Are buy and sell agreements *pacta successoria?*

Defining buy and sell agreements in the light of the prohibition against *Pacta Successoria*

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This talk aims to analyse buy and sell agreements in order to determine whether or not they are legally enforceable.

Outline:

- The business owner’s estate planning dilemma
- Recent trends
- *Pacta successoria* and their characteristics
- The cases of Van Aardt and McAlpine
- The article of Gerald Peter
- Buy and sell agreements are not agreements of sale
- If not agreements of sale, then what?
- Van Aardt and McAlpine reprised

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The business owner’s estate planning dilemma

- Business assets usually make up a large portion of the owner’s estate.

- In planning towards his death the business owner is faced with two challenges:
  - ensuring the continuation of the business (and thus the retention of its value), or
  - liquidating the asset to best advantage.

If the business is owned by more than one person the need for planning increases.

Individuals remaining are also interested in:

- the continuation of the business and
- retaining the business’ intrinsic value

It is important to the other shareholders that:

- transfer of the deceased owner’s interest in the business proceeds smoothly;
- with the least possible impact on the business’ solvency and operations.

It is important to the deceased’s heirs that:

- the deceased’s estate is speedily resolved.

Speedy resolution requires - CASH:

- to settle his loan account; and
- to settle the purchase price for the sale of the business

NB: It is important for the peace of mind of all concerned to:

- have certainty that these amounts will be paid; and
- that it happens as soon after death as possible.

Traditionally buy and sell agreements are used to address these issues. Their terms can be summarised as follows:

- shareholder's shares and (usually) any loan account owed to him, to be bought by his co-owners upon his death, and;
- shareholder, while alive, to first offer his shares to his co-owners and;
- should the co-owners not be interested in purchasing the shares at the price offered, restricting him from selling the shares to a third party at a price lower than that at which they were offered to his co-owners, without first offering the shares to his co-owners at the reduced price.

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- Ordinarily the purchase price is funded by life insurance.
- Risk policies used to fund “buy and sell insurance” enjoy estate duty advantages. (sec 3(3)(a)(iA))
- The use of life insurance ensures that the required cash will be available when it is needed.

However, we’ve recently encountered individuals that argue against using traditional “buy and sell agreements”. According to them:

- “buy and sell agreements” constitute *pacta successoria* and are therefore invalid and not legally enforceable; and

- therefore offer the parties thereto no certainty in their planning.

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Foremost of these is Gerald Peter in his article:

“Are Buy and Sell Agreements Pactum Successorium?”

(Refer to: Premiums and Problems Article edition Nr. 108 January 2014.)

The author bases his argument on the cases of **Van Aardt v Van Aardt** and **McAlpine v McAlpine.**

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Freedom of testation is a fundamental principle of our law – and guarantees the testator:

- the freedom to bequeath his assets as he wishes and to whom he wishes;

- the freedom to revoke his will at any time before his death.

"A pactum successorium is an agreement in which the parties regulate the devolution of the inheritance (or a part of it, or of a particular thing that is a part of it) of one or more of the parties after the death of the party or parties concerned."

Paraphrased from: Bornman & De Vos v Potgietersrusse Tabakkorporasie Bpk

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Barring two exceptions, *pacta successoria* are invalid. The exceptions are:

- agreements made in terms of a valid antenuptial contract; and
- *donatio mortis causa,*

NB: A *pactum successorium* is invalid regardless of whether it relates to the whole of the person's estate or to a particular property only.

Some forms that a *pactum successorium* can take are:

- A undertakes to make a bequest in favour of B in his will;
- A and B enter into a contract in which A purports to dispose of his property *mortis causa* in B’s favour;
- A and B enter into an agreement in which B undertakes to make a bequest of his property or part of it to C.

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But how does one determine if an agreement is a binding contract or an invalid *pactum successorium*?

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According to *Ex parte Calderwood*: *In re Estate Wixley:*

"The foundation of a pactum successorium is that the person who contracts with regard to his own succession purports to bind himself to that contract. He does not seek to retain the unilateral right to revoke his promise. Should he do so, then the contract is not one which conflicts with the general rule of our law that inheritances must devolve ex testamento or ab intestato."

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While in **Jubelius v Griesel** the vesting test was determined as the most useful in identifying an invalid *pactum successorium:*

> *"[The test] … has a bearing on the time when the right to the promised benefit is withdrawn from the giver and vests in the beneficiary. If the transfer of the right in terms of the agreement takes place immediately or at least before the death of the giver, the transfer occurs inter vivos and can thus not be interpreted as a pactum successorium, even if its use is postponed until after the giver's death."*

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The **vesting test**, as a means of identifying an invalid *pactum successorium,* was approved by the Supreme Court of Appeal in **McAlpine v McAlpine** where it was found to be:

> *"…an eminently appropriate one for determining whether or not a contract amounts to a pactum successorium."*

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McAlpine v McAlpine – the facts:

- Two brothers each owned 50% of the shares in a company.

