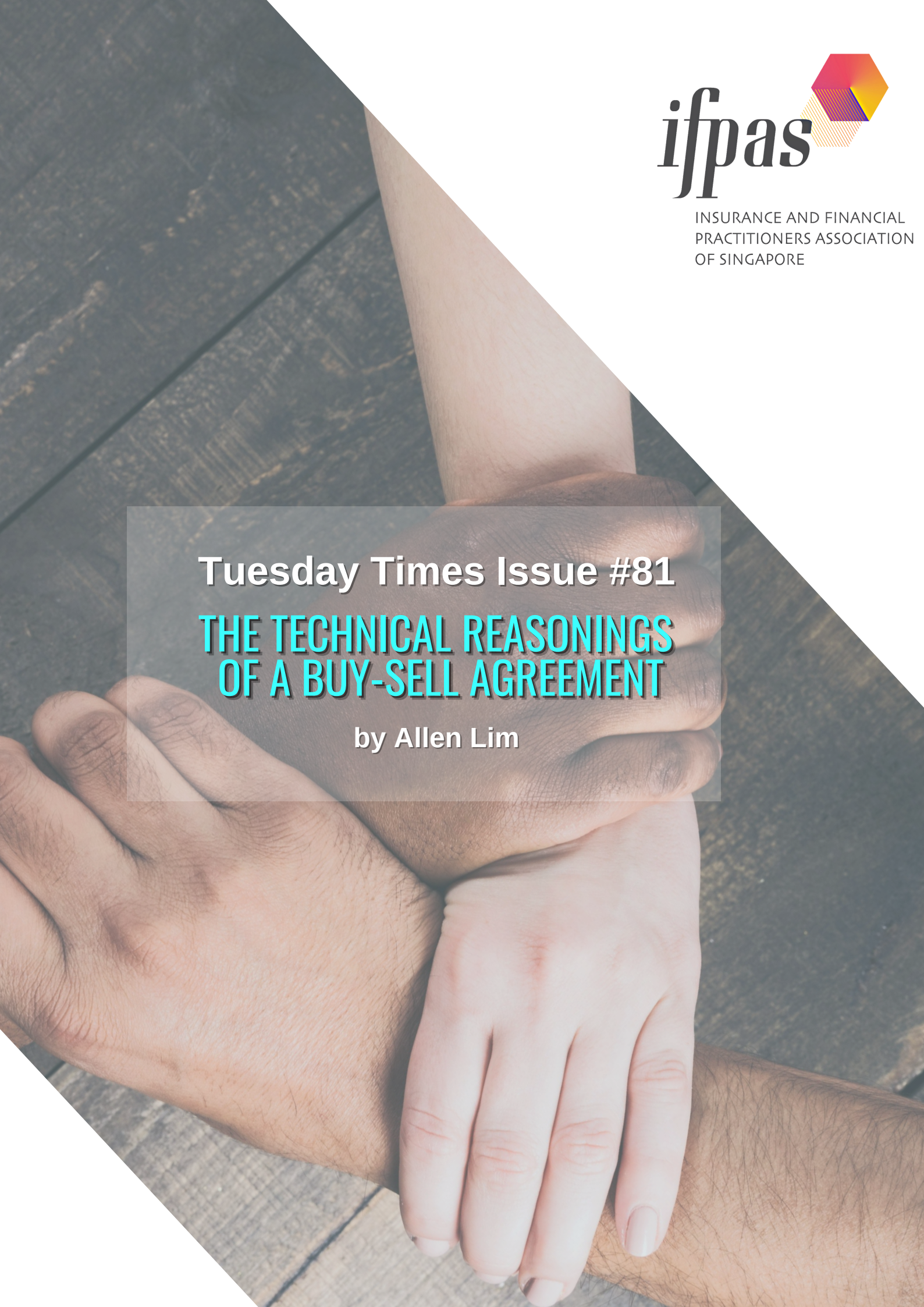

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by Allen Lim

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THE TECHNICAL REASONINGS OF A BUY-SELL AGREEMENT

The technical reasonings of a buy-sell agreement

COVID-19 has seen an increased number of clients seeking estate planning services, and amongst this group of clients, a high proportion are business owners. Evidently, the risk of death or critical illness is keenly felt by all in this unusual time. One of the key estate planning tools for a business owner is a buy-sell agreement. The purpose of this article is to highlight the technical reasonings of this tool. To keep things simple, let's assume the business structure is a private limited company, and the shareholders consist of a small group of people.

Effects of death on business

To understand the buy-sell agreement, it is necessary to first understand the effects of death, on the business. Business shares are tangible assets that will form the estate of the deceased business owner. This means that the business shares have to be included in the schedule of assets for submission to the state or high court to clear probate, after which, the inheritance rights of these shares are based on the Intestate Succession Act, Administration of Muslim Act (if the deceased is a Muslim) or a valid Will. This will give rise to 3 risks:

a. Risk of estate creditors – As the shares are part of the estate, they are completely exposed to estate creditors. The shares could then be liquidated or forced sold to satisfy estate debts such as unpaid taxes, mortgage loans, guarantees, or arrears in alimony or child maintenance. Therefore, if the business is an income generating asset or the main source of wealth for the family, the consequence of an unplanned liquidation or forced sale can be detrimental to both the business and the deceased's family.

b. Risk of undesirable successor(s) – As there are no planned successors to the business shares, the relevant beneficiary under the will or intestacy laws will be the lawful successor. Such a situation could bring more grief than joy to the business. Legally, a share (of business) has its rights and obligations. The rights are:

