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Insuring a shareholders’ buy/sell agreement

Is your business prepared if a shareholder dies? What happens to their interest in the business? Read about buy/sell agreements and how life insurance can fund the obligation upon the death of a shareholder.

Buy/sell agreements between shareholders provide the terms and conditions for the transfer of share ownership after a death, retirement, disability, bankruptcy, marital breakdown or shareholder dispute. Under the agreement, one or more parties agree to purchase the shares of another shareholder at a fixed price, or for a price that follows a specified formula if certain events take place. The agreement can be a separate agreement among the shareholders and the company, or it can be included in a comprehensive shareholders’ agreement.

This article discusses buy/sell agreements with a focus on how life insurance can be used to fund the buy/sell obligation upon the death of a shareholder.

Funding the buy/sell agreement

It’s important to fund the buy/sell agreement in advance so the other parties can buy the shares at the time of a shareholder’s death. Life insurance provides guaranteed funding and is often more cost-effective than starting a sinking fund, selling assets, or borrowing funds from a bank.

- Canada Life™ offers competitive rates, guaranteed at issue, to fund buy/sell arrangements.
- Our term life insurance policies may be converted to permanent insurance policies.
- We offer a business growth protection rider, to be purchased at issue, that can provide additional coverage as the business grows.
- Our customizable term coverage durations let shareholders plan for scheduled departure dates such as a shareholder’s retirement.

The need for a buy/sell agreement

The deceased shareholder and surviving shareholders have different needs and concerns to consider.

Deceased shareholder’s perspective

- How will my estate pay the tax liability associated with the deemed disposition of my shares as well as my other final testamentary expenses, debts, etc.?
- Do my heirs want to be active owners or passive investors in the business? This is important because without an agreement, heirs will inherit the shares.
- If my heirs don’t want to be involved in the business, is there a market/buyer for the shares?
- Will my heirs receive payment equal to the fair market value or a discounted value of my shares?
- Do I want my heirs to receive the value of my shares in cash to maintain their standard of living or do I want them to rely on the future of the business for ongoing living expenses?

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Surviving shareholder's perspective

Do I want:

- To be in business with the deceased shareholder's heirs?
- My hard work to pay dividends to the deceased shareholder's heirs?
- To sell business or personal assets to generate the funds I need to purchase the deceased's shares?

Advantages of a buy/sell agreement

Ensures a buyer for the shares

Typically, there's no ready market or buyer for a private company so it may take a long time to sell a shareholder's shares. These agreements establish a market and buyer (other shareholders and/or the corporation) for shares that might be difficult to sell.

Guarantees heirs a fair price

These agreements are usually drafted when parties are healthy and can objectively agree to a price or valuation method. In the case of a shareholder's death, their estate and heirs don't depend on the other shareholders or the financial success of the business for future income.

Offers protection from unwanted shareholders

Surviving shareholders aren't forced to conduct business with a deceased shareholder's heirs who may not be capable of managing, participating, or working in that business.

Allocates shares in agreed manner

These agreements can specify the proportion of shares other shareholders need to purchase. This can ensure that certain shareholders retain their majority of votes and participation in profits.

Establishes the method of determining price

Shareholders agree to a price or valuation method in advance. This reduces the potential for disputes and helps them obtain the insurance coverage they'll need to fund the purchase price.

Disadvantages of a buy/sell agreement

Timing and terms

Circumstances and wishes may change over time. If the buy/sell agreement isn't updated, it may not reflect the current situation and wishes of the shareholders.

Estates and heirs must sell the shares

If a shareholder dies, their estate and heirs may be required to sell their shares even if they want to remain as owners and participate in the business.

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Surviving shareholders must buy the shares

Shareholders must have funds available to purchase shares. In the case of the death of shareholder, the timing is generally unknown. If the deceased shareholder was also a key employee, finding the funds to carry out the buy/sell agreement adds to the other challenges surviving shareholders may already be facing.