- They concluded a contract in terms of which:

  "In the event of either party's death, the other party will get 100% of the shares in the company … in other words, the deceased party's shareholding will go to the one remaining alive."

- When one of the brothers died, the other claimed transfer of his deceased brother’s share in accordance with the contract.

- The executor in the deceased brother’s estate refused to transfer the shares in accordance with the agreement on the grounds that the particular provision amounted to an invalid *pactum successorium*.

- The application of this test involves the distinction drawn in our jurisprudence between vested and contingent rights.

- Different meanings that the word **“vest”** could have:

  - A right can be said to **vest** in a person when he owns it; or

  - the word **vest** can be used to draw a distinction between “what is certain and what is conditional – a vested right is distinguished from a contingent or conditional right.”

- A further interesting aspect of vested rights:

    - A right may be "immediate", but "the enjoyment thereof may be postponed." A right can be said to be "immediate" if it is not dependant on any further contingency, such as the survival of the beneficiary to a given age or the death of a given person.

    Goliath v Estate Goliath 1937 CPD 312

- The court concluded that the agreement was subject to a suspensive condition of survivorship as, for either brother to receive a benefit in terms of the agreement, he would have to outlive the other;
- As such it constituted an invalid *pactum successorium.*

Van Aardt v Van Aardt – the facts:

The case provides a further application of the vesting test.

- Deals with a contract between two brothers who used to farm in partnership.
- They had entered into a written agreement in terms of which the one brother **sold his farms to the other brother, or his descendants, by way of a deferred deed of sale.**

- The agreement would become effective on the death of the seller;

- upon which date the respondent or his descendants were obligated to pay the purchase price.

- However, upon dissolution of their partnership the seller sold his farm to a third party in order to raise capital to enable him to continue farming in his own name.

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- This sale was in conflict with their agreement, and
- the brother who originally purchased the farm applied for an interdict against the sale and transfer of the farm.
- The success of this application depended on whether or not the contract between the two brothers was an invalid *pactum successorium*.

The court in Van Aardt formulated the vesting test as follows:

> ***"Do the terms of this contract divest the seller of his right to dispose of the property during his lifetime? Do they confer a right to acquire the property which becomes vested in the purchaser during the lifetime of the seller? This is a matter of interpretation of the agreement."***

The court found it was clear that, in the circumstances, **there could be no certainty regarding the identity of the purchaser before the death of the seller.**

The court referred to three considerations:

1) the fact that it was uncertain whether the seller would be survived by his brother or by his brother’s descendants;

2) the fact that the final purchaser would come from a class of purchasers, i.e. **the brother or his descendants**, the extent of the class would only be determinable at the seller’s death; and

3) the fact that the contract indicated a purchaser in the alternative, i.e. the brother ***or*** his descendants.

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On the basis of these considerations the court came to the following conclusion:

> ***"(it) …is inescapable that by providing for the person who buys the farms to be either the purchaser or his successors in title (descendants), the parties have by necessary implication postponed vesting to the date of the seller's death, and…***

…the only rights that Stephanus Cornelius van Aardt or his descendants acquires on the date of the agreement are contingent.

A further conclusion is also inescapable: it is that the contract makes an irrevocable post mortem disposition of the right to acquire the seller's farms. It is therefore a prohibited pactum successorium."

Van Aardt v Van Aardt 2007 (1) SA 5 (E) at par 9.

Based on the McAlpine case Mr Peter concludes: *"…there can be little doubt that buy and sell agreements are classic examples of a pactum successorium. This is because:*

1) The right to purchase a deceased shareholder's shares only vests on the death of that shareholder.

2) The other reason is that the enjoyment of the right to purchase is conditional upon the happening of an uncertain future event (i.e. one of the shareholders surviving their co- shareholders)."

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In dealing with the Van Aardt case, Mr. Peter seems to draw a parallel between buy and sell agreements and the agreement in Van Aardt on the basis that in a buy and sell agreement it is supposedly also uncertain as to who the purchaser in terms of the contract will be.

This, I believe, is incorrect.

- In the Van Aardt case it was uncertain who the purchaser would be and hence one of the essential requirements for a sale were not met. This is not the case with a buy and sell agreement.

- The differences between the two scenarios can most easily be explained by reference to an example.

Assume that company A has three shareholders:

Frans – 10 shares, Louis 30 shares and Marius – 60 shares.

Assume too that the three of them have entered into a buy and sell agreement in terms of which they agree that the two survivors will buy the shares of the deceased shareholder for a R10 per share.

Is there in terms of that agreement, like Mr Peter seems to imply, uncertainty as to who the purchaser will be? No.

- We are dealing with three different objects forming the subject matter of the sale that will follow from the parties to the agreement enforcing their rights following from the buy and sell agreement i.e. 10 shares for R100, or 30 shares for R300 or 60 shares for R600.