1. Right to expect dividends upon declaration of final dividend
2. Right to observance of company constitution and Companies Act
3. Access to meetings and information (financial statements or otherwise)
4. Pre-emption rights
5. Right to bring legal proceedings against or on behalf of the company
6. Right to vote
7. Rights in the event of winding up due to insolvency

The corresponding obligations are:

1. Approving the declaration of dividends
2. Appointing and removing of directors
3. Reading and responding to communications from the company
4. Attending general meeting and raising areas of concern
5. Policing wrongdoing of the directors
6. Exercising voting decisions
7. Paying for shares

Can you picture the harm that may be done to the business if the above rights and obligations are given to a heir who might not appreciate or respect the business?

c. Risk of forced liquidation – Perhaps the most damaging risk is the exposure to a forced liquidation by a shareholder. Under Section 216 of the Companies Act, a shareholder can apply to the court to wind up a company under "Just and Equitable" ground. Amongst the reasons for just and equitable ground are:

1. The company pursues a different path to that originally envisaged
2. The minority shareholder felt oppressed and excluded from the management of the company
3. Non-agreement by conflicting shareholders on the management and governance of the company

A classic example is the case of Ting Shwu Ping (Administrator of the estate of Chng Koon Seng, deceased) v Scanone Pte Ltd and another appeal (2016) [SGCA 65].

In this case Mdm. Ting inherited the shares rights from her deceased husband, disputed with the surviving shareholder on the buy-out price, and applied to the court to wind up the company. The judge dismissed her appeal because of an existing buy-out mechanism in the companies' constitution then.

The buy-sell agreement

After a good understanding on the rights and obligations of business shares, it is not difficult to see the point of ensuring a proper transfer of the shares to the right party. This would then explain the main reason of a buy-sell agreement. In effect, such an agreement would create a legal contract to transfer the rights and obligations of business shares to another party at an agreed valuation, an agreed trigger event and an agreed funding vehicle. I shall now explain how a buy-sell agreement can mitigate the 3 risks as mentioned previously.

a. Buy-Sell Agreement can mitigate the risk of estate creditors – Under this situation, the transfer of shares is via contract instead of estate. Hence, the shares won't be held up in the probate process and be subjected to estate creditors' claim.

Instead, the value of the shares will be realised by payment from the buy-sell agreement counter party. And this payment will then be subject to probate. The important thing to note is, the rights and obligations of the shares are being transferred to the intended party.

b. Buy-sell agreement can mitigate the risk of undesirable successor – As the shares' successors are pre-determined and formalised via a legal contract, it reduces the likelihood that the shares land on the hands of undesirable successors via Interstate Succession Act, Administration of Muslim Law Act, or the will. I need to emphasize that though a will can indicate the successors as well, but the difference is that the shares would then be subjected to probate before it can be transferred to the testamentary successors. Having a buy-sell agreement would avoid that situation.

c. Buy-sell agreement can mitigate the risk of force liquidation – A well-executed buy-sell agreement (i.e. properly drafted and documented with acknowledgement by the company's directors) has a strong case to prevent surviving shareholders using Section 216 of Companies Act to wind down by force and liquidate the company. This is because the buy-out mechanism of the shares has been deliberated, agreed, and formalised in a legal contract.

Funding the buy-sell agreement

The funding of Buy-Sell Agreement needs to be seen in the right perspective. Having an agreement without deep considerations on the funding mechanism is tantamount to professional malpractice. Because, the selling party can sue the buying party for non-performance of the contract. Citing a lack of capital and liquidity is not acceptable. Essentially, there are three ways to fund the agreement (the principal consideration is to have a guaranteed capital and liquidity at death of a shareholder).

i. Savings – The first way is to set aside a fund each year via retained earnings of the company or personal savings by the shareholders. This is highly ineffective because one is locking up the funds which could have been better utilised to run the business or for investment. Second, this method assumes one has the luxury of time to accumulate the funds, but the reality is, be it death or tomorrow, whichever comes first, no one can predict.

ii. Borrowings – The second way is to borrow from bank. This method isn't feasible as well, because there is no certainty that the bank will avail capital to the company or buying parties. This is especially so because, if the death of one shareholder severely affects the credit standing of the company, the bank might not avail the capital, or if it does, it may do so with a high lending cost at best. And in the worst-case scenario, if the bank withdraws the existing credit facility, this could effectively collapse the company financially and render the Buy-Sell Agreement not meaningful.

iii. A Life Insurance – The third method is using life insurance policy to provide the funding death. it is important to see this from the perspective of having a certainty of capital and liquidity triggered by the death of the shareholder. Moreover, the capital (represented by the death benefit of a life insurance policy) is purchased with a much lower cost (represented by the premium). However, though this method is good, it has its limitation if the shareholder is not medically insurable. One point to note is that, in underwriting a life insurance policy for this purpose, the sum assured is based on the valuation of the shares held by the shareholder as indicated in the buy-sell agreement, and not on the human life value of the shareholder.

Conclusion

In conclusion, this article highlights the technical reasoning of a buy-sell agreement in the context of estate planning for businessmen. A business has a life of its own, and if the share ownership falls into the wrong hands, the demise of such a business may be quick. Hence, business succession warrants serious planning, which is best guided by a trained professional adviser, to ensure the succession is equitable, fair and meaningful.

ABOUT THE AUTHOR

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