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Events Triggering Buy-Sell Obligations

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A buy-sell agreement ensures that your client stays in business only with co-owners of his choosing. Without such an agreement, your client may find himself in business with his partner's spouse, child or even an unknown third party. With such an agreement, your client may purchase the equity of his partner upon a triggering event. Some common, and not so common, events triggering a buy-sell obligation are discussed in this article. Of course, the specific events triggering a buy-sell obligation will depend on several factors, including the type of business. For example, a business comprised of owners active in the business will likely have different buy-sell provisions than a business with passive owners, such as a real estate holding company. Indeed, with the latter type of business, there may not be a need for a buy-sell agreement.

Death: One reason why death triggers a buy-sell is that an owner does not want to be in business with his deceased partner's spouse or children. Another reason is that a buy-sell provides needed money to the deceased owner's estate because a business may be unlikely to pay dividends or other distributions to the family members of a deceased owner who is no longer contributing to the business.

The initial question to be asked is whether the buy-sell should be mandatory or optional. The obligation is typically mandatory where the owners are active in the business. The obligation can be optional where, for example, the business is a real estate holding company with growth opportunities or an income stream.

Disability: The total and permanent disability of an active owner can trigger a buy-sell obligation because the disabled owner can no longer perform his duties for the business. As a result, a disabled owner will no longer receive the same amount of compensation and a buy-sell provides the disabled owner with cash in exchange for his equity.

Again, the initial question to be asked is whether the buy-sell should be mandatory or optional upon the disability of an owner. However, there are additional questions to be asked, such as: (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.

When defining the triggering event of "total and permanent disability," the agreement can use the same definition as that found in a disability buy-sell insurance policy to ensure that there will be monies to buy the equity. If there is no insurance policy, then disability can be determined by several alternate methods: (1) the opinion of a physician based upon an examination of the disabled owner or medical information provided to the physician; (2) the decision of a majority of the other owners based upon the relevant information available to them; and (3) the passage of a period of time, such as six months of continuous disability or disability for 180 (noncontinuous) out of 365 days.

Termination of Employment: A buy-sell obligation can be triggered upon the termination of employment of an active owner. This encourages an owner to increase the value of the business during his employment with the comfort of knowing that he will be paid for his equity upon termination of employment. Since it is unlikely that the business will pay dividends or other distributions to a terminated owner, a buy-sell provides the terminated owner with cash in exchange for his equity.

A buy-sell can be optional to avoid situations where an owner terminates his employment to force a buyout of his equity at the best time for him and the worst time for the business and the other owners. However, a mandatory obligation should be used upon termination for cause. For example, if an owner is terminated due to the commission of a felony or a crime involving dishonesty (e.g., theft), the other owners will want to sever ties with the owner by purchasing his equity.

Retirement: A buy-sell obligation

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can be triggered upon an owner reaching a certain age or a certain number of years with the business. This provides a transition of ownership of the business to the next generation. The retired owner's employment and compensation will end and a buy-sell will provide cash payments to him in exchange for his equity.

Bankruptcy or Insolvency: A buy-sell obligation can be triggered upon bankruptcy or insolvency of an owner because the other owners do not want a bankruptcy trustee, a creditor or some other third party as an owner. 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. three-to-five 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.

Divorce: A buy-sell obligation can be triggered on the divorce of an owner because the other 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 transfers to cover an award of equity in a divorce. Therefore, the buy-sell needs to specifically address divorce as a triggering event.

The triggering event of divorce should provide for an optional, not a mandatory, purchase. A mandatory purchase may result in a court viewing an otherwise unmarketable ownership interest as marketable, thereby increasing 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.

Call Right: A buy-sell obligation can be triggered upon the majority vote of the owners. In other words, an owner can be forced to sell his equity by the requisite vote of the other owners. This type of provision allows the majority of the owners to remove an unwanted owner under any circumstances.

Put Right: A buy-sell obligation can be triggered by an owner exercising a put right, which requires the entity or the other owners to purchase the withdrawing owner's equity. The put right can be mandatory or optional. If optional, it may give 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 equity to a third party.

Deadlock: A buy-sell obligation 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 equity or buy the equity of the other owner.

Loss of Qualification: A buy-sell obligation can be triggered when an owner is no longer qualified to be an owner. For example, an owner may lose his license to practice law and, therefore, as a matter of law will not be permitted to own equity in a law firm.

Alternatives: Here are several alternatives that can be used in the buy-sell agreement. For example, instead of an outright buy-sell obligation, an owner may continue to own equity, but the business and the other owners may have a call right to buy the equity in the future. Or, the owner may continue to own the equity, but he may have a put right to sell the equity to the entity or the other owners in the future. Also, the owner's equity can be converted from voting equity to nonvoting equity.

Every business with two or more owners should have a buy-sell agreement, which can be a standalone document or, more often than not, which is incorporated into a stockholder, LLC operating or partnership agreement. A buy-sell agreement provides for the orderly transfer of equity upon a triggering event and, by doing so, ensures the continued viability of the business. ■