- Three different people owning three different (yet in this case similar) assets. The objects of the sales could just as well have been a motorcar, a boat and a house.

For a valid contract of sale to exist, the parties need to be in agreement on two things:

- the subject matter of the sale and
- the purchase price to be paid.

That is clearly the case.

- Frans’ 10 shares can only be purchased by Louis and Marius.
- Louis’ 30 shares can only be purchased by Frans and Marius.
- Frans and Louis are likewise the only people, ascertainable from the agreement, who can buy Marius’ shares.
- As far as the potential consequences of the buy and sell agreement are concerned, you are faced with not one but three possible agreements of sale.

Regarding the three potential sales, it is clear that all the requirements for a sale have so far been complied with in respect of all of them.

And yet no vesting of rights in respect of the ownership of the shares has as yet taken place in favour of either Frans, Louis or Marius.

But not because there is uncertainty to who the purchasers are.

The uncertainty, in as far as it exists, is with regards to a condition.

The sale and purchase in a buy and sell is made subject to the condition of survivorship - similar in that regard to the McAlpine case and not the Van Aardt case.

This condition of survivorship is an unfulfilled suspensive condition in respect of the sale and no sale has as yet taken place.

A typical buy and sell agreement is nothing like the agreement by the two brothers in McAlpine, which provided only:

> *"In the event of either party's death, the other party will get 100% of the shares in the company … in other words, the deceased party's shareholding will go to the one remaining alive."*

In McAlpine, the surviving brother was not obligated to any other type of performance.

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In McAlpine one of the requirements of a valid sale, *vide* the purchase price, is lacking.

If the contract in McAlpine were to have been enforced the surviving brother would simply have received the farm – like an inheritance or a *donatio mortis causa*.

A bequest and a *donation mortis causa* are, until his death, revocable by the testator at will, which the McAlpine agreement purported not to be.

But does this mean that no obligations have as yet arisen between the parties in which they could have acquired a vested right?

Of course not.

A buy and sell agreement has as its intention the conclusion of a valid sale, **but**

it is not in and of itself an agreement of sale.

The benefit of advantages and the risk of loss in an object sold pass to the buyer as soon as the sale is *perfecta*.

This has not happened in a buy and sell agreement.

But a contract of sale is not the only type agreement known to our jurisprudence;

Nor are the rights and obligations arising therefrom the only obligations known to us that could have vested in satisfaction of the vesting test.

But, what then are the rights that have vested in respect of a buy and sell agreement?

The right that has vested is the rights to claim performance from one another in terms of the provisions of the buy and sell agreement.

I suggest that a buy and sell agreements is no more than a slightly unusual form of option agreement.

- An option is usually a promise to sell - an option to sell, but
- a promise to buy is as binding on the promisor and is referred to as an option to buy.
- In investment parlance an option to sell is referred to as a "put option", while an option to buy is referred to as a "call option".

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A buy and sell agreement, as a “slightly unusual form of option agreement”.

- In order to be a useful tool the agreement must be enforceable by all parties; and

- as such it differs from an ordinary option agreement (be it an option to buy or to sell) in that all parties acquire both rights and obligations.

It is an agreement both to buy and to sell.

In order to give rise to a valid sale an option has to contain all the essentials of a sale.

> *"The subject matter and the price, and all terms upon which the parties expressly or impliedly regard as material, must be agreed upon exactly as in the case of a concluded sale. If these terms are not set out in the option, then it cannot be translated into a valid contract of sale…"*

RH Zulman & G Kairinos: Norman's Law of Purchase and Sale in South Africa 5th Edition at 6.2.1.

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Whether or not an option is enforceable on the death of the grantor will depend:

- on the option;
- on the obligations created; and
- whether or not the obligations created contemplate personal performance thereof by the person granting the option.

It was held in the case of *Major's Estate v De Jager,* if the agreement allowed for it, that an option could be exercised by the executor of the deceased estate.

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Viewed as an option, a buy and sell agreement is not *“conditional upon the happening of an uncertain future event”*.

In regards to exercising the rights created in a buy and sell agreement, death is a certainty.

It is not a condition but a time clause indicating when performance of the various obligations created thereby are claimable.

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To summarise:

Buy and sell agreements are **not** *pacta successoria.*

They are valid option agreements containing in one document an option to sell and an option to buy; **and**

if implemented correctly will result in valid sale agreements when the rights that flow from them are exercised.

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Other solutions for the business owner’s dilemma do from time to time emerge. (e.g. share buy backs by the company and Mr Peter’s solution of a bequest subject to a bequest price)

However, buy and sell agreements are the only solution not dependent on the unpredictable actions of others after the business owner’s death.

It is enforceable by **any** of the parties thereto against all the others and as such provides all the parties thereto with the certain knowledge that it will be given effect to.

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Thank you

This talk was based on an article titled:

“Defining buy-and-sell agreements in the light of the prohibition against *pacta successoria*”
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