of purchasing a few shares back each time a payment is made.

Funding a Buyout Through Insurance

That down payment can be a critical part of a buyout brought about by a shareholder's death. Not only can it serve to reduce the outstanding amount owed, easing the buyer's ongoing payment burden and reducing the seller's credit risk, it might be needed to allow the seller to meet his or her estate tax obligations. It can be a burden, however, for the buyer (whether company or shareholder) to come up with a lump sum on perhaps little or no notice.

One approach is to have the company purchase a term life insurance policy on each of the shareholders to cover at least the down payment obligations. This effectively forces a prefunding of some of the repurchase obligation. Although the insurance premiums on policies where the company is the beneficiary are generally not deductible, with some advance planning, insurance proceeds are often received tax-free. (There can be different rules on this for entities taxed as corporations as opposed to flow-through entities, so check for your specific situation before deciding on a final approach.)

Similarly, where the shareholders will be the buyers, they can purchase policies on each other's lives to help cover the buyout cost. As with company-purchased policies, premiums paid are probably not deductible, but proceeds may not be taxable income to the beneficiary-shareholder.

There can be difficulties with shareholder-purchased policies. One is simply making sure each shareholder keeps up with the premium payments to keep the policies in place. Other problems can develop over time in an insured buyout situation, perhaps as the company's value grows, making the insured amount inadequate for the task at hand. The costs can escalate over time if a shareholder's health changes, or just due to age, as new or replacement policies are needed. If the shareholders are in different circumstances (e.g., different ages or states of health), the

variation in premiums can result in unequal costs. Nevertheless, many companies choose to use, or at least to allow for the possibility of using, insurance to help fund buyout obligations.

Cross-Insurance

An insurance program can be rather straightforward in a company with two shareholders—either the company purchases a policy on each shareholder or each shareholder buys one on the other. More shareholders make for difficult cross-insurance situations. With three shareholders, each one now needs two policies on the others, meaning a total of six policies. The problem only escalates from there.

The same problem exists where there are several related companies with identical, or overlapping, shareholder bodies. Even where the companies are designated as the primary purchasers, it can be complex to work through and administer a number of policies where each company insures its own equity holders.

Some clients have both these situations—multiple shareholders (maybe spanning two generations) and multiple companies (an operating entity, a real estate company owning the primary building, an equipment leasing company owning some of the major operating assets, a related company in another location with a local partner, and so on). Designing a traditional cross-insurance program here would be impossibly complex, and yet the same concerns still need to be addressed. What is a counselor to do?

Cross-Insurance Trusts

There is a relatively simple way to solve this problem—connect the funding source with the payment obligations at one central point. To do this, each company starts with its own buy-sell agreement, setting out its purchase events and prices, as in a normal situation. The parties then establish a simple trust, and the companies, each of the shareholders, and the trustee enter into a cross-purchase agreement.

This agreement has several purposes. First, it requires each shareholder to assign the record ownership of his or her equity interests to the trust. Often, they also deliver the stock certificates and stock transfer powers executed in blank to the trustee. This simplifies the ultimate purchase process, as all the share certificates and assignment documents are centrally located and ready

when needed. The holders retain a beneficial interest in the shares, allowing them to vote and receive dividends and other distributions.

Next, each potential purchaser (whether redeeming company or cross-purchasing shareholder) covenants to complete the purchase it has agreed to do in the separate company buy-sell agreements, and to use any proceeds received under the cross-purchase trust agreement to make those purchases.

Finally, the trust agrees to obtain life insurance on each shareholder in an amount to cover some or all of the potential purchase obligations. The trustee holds the policies for the benefit of, and at the expense of, the potential purchasers. The trust then has the obligation of collecting the policy proceeds at the appropriate time, and distributing them to the appropriate purchaser in a way that allows them to make the appropriate payments, as they had agreed.

Suddenly, a complex process has been streamlined, and the parties can go back to operating their business, knowing that at least one situation is under control. There are certainly some setup expenses and ongoing administrative obligations, but experienced counsel and financial advisors have worked with these before, so the cure is not worse than the disease.

Conclusion

Shareholder agreements are among the most common, and most critical, documents that are in a close corporation's files. They do not need to be complex, or elaborate, but they do take some time to craft. As a side effect, this process also can lead to a better understanding on the lawyer's part as to what the company and its stakeholders are really intending to accomplish. Better understanding between lawyers and clients may not change the world, but it can lead to more effective and efficient representation, and, as side effects go, that is a pretty good one.

High is a member in the Detroit office of Dickinson Wright PLLC. He is a member of the ABA Business Law Section's Corporate Documents and Process Committee, helping to draft a Model Shareholder Agreement. His e-mail address is mhigh@dickinsonwright.com.