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# EVENTS TRIGGERING BUY-SELL OBLIGATIONS

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The purpose of 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.

These materials are limited to the different events that can trigger an obligation to buy/sell equity. They do not address such issues as whether to use a redemption by the entity or a cross-purchase by the other owners and how to value the equity for purposes of the buy-sell.

Events triggering buy-sell:

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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.

Example 1:

> **Transfers at Death.** On the death of any Shareholder, his or her personal representative shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of the deceased Shareholder's shares of Stock at the price and upon the terms set forth herein. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 2.A:

> **Disability.** Upon the Total and Permanent Disability of a Shareholder who is also an employee of the Corporation, all of the Shares of that Shareholder shall be purchased by the Corporation or the other Shareholders at the price and upon the terms set forth herein. The term "Total and Permanent Disability" shall mean a Shareholder's inability, by reason of accident or illness, to carry on the duties and functions, exercise the responsibilities, and/or discharge the obligations of employment with the Corporation, for a period of 180 days within a 365 day period, whether or not continuous, in accordance with his or her previous experience of employment with the Corporation. Such determination shall be made by the mutual agreement of the parties hereto, or in the event such agreement cannot be reached within thirty (30) days of the event resulting in such inability, by the following procedure:
>
> (a) If the Corporation then has a disability income or disability buy-out policy covering the Shareholder, the definition set forth in such policy shall control, provided the issuing insurance company agrees to commence disability buy-out or income payments as a result of such permanent and total disability.
>
> (b) If the Corporation does not then have a disability income or buy-out policy covering the Shareholder: (i) Each party shall select an independent physician who shall examine the subject Shareholder. The mutual agreement of the two examining physicians shall control, and their opinion shall be binding on the parties. If the two physicians cannot agree, those physicians shall select a third physician to examine the subject Shareholder. The majority opinion of those three physicians shall control, and their decision shall be binding on

the parties. (ii) If any of the physicians are not able to provide their opinion to the Corporation due to privacy laws or other such obstacles that the Shareholder is not able or willing to remove by giving the appropriate consents, then the other Shareholders shall make the determination regarding the subject Shareholder's condition based on the information available to them in their sole discretion, and the other Shareholders' determination shall be binding on the parties. [Form language from ACTEC's *Shareholders Agreements for Closely Held Corporations* as modified by author.]

Example 2.B:

**Disability.** Any Shareholder who, at any time, becomes a Disabled Shareholder shall be deemed to have offered to sell all of his or her shares of Stock to the Corporation and to the other Shareholders at the price and upon the terms set forth herein. A Shareholder is a "Disabled Shareholder" if the Shareholder:

1. Is under a legal decree of incompetency (the date of such decree being deemed to be the date on which such disability occurred);

2. Submits any claim for disability insurance benefits (the date of the earliest of such claims shall be the date on which such disability shall be deemed to have occurred); or

3. Is subject to a medical determination that the Shareholder, because of a medically determinable disease, injury, or other mental or physical disability, is unable to perform substantially all of his or her regular duties, and that such disability is determined or reasonably expected to last at least twelve (12) months, based on then-available medical information. In this regard:

A. A medical determination of disability shall exist upon the receipt by the Corporation of the written opinion of a physician who has examined the Shareholder whose disability is in question.

B. If the Corporation disagrees with the opinion of such physician (the "First Physician"), it may engage at its own expense another physician (the "Second Physician") to examine the Shareholder whose disability is in question. The Second Physician shall confer with the First Physician and, if they together agree in writing that the Shareholder is or is not disabled, their written opinion shall be conclusive as to such disability. If the First and Second Physicians do not agree, they shall choose a third consulting physician (the expense of which shall be borne by the Corporation), and the written opinion of a majority of these three (3) physicians shall be conclusive as to such disability. The date of any written opinion that is conclusive as to such disability is the date on which such disability, if that is the conclusion, will be deemed to have occurred.

