



EVENTS TRIGGERING BUY-SELL OBLIGATIONS

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The purpose of a buy-sell agreement is to ensure that only desired owners own equity in a business entity. Some common events triggering a buy-sell obligation are discussed below. However, the specific events triggering buy-sell obligations to be incorporated into an agreement will depend on several factors, including the type of business. For example, a business comprised of individuals providing services will likely have different buy-sell provisions than a business that is a real estate holding company.

Events triggering buy-sell:

1. Death
2. Disability
3. Termination of Employment
4. Reaching a Certain Age (“Retirement”)
5. Bankruptcy or Insolvency
6. Divorce
7. Non-Permitted Transfers / Bona Fide Offers
8. Breach of Agreement
9. Call upon Specified Vote
10. Put Right (“Withdrawal”)
11. Deadlock
12. Competition with the Business
13. Loss of Qualification to own Equity
14. Pledge of Equity Interest
15. Tag-Along / Drag-Along

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1. Death

Buy-sell obligations can be triggered upon the death of an owner. Reasons:

- The remaining owners do not want to be in business with members of the deceased owner's family.
- It also provides liquidity to the deceased owner's estate. A business entity is unlikely to pay a salary, dividends or other distributions to family members of the deceased owner.

The initial question to be asked is whether the buy-sell should be mandatory or optional. The obligation is typically mandatory, especially where the owners are active in the business. However, the obligation can be optional where they are not. For example, where the business is a real estate holding company with growth opportunities and/or an income stream and managed by non-owners, should the estate be required to sell?

Alternatives:

The family members of the deceased owner may continue to own equity in the business, but:

- the remaining owners have a call right if the family members create problems, and/or
- the estate or family members have a put right to sell the equity to the entity or the remaining owners in the future.

Another alternative:

The deceased owner's equity interest can be converted into a non-voting equity interest, thus providing growth opportunities and/or income to family members.

2. Disability

Buy-sell obligations can be triggered upon the total and permanent disability of an owner who is also an employee. Reasons:

- A disabled owner-employee can no longer perform his/her duties for the business and a buy-sell eliminates such a non-contributing owner.
- A disabled owner-employee will no longer receive a salary and the buy-sell provides the disabled owner with cash.

The same initial question asked about the buy-sell upon death also needs to be answered in connection with a buy-sell upon disability. The additional questions are 1) whether there is a disability, 2) whether it is a total (as opposed to partial) disability and 3) whether it is a permanent (as opposed to temporary) disability.

Defining the triggering event of "total and permanent disability:"

- Disability buy-sell insurance policy – use the same definition as in the policy to ensure that there will be proceeds to buy the equity.
- Disability income policy – receipt of (or eligibility to receive) payment under the policy triggers the buy-sell.

If there is no insurance policy, then disability can be determined as follows:

- The opinion of a physician (or group of physicians) selected by the parties and based upon an examination of the disabled owner or medical information provided to the physician, or
- The decision of a majority (or supermajority) of the owners, in their sole discretion, based upon all of the relevant information available to them, or
- A period of time, such as six months of continuous total disability or disability for 180 (non-continuous) out of 365 days.

3. Termination of Employment

Buy-sell obligations can be triggered upon the termination on employment of an owner who is also an employee. Reasons:

- It encourages an owner-employee to increase the value of the business during his/her employment with the comfort of knowing that he/she will be paid for his/her equity upon termination of employment.
- Upon termination of employment, the owner who is no longer an employee will desire dividends or other distributions, but the owners who are still employees may not be able or willing to make such payments to non-employee owners. The buy-sell provides the terminated owner-employee with cash.

An obligation to purchase the equity of an owner-employee whose employment is terminated may cause a financial hardship on the entity and/or the remaining owners. To prevent such a hardship:

- the obligation to purchase the equity can be optional rather than mandatory, and/or
- the purchase price can be paid over a period of years instead of a lump sum.

Note:

- Consider an optional buy-sell to avoid situations where an owner-employee terminates his/her employment to force a buyout of his/her equity at the best time for him/her and the worst time for the entity and the other owners.
- Consider different valuations amounts for terminations for cause and without cause (however, the price and other terms must be reasonable).
- Consider a mandatory buy-sell upon termination for cause. For example, if an owner is terminated as an employee due to the commission of a felony or a crime involving dishonesty (e.g., theft), the other owners will likely want to completely sever ties with the owner by purchasing his/her equity.

Alternatives:

A terminated owner-employee may continue to own equity in the business, but:

- the entity or the remaining owners have a call right if the terminated owner-employee creates problems, and/or
- the terminated owner-employee has a put right to sell the equity to the entity or the remaining owners in the future.

4. Reaching a Certain Age (“Retirement”)

Buy-sell obligations can be triggered upon an owner reaching a certain age and/or a certain number of “service” years with the business. Reason:

- Transition of ownership to the next generation.
- The retired owner’s employment will terminate and a buy-sell will provide cash payments to the retired owner in place of his/her salary.

