The 8 Basics
Of A Buy & Sell Agreement

1) Who Are The Parties To The Agreement?

2) What Is Being Sold?

3) When Are The Shares to Be Sold?

4) How Is The Price Of The Stock Calculated?

5) When Is The Price Calculated?

6) When Is Payment To Be Made To The Estate?

7) What Security Is to Be Given To The Estate During The Period Of Any Deferred Payments?

8) When Will The Agreement Terminate?

1) **Who Are The Parties To The Agreement?**

The parties to the agreement can be the corporation with the shareholders and/or the shareholders themselves and not the corporation. The life underwriter should make sure that, if any insurance is in force, the insurance ownership and the beneficiaries of the policies coincide with the agreement.

2) **What Is Being Sold?**

The buy and sell agreement should be checked with the shareholders to be sure that they understand what is being sold. For instance, if the corporation owes money to the shareholders, is it intended that the debt be wiped out by the agreement? If the debts are to be added to the sale, does the agreement reflect this fact?

3) **When Are The Shares To Be Sold?**

Are the shares to be sold immediately after death, or are they to be sold at a later date?

Often an agreement will require shares to be sold by the estate of the deceased shareholder on a delayed basis, which can cause substantial problems for the executor and the heirs of the estate. As an example, suppose a shareholder owns 100 shares of stock in a closely held corporation. An agreement might provide that the stockholder's estate might be required to sell a few shares of stock each time the corporation paid the estate a partial payment. This happens in many buy and sell agreements in which the surviving shareholders expect to be protected against payments of substantial amounts, which can cause them financial difficulties. The effect of this provision is that the estate might be paid for a few shares of stock and be left holding the bag for many years until the corporate officers decide to make another payment. Hence, it is imperative that the buy and sell agreement stipulate when the shares are to be sold to protect the estate from unreasonable delay in payment.

4) How Is the Price Of The Stock Calculated?

Many times, the price is established either on a "fixed dollar" value, or based upon a "formula" for calculating the price. If the price is a fixed price, does the fixed price reflect the value of the shares in good times and bad? If a formula is used, is the formula one which properly reflects changing values? As an example, real estate, machinery and similar assets may be depreciated on the books of the corporation, but the *real* value may have appreciated. Does the formula recognize this appreciation? Inventory values may be valued at cost, or at a lower market value to reduce corporate income taxes. Frequently, the value of the inventory is conservatively valued resulting in an under-valuation of the shares and, hence, would reduce the price to be paid to the estate. It is impossible to state whether the price of the stock should be calculated based upon a fixed price or based upon a formula. What is important is that the stockholders understand what their agreement provides and that a calculation be made periodically to determine how much each shareholder's estate would be paid pursuant to the agreement if death occurred.

5) When Is The Price Calculated?

Is it calculated as of the instant before death, or the instant after death? Frequently, the formula will provide that the calculation is to be made as of "day of death". This can cause confusion and possible litigation. The problem is easy to understand if life insurance is in force on the life of the shareholder payable to the corporation. Suppose a corporation has $100,000 of insurance on a shareholder's life. If the formula is calculated as of the day before death, the $100,000 of insurance proceeds will not be included in determining the price. If the agreement states the calculation is to be made as of the day after death, the $100,000 insurance proceeds would then be added to the remaining assets in determining the price to be paid to the estate. It is not for us, the life insurance agent, to suggest "as of when" the price should be calculated, but the parties to the agreement must understand the effect of the language of the agreement.

6) When Is The Payment To Be Made To The Estate?

Does the agreement permit the corporation to pay for the shares owned by the decedent stockholder over a period of years? What is the interest rate stipulated in the agreement for the unpaid balance owed the estate? Is the corporation going to be able to earn enough money after taking care of the normal needs of the business to carry inventory, carry accounts receivable, and pay the income taxes, and still leave enough money to pay the estate the price determined by the agreement?

Generally speaking, in days of high inflation, corporations have substantial debts incurred to carry accounts receivable and inventory and have little or no money to pay for shares purchased at the time of death. In inflationary periods, the value of the business may increase rapidly on a current value basis, but *available* cash *after* paying income taxes is scarce. At this point of the discussion of a buy and sell agreement, I usually ask the shareholders whether or not they have considered the problem that arises for the surviving shareholders if inflation continues. The purpose is to have them consider the position they would be in if the corporation had to raise the money to pay the estate of the deceased. I point out that if the shareholder is uninsurable, the problem becomes acute.

7) What Security Is To Be Given To The Estate During The Period Of Any Deferred Payments?

Frequently, the existing agreement has a provision which will inhibit the surviving shareholders from carrying on the normal business operations. Often the corporation must pledge to the estate of the shareholder assets which can cost the corporation substantial opportunities to make a profit. As an example, the agreement might prevent the corporation from borrowing additional funds from a bank to maintain inventory or accounts receivable. If the corporation cannot incur the additional bank debt particularly in these inflationary times, the corporation could be severely restricted in its operations. The surviving shareholders might find themselves without any opportunity of maintaining the business and will be forced to liquidate the corporation.

Some agreements require the surviving shareholders to pledge their stock to the estate of the deceased as security.

What happens if a second shareholder dies? His heirs and beneficiaries are second class citizens to the heirs of the first to die. If the heirs and beneficiaries of the first to die give up their security under the agreement, what protection do they have from the acts of the officers who run the business? Will the surviving officers run the business into the ground because the deceased shareholder might have been important to the operation of the business?

The last basic requirement of the buy and sell agreement refers to the duration of the agreement. Sometimes the agreement is permanent, until the death of a shareholder or amended by consent of all parties.

8) When Will The Agreement Terminate?

Very often the agreement will stipulate that it is operative only for a term of years, such as 5 or 10. Many things can occur during a term of years. The business may increase substantially in value or the health of one or more of the shareholders may become impaired. When the present agreement terminates, the healthy shareholders might attempt to negotiate a new agreement with lower values than the previous agreement. The reason, consciously or unconsciously, might be biased because of the ill health of the shareholder who might be expected to die. If the corporation needs money, the healthy shareholders might rationalize that the corporation cannot afford to pay the money to an estate of a shareholder. Of course, life insurance solves this problem. Hence, many agreements do not terminate until the death of a shareholder or until sale of the shares during lifetime.

A corollary problem could arise if the agreement does not terminate until the deaths of all of the shareholders. Will the changes in value of the business result in the fixed price or the formula established by the agreement reflect a realistic value of the shares? If so, the agreement could amended by common consent of all parties from time to time. If the shareholders are uninsurable, the problem of changing values can be resolved and an amended agreement can be executed.