C. Each Shareholder hereby consents to such examination, to furnish any medical information requested by any examining physician, and to waive any applicable physician-patient privilege that may arise because of such examination. All physicians except the First Physician selected hereunder must be board-certified in the specialty most closely related to the nature of the disability alleged to exist. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 3:

> **Termination of Employment.** The parties believe that it is in the best interests of the Corporation and the Shareholders to limit the ownership of the Stock to Shareholders who are employees of the Corporation. Therefore, it is agreed that any Shareholder who, at any time, ceases to be an employee as a result of voluntary termination of employment, termination of employment by the mutual consent of the Shareholder and the Corporation, or termination of employment by the Corporation for Good Cause, shall be deemed to have offered to sell all of his or her shares of Stock to the Corporation and to the other Shareholders at the price and upon the terms set forth herein. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 4:

> **Retirement.** The parties believe that it is in the best interests of the Corporation and the Shareholders to provide for the transition of ownership of the Stock from one generation of Shareholders to the next generation of Shareholders. Therefore, it is agreed that on the last day of the year in which a Shareholder reaches the age of 75, that Shareholder shall be deemed to have offered to sell all of his or her shares of Stock to the Corporation and to the other Shareholders at the price and upon the terms set forth herein.

**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.

Example 5:

> **Bankruptcy or Insolvency.** Upon an involuntary transfer by operation of law of a Shareholder's Shares to a Shareholder's trustee in bankruptcy or a purchaser at any creditors' or judicial sale, that Shareholder shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of that Shareholder's shares of Stock at the price and upon the terms set forth herein. [Form language from ACTEC's *Shareholders Agreements for Closely Held Corporations* as modified by author.]

**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.

Example 6:

> **Divorce.** Notwithstanding the prior provisions, if in the event of a Shareholder's marital dissolution ("Divorced Shareholder") such Shareholder's Shares are awarded to such Shareholder's spouse, the Divorced Shareholder shall instead have the first option to purchase all or any portion of the Shares awarded to the former spouse, such option to be exercised within 30 days, and the options otherwise given to the other Shareholders and the Corporation above shall apply but as second and third options with 60-day and 90-day periods. [Form language from ACTEC's *Shareholders Agreements for Closely Held Corporations* as modified by author.]

**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.

Example 7:

> **Receipt of Bona Fide Offer.** Upon a Shareholder's desire to sell any portion or all of his or her Shares pursuant to a Bona Fide Offer, that Shareholder shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of that Shareholder's shares of Stock at the price and upon the terms set forth herein. [Form language from ACTEC's *Shareholders Agreements for Closely Held Corporations* as modified by author.]

**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.

Example 8:

> **Breach.** Upon the occurrence of a material breach of this Agreement by a Shareholder, the Corporation shall provide written notice of the same to the breaching Shareholder. If such breach remains uncured for a period of fifteen (15) days after written notice, that Shareholder shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of that Shareholder's shares of Stock at the price and upon the terms set forth herein. (This option to purchase shall be in addition to, and not in lieu of, any damages that the Corporation or other Shareholders incur as a result of the breach.) [Form language from ACTEC's *Shareholders Agreements for Closely Held Corporations* as modified by author.]

**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.

Example 9:

> **Right to Require Shareholder to Sell Stock.** Circumstances may exist under which the interests of the Corporation and its Shareholders shall be best served if a Shareholder or group of Shareholders owning shares of Stock representing more than fifty percent (50%) of the combined voting power of Stock ("Majority Shareholders") can buy the shares of Stock owned by any other one (1) or more of the Shareholders. Therefore, the Majority Shareholders, however constituted, may require any other Shareholder or Shareholders to sell to the Majority Shareholders all of such other Shareholder's (or Shareholders') shares of Stock, at the price and upon the terms set forth herein. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 10:

> **Right to Require Corporation to Buy Stock.** The parties agree that a Shareholder may justifiably wish to sell his, her, or its shares of Stock to the Corporation, and the parties agree that the Corporation should effect such sales. Therefore, any Shareholder may at any time require the Corporation to buy all, but not less than all, of his, her, or its shares of Stock, at the price and upon the terms set forth herein.
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> If the Corporation is unable to effect such purchase within said thirty (30) days because of provisions in its articles of incorporation, bylaws or applicable law, the Shareholders, including the Shareholder exercising the rights under this section x.x, shall take such actions as may be required to permit the Corporation to make such purchase. The Shareholders shall be required to make additional contributions to the Corporation's capital or guaranty more of its debts pro rata according to their percentage of stock ownership before the exercise of any rights under this section, if these are the only methods by which such sale may be made possible. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 11:

**Right to Require Shareholder to Sell Stock.** A Deadlock among the directors or Shareholders of the Corporation would have an adverse impact on the Corporation and its Shareholders. Therefore, during any Deadlock, a Shareholder or group of Shareholders owning shares of Stock representing more than fifty percent (50%) of the combined voting power of Stock ("Majority Shareholders"), however constituted, may require any other Shareholder or Shareholders to sell to the Majority Shareholders all of such other Shareholder's (or Shareholders') shares of Stock, at the price and upon the terms set forth herein.

A "Deadlock" shall be deemed to exist whenever either:

1. A resolution shall have been formally submitted two (2) times within a period of twelve (12) consecutive months, to a vote of either the directors or the Shareholders, at meetings called in conformity with applicable state law and the Corporation's bylaws, and no majority of the directors or Shareholders attending such meeting shall have been voted either for or against such resolution; or

2. A quorum shall not have been present to enable business to be conducted at two (2) or more meetings of the directors or the Shareholders called in conformity with applicable state law and the Corporation's applicable bylaws, within any period of twelve (12) consecutive months. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]

**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.

Example 12:

> **Competition.** Upon a Shareholder entering into Competition (as defined in the Agreement) with the Corporation, that Shareholder shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of that Shareholder's shares of Stock at the price and upon the terms set forth herein.

**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.

Example 13:

> **Disqualification.** Upon the surrender, revocation or suspension of a Shareholder's license to practice law in the State of New Jersey, whether or not an appeal is pending, and whether or not such Shareholder may remain employed by the Corporation in some capacity other than as a lawyer, that Shareholder shall be deemed to have offered to sell to the Corporation and to the other Shareholders all of that Shareholder's shares of Stock at the price and upon the terms set forth herein.

**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.

Example 14:

> **Limit on Right to Pledge Stock.** A Shareholder shall not have the right to pledge or hypothecate any shares of Stock owned by him or her, except as collateral for a note (a) in favor of the Corporation or (b) in favor of a recognized lending institution, but only if the proceeds of the loan are used in their entirety to purchase additional shares of Stock of the Corporation and the borrowing Shareholder delivers to the Corporation the written undertaking of the lender, in form acceptable to the Corporation that the lender will not dispose of the shares of Stock without first affording the Corporation and the other Shareholders the right for a period of ninety (90) days to purchase the shares at a price satisfactory to the Corporation and the other Shareholders. [Form language from *New Jersey Forms: Legal and Business § 17B:32* as modified by author.]

**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").

Example 15:

> **Tag-Along / Drag-Along.** The value of the Stock of each of the Shareholders is enhanced by the control over the Corporation's affairs by GIANFRANCO A. PIETRAFESA. Therefore, in addition to all other conditions of all other provisions of this section, GIANFRANCO A. PIETRAFESA shall not effect any Transfer resulting in one (1) individual or entity owning, directly or indirectly, shares of Stock representing more than fifty percent (50%) of the Stock, unless such Transferee also buys all of the shares of Stock of each other Shareholder.
>
> [*Add this language to limit the provision to a Tag-Along*:] Each Shareholder who declines to sell his, her, or its shares of Stock pursuant to this section shall send a signed written notice delivered to the Transferee at least fifteen (15) business days prior to the date of the closing of the sale of GIANFRANCO A. PIETRAFESA's shares of Stock. [Form language from *Structuring Buy-Sell Agreements* as modified by author.]