Don’t Overlook the Importance of Corporate Buy-sell Agreements
by Danny Klinefelter¹

As commercial agriculture becomes more industrialized and involves more multiple-owner corporate entities, part of the credit analysis needs to consider that relationship between the owners as it relates to business viability. Just as written leases formalize landlord-tenant relationships, written buy-sell agreements can be critical in terms of the business’s financial condition and performance if owner relationships change as a result of death, disability, divorce or the departure of one or more of the owners. These issues are frequently not discussed, not put in writing, or not addressed until a problem arises. In many instances, these issues have been at least as important as commodity prices and production levels in determining long term business viability.

There are three types of buy-sell agreements: cross-purchase agreements between the individual shareholders, entity agreements between the corporation and its shareholders, and a combination of the two. While there are an unlimited number of provisions that may be included, this article outlines few of the more important ones.

A right of first refusal. This provision allows the corporation or other shareholders to purchase stock proposed to be sold or transferred by a shareholder by matching the terms offered for the stock.

Put or call provisions. A “put” provision specifies the right of shareholders to sell their stock back to the corporation at some formula based price is specified conditions are met. A “call” provision specifies the right of the corporation to purchase a stockholder’s shares at some formula determined price if specified events occur. Common triggering events include death, disability, divorce, or discontinuation of employment.

A valuation provisions. One of the most frequent sources of conflict and litigation centers around the value of stock in closely held businesses. A buy-sell agreement can help avoid these problems by specifying a valuation method agreed upon by all the shareholders. Valuation methods take many forms such as earnings multipliers, capitalization formulas, book value, or formal market value appraisals. It is extremely important that spouses have signed off on the agreement or entered into a separate spousal or prenuptial agreement, particularly in community property states.

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Installment purchase provision. This provision can avert or at least minimize potential liquidity or capital adequacy problems that would be created by the purchase of a major shareholders stock. The agreement should specify a payout period, often 5-10 years, and the basis for determining the interest rate to be paid on the unpaid balance.

Conversion rights. This provision relates to management control. It defines the right or the obligation to convert from one class of stock to another. It may be from voting to non-voting common or from common to preferred stock. Many buy-sell agreements specify that only those actively involved in management, serving on the board of directors, or employed in the business can hold voting stock. Termination, retirement, disability or gifting stock to someone not working in the business may trigger a conversion.

A dispute resolution provision. This one way to reduce the likelihood that disagreements will end up in litigation. The provision states that the shareholders agree to settle any disputes related to the terms of the agreement by submitting to mediation and failing there by submitting the issue to an arbitrator.

Two other provisions frequently included are antidilution rights and take along rights. Antidilution rights specify that if the corporation issues new stock, existing shareholders have the option but not the obligation to purchase share in proportion to their current ownership percentage. Take along rights require a controlling shareholder(s) to negotiate the right of minority shareholders to receive the same terms on a pro rata number of their shares if the controlling stockholder(s) sells all or part of his shares. These rights will become more important as business value is created through contractual arrangements, franchise rights, quotas or patents.

It is important that the terms of these agreements are reviewed regularly and that any changes are signed off on by all parties with a direct ownership claim.