Alternatives:

A retired owner may continue to own equity in the business, but:

- the entity or the remaining owners have a call right if the retired owner creates problems, and/or
- the retired owner has a put right to sell the equity to the entity or the other owners in the future.

Also:

- Consider requiring non-competition/non-solicitation provisions as a condition of any buy-out.

5. Bankruptcy or Insolvency

Buy-sell obligations can be triggered upon bankruptcy or insolvency of an owner. Reason:

- The entity and the other owners do not want a bankruptcy trustee, a creditor or some other third party as an owner.

Note:

- An owner should be obligated to sell and the business entity or the remaining owners obligated to purchase the equity of a bankrupt or insolvent owner. This mandatory obligation will make it more likely that the buy-sell agreement will not be voided in the bankruptcy as an “executory” agreement.
- In such an event, the parties can provide for a lower purchase price and/or a purchase price paid out over a longer period of time. However, such a provision must have an objective rationale in order to be binding upon a bankruptcy trustee. For example, a longer payout (e.g., 10 years vs. 3-5 years) can be used in all triggering events except where the business entity or the remaining owners are in control of the trigger and can “plan ahead” for the purchase obligation.

6. Divorce

A buy-sell agreement can be triggered on the divorce of an owner. Reasons:

- The owners do not want any equity owned by a former spouse of an owner. Therefore, owners will want to prevent a transfer of an ownership interest to a former spouse.

Courts do not consider a general restriction on lifetime transfers to cover an award of equity in a divorce. Therefore, the buy-sell needs to specifically include divorce as a triggering event.

Note:

- The triggering event of divorce should provide for an optional, not a mandatory, purchase.
 - A mandatory purchase may compel a court to view an unmarketable ownership interest as marketable and/or increase the liquidity and therefore the value of the equity.
 - A mandatory purchase may cause harm to the entity and the remaining owners if they unexpectedly are required to purchase the divorced owner's equity.
- When divorce is a trigger, typically the buy-sell provides the divorcing owner with the first right to purchase the equity.

7. Non-Permitted Transfers / Bona Fide Offers

Buy-sell obligations can be triggered upon an owner's transfer or attempted transfer of equity in violation of the parties' agreement, or upon an owner advising the entity and the other owners of a desire to sell his/her equity to a third party making a bona fide offer.

8. Breach of Agreement

Buy-sell obligations can be triggered by an owner's breach of the parties' agreement other than a non-permitted transfer of equity. Typically, this is an optional, not a mandatory, purchase of the breaching owner's equity.

Note:

- The agreement can provide for notice to the breaching owner and the opportunity to cure the breach.
- The buy-sell trigger can be based on a final adjudication of whether there is a breach or on a determination by the other owners in their sole discretion.

9. Call upon Specified Vote

Buy-sell obligations can be triggered upon the majority (or supermajority) vote of the owners. In other words, an owner can be forced to sell his/her equity by the requisite vote of the other owners. This type of provision allows the owners to remove an unwanted owner under any circumstances.

10. Put Right (Withdrawal)

Buy-sell obligations can be triggered by an owner exercising a put right, which requires the entity or the remaining owners to purchase the withdrawing owner's equity. Reasons:

- An owner may need to sell his/her equity for a variety of reasons, such as he/she wants to pursue other business interests, no longer gets along with the other owners, needs cash, has suffered an unexpected life crisis (e.g., spouse is ill), etc.

The put right can be mandatory or optional. If optional, it gives the entity and the other owners a right of first refusal. If they do not purchase the equity, then the withdrawing owner can sell his/her equity to a third party.

11. Deadlock

Buy-sell obligations can be triggered by a deadlock between the owners. One way to resolve a deadlock is to require an owner to make an offer at a specified price and allow the other owner to decide whether to sell his/her equity or buy the equity of the other owner.

12. Competition with the Business

Buy-sell obligations can be triggered by an owner competing with the business (regardless of whether he/she is also an employee). Typically, this is an optional, not a mandatory, purchase of the equity of the competing owner.

Note: The entity and the other owners may not want to fund the competing owner's other business venture with a lump sum payment. Therefore, the buy-sell may provide for payments over time, including requiring the first payment one year after the effective date of the buy-out.

13. Loss of Qualification to Own Equity

Buy-sell obligations can be triggered when an owner is no longer qualified to be an owner. For example, an owner may lose his/her license to practice law and, therefore, as a matter of law will not be permitted to own equity in a law firm.

14. Pledge of Equity Interest

If the parties' agreement does not prohibit an owner from pledging his/her equity as collateral for a personal loan, then a buy-sell obligation can be triggered when a lender threatens to foreclose on the equity interest.

Note:

A lender may argue that a general restriction on transfers does not prohibit an involuntary transfer of equity upon foreclosure. Therefore, the language must specifically state that a transfer incident to foreclosure is subject to the buy-out provision.

15. Tag-Along / Drag-Along

A buy-sell obligation can be triggered where a majority owner sells his/her equity to a third party. In such a case, a minority owner will also sell his/her equity to the third party. This provision can be mandatory (“drag-along”) or optional (“tag-along”).