Guarantees of a pre-funded buy/sell agreement

- Funds are available to purchase shares.
- The estate or heirs aren't dependent on the surviving shareholders or financial success of the business for their future income or payment of the shares' purchase price.
- That the sudden death of a key employee does not affect the borrowing capacity of the business, or its shareholders, or force them to sell valuable assets.

Non-insurance funding considerations

Surviving shareholders may rely on different sources to arrange the required funds including:

- **Sell assets?** How would this impact business operations? Could assets be sold when required? Would they generate the required cash? What are the tax implications?
- **Borrow from a bank?** Would the loan be granted? If yes, how will the unforeseen loan affect business plans for the future? Would the bank's requirements always be met? How and when would the loan be repaid?
- **Issue a promissory note?** Would shareholders want to be indebted? In the case of the death of a shareholder, does their estate want to rely on the future success of the business for the purchase price of the shares? How will their estate and heirs pay final expenses and taxes without having immediate access to the funds?
- **Cash on hand or save with a sinking fund portfolio?** Is it realistic for the business or shareholders to save the specified purchase amount? What if a shareholder dies tomorrow?

Advantages of funding with life insurance

- Shareholders receive necessary funds precisely when needed, provided claims requirements are met.
- Shareholders aren't forced to sell assets or take out loans.
- Guaranteed base death benefit not affected by capital market risks.
- Base premium costs are known at issue so shareholders can budget for the cost of life insurance.
- Some permanent life insurance policies allow premiums to be paid from policy dividends which could limit out-of-pocket premiums for shareholders.
- Generally, the amount of the death benefit received by a private corporation, in excess of the policy's adjusted cost basis, credits its capital dividend account. This gives the corporation the opportunity to declare tax-free capital dividends to the estate or any remaining Canadian resident shareholders.
- An optional, additional benefit for business growth protection can increase the insurance coverage based on the growth of the business, ensuring sufficient funds will be available when needed

Determining the amount of insurance

The amount of insurance needed depends on the value of the shares of the deceased shareholder at the time of his or her death.

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Depending upon the business's growth rate, additional insurance coverage may be required in the future at a time when a shareholder may not be able to get additional insurance because they no longer meet the underwriting requirements. It may be a good idea for shareholders to buy an optional, additional benefit for business growth protection to meet the future needs of the business.

Structuring life insurance

Once shareholders decide to purchase life insurance to fund a buy/sell agreement, it's important to structure insurance ownership to fit the client's goals and unique circumstances. There are different ways to structure life insurance ownership and beneficiary designations. Please refer to our separate articles explaining the more commonly used methods (i.e., crisscross purchase, promissory note, share redemption, and hybrid) including their advantages and disadvantages.

Life insurance clauses for buy/sell agreements

After they decide to fund the buy/sell obligation with life insurance policies, shareholders should consider adding clauses, as appropriate, to the buy/sell agreement after discussions with their tax accountant and lawyer:

- If, and how, the life insurance policies may be transferred or terminated, if the parties want to end the agreement.
- On the death of a shareholder, in the case of a crisscross buyout arrangement, the deceased person's estate assigns their ownership in the remaining life insurance policies, if any, held on the lives of the remaining shareholders.
- List insurance policies on a schedule to the agreement with a provision to add additional funding as required by any increase in the value of the business.
- Restrict shareholders and the business from using the insurance policies for purposes other than to fund the buy/sell during the term of the agreement.
- Predetermine timing to complete the purchase of a deceased shareholder's shares. This could be the date the insurance proceeds are received or a certain number of days after death. If the insurance proceeds aren't enough to cover the purchase price, the agreement may provide any excess be payable, over a specified period, with interest payable on the unpaid balance of the purchase price.
- Shareholders agree to exercise their influence and vote their shares to ensure the corporation uses its capital dividend account when facilitating the buyout of the deceased shareholder.

Conclusion

A buy/sell agreement is an important contract that every business and business owner with multiple shareholders or business partners should consider. Once established, these parties should ensure that the agreement is adequately funded. Life insurance may be the most economical and efficient means to guarantee funds are available to meet buy/sell obligations arising from death.

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