CORPORATE MATTERS:
BUY/SELL ARRANGEMENTS

Author
Simon H. Prisk

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In our May issue, we discussed the implications and importance of drafting governance documents to cover the death of a business partner. We thought an appropriate follow-up would be a brief examination of buy/sell provisions.

Buy/Sell provisions deal with the transfer of ownership interests, typically within a business enterprise, when one of the partners wants out, or, potentially, wants another partner out. In either circumstance, it is not uncommon for each partner to want to carry on with the business – just as long as the other partner is excluded.

One buy/sell provision that is designed to deal with this situation is the "shotgun" buy/sell provision. As dire as this provision sounds, it is designed to be a fair way to transfer ownership in the event of a dispute. Its use is perhaps best suited to 50/50 ownership structures where the parties are on equal financial footing, but it can also be used in situations involving multiple owners.

When a shotgun clause is triggered, one shareholder makes an offer to the other shareholder to either sell his or her shares or to purchase all of the shares owned by the partner. The offer must set out the terms detailing what the offeror believes is an appropriate transaction value for the shares and appropriate terms to consummate the transaction. At that point, the recipient of the offer is either a buyer of the shares of the shareholder making the offer or a seller of his or her shares to the offeror. The shotgun buy/sell provision is potentially fair to both parties, as the initial offeror does not know whether the price and terms contained in the initial offer will be accepted (so that he or she has sold the interest) or rejected (so that he or she has purchased the interest of the offeree). The specified price must, therefore, be carefully considered as rejection creates an obligation for the offering party to buy the offeree's interest at the same price at which the offeror was willing to sell.

While a shotgun buy/sell provision is typically used only in the event of a deadlock caused by an irreconcilable disagreement between parties on an issue that is fundamental to the existence of an entity, it is can also be be drafted so that it can be triggered at any time by one of the partners. When a deadlock triggers its use, the type of deadlock may be defined in the governing documents and can include matters such as a failure to approve an operating budget for successive years. One also sees agreements where either party may invoke the provision after a certain time. We would not advise a client to use the procedure in this way, as it creates a situation where the partners are living with the constant threat of the shotgun provision being triggered by the other party, and this is definitely not conducive to a harmonious relationship.

As mentioned earlier, the shotgun buy/sell provision works best with two shareholders or two clearly defined groups of shareholders. In an 80/20 scenario, the 20% owner would have to come up with four times the funds as the 80% owner, and if the minority owner wanted to leave the entity, he or she could potentially end up in a situation where he the 80% owner of a company must be bought out in order for the minority shareholder to exit.

In practice, the fairness of the procedure can also be questioned, especially when the parties have unequal access to capital. The procedure favors the party with the deepest pockets, as an owner with the most money is able to put together an offer that the other party cannot match and can live with a resulting premium, if so required.

An exit strategy that avoids this potential for unfairness is a right of first refusal. Rather than making an offer for the other shareholder's interest, a shareholder who wants to exit the entity is entitled to find a buyer for his or her shares with the only restriction being a right of first refusal in favor of the other shareholders. While selling shares in a closely-held company is often difficult, this can still be a meaningful exit strategy. Closely related to a right of first refusal is a right of first offer. Here, the party wishing to exit sets a price below which he will not sell and payment terms and conditions that are acceptable and offers to sell at that price to the offeree partner. The offeree party can accept that offer under those terms or let it pass. At that point, the offeror has a period of time to identify a purchaser willing to pay an amount that is not less than the price set in the offer under terms that are not less favorable. As can be seen the difference between these two approaches is that in the former, the offeree need not act until the end of the process, when a *bona fide* offer is received. In the latter, the offeree must make his decision at the start of the process.

Many legal advisers believe that a right of first refusal limits the universe of purchasers for the shares because the potential purchaser cannot be certain that a deal has been struck until the holder of the right of first passes on his right to make the purchase.

As can be seen from the above, the shotgun buy/sell is not necessarily suitable for all situations. In the controlling documents, provisions may need to be made for many different exit strategies depending on the particular circumstances. Care should be taken in choosing the correct mechanism in order to avoid uncertainty and litigation following a triggering event.