Buy-Sell Agreement Trigger Events

Buy-sell agreements are designed to accomplish one or more of the following objectives from one or more of several viewpoints: the corporation, the employee-shareholder, the non-employee shareholder, and any remaining shareholders. **The buy-sell agreement provides for what happens to the shares of owners who leave, for whatever reason, whether favorable or unfavorable.**

From the corporation's viewpoint, the agreement may prevent the departing shareholder from retaining his shares. By requiring a departing shareholder to sell his or her shares to the corporation, the corporation and remaining shareholders eliminate any potential for conflict over future corporate policies with the departed shareholder. They also eliminate the potential for the departed shareholder to benefit from future success of the business created by the remaining shareholders. Finally, the agreements prevent a shareholder (or his or her estate) from selling shares to "undesirable" parties, enabling the remaining shareholders to decide who the next shareholder will be, if any. **These reasons for buy-sell provisions apply to virtually all trigger events.**

We use **"QFRDD"** to denote **common trigger events for buy-sell agreements.**

If you think about the events suggested by QFRDD, none of them are very pleasant to talk about, particularly to a group of shareholders who may have just come together for a common business purpose. In fact, circumstances could be such that the shareholder most affected by a trigger event has a proverbial gun to his or her head. In the alternative, the company may perceive that it has a gun to its head in order to fulfill the repurchase requirements of an agreement.

Think of QFRDD to remember.

Q - Quits. A buy-sell agreement may provide a mechanism for shareholders who leave a business to sell their shares to the corporation or other shareholders. Shareholders may quit under a variety of scenarios, some of which are more favorable to the corporation and other shareholders than others. The circumstances of quitting may determine how the departing shareholder is treated under the terms of the agreement.

- Favorable circumstances. A shareholder may decide to leave a company to pursue other interests that are not competitive with the activities of the company. Assuming the ability to fund the purchase, the company and remaining shareholders are likely to view such a departure on favorable terms.

- Unfavorable circumstances. Alternatively, a shareholder may decide to leave a company and to pursue competitive activities. Under such circumstances, the company and remaining shareholders may be reluctant to pay full price (whatever that means - to be determined as we proceed) and desire to stretch out payment as long as possible. After all, no one wants to finance a competitor!

F - Is Fired. When an employee-shareholder is terminated, most corporations desire to retain control over the shares.

- Terminations generally result in diverse, or more likely, adverse interests between the fired shareholder, the corporation, and remaining shareholders.
- From the employee's viewpoint, the agreement assures that his or her shares can be sold at the buy-sell price and creates a market for the shares.
- From the corporation's viewpoint, buy-sell agreements create the right, or the obligation, to purchase the departing employee-shareholder's shares.
- They also eliminate the potential for the terminated shareholder to benefit from any future success of the business created by the remaining employees and shareholders. Some agreements call for a penalty to the valuation in cases of termination, particularly for cause.

R - Retires. The retirement of an employee-shareholder creates a potential divergence of interests between the shareholder and the corporation.

- The shareholder may desire current liquidity over the uncertain future performance of the corporation.
- The corporation may desire not to have potential interference or disagreement with corporate policy, or to have the retired shareholder benefit from future appreciation in value.
- Further, the corporation and the remaining shareholders likely do not want a retired employee to continue to benefit from their ongoing efforts.

D - Disabled. After a defined period of time, the corporation may have the right (from its viewpoint) or the obligation (perhaps, from the employee's viewpoint) to purchase the disabled employee's shares. If disability is a trigger event, it is essential to have a clear definition of what "disability" means.

D - Dies. The death of a shareholder creates issues that are often resolved by buy-sell agreements.

If a shareholder dies owning a minority interest in a corporation for which there is no market for its shares, the illiquidity of the stock can create estate tax issues.

- The shares must be valued for estate tax purposes, and the appraisal amount will add to the estate's value.
- To the extent that the estate is taxable, there may be no liquidity to pay the estate taxes.
- Buy-sell agreements provide a mechanism for determining the value of shares for estate tax purposes and for monetizing that value for the estate, generally in cash or in a term note.
- Therefore, the shareholder's estate realizes liquidity and can pay taxes due and does not face the combination of uncertainty of independent valuation and the certainty of payment of taxes in the absence of liquidity.
- From the corporation's viewpoint, the agreement eliminates the need to address uncertain ownership dictated by the deceased shareholder's will and can create the requirement for funding.

If the parties agree, buy-sell agreements also operate in the event of the divorce, declaration of insolvency, or bankruptcy of one or more shareholders (or even the corporation). In the event of the

divorce of an employee-shareholder, the buy-sell agreement will most likely be designed to prevent the non-employee spouse from realizing any ownership in the stock of the corporation. If an employee declares bankruptcy or becomes insolvent, the corporation may exercise its right to purchase the shares to prevent their dispersion to creditors.

It should be clear from the above that **buy-sell agreements can be favorable from the viewpoints of employee-shareholders, non-employee shareholders, the corporation, and any remaining shareholders in many diverse situations.** The emphasis is on "can be" because the operation of an agreement can go awry despite the best intentions of its creators.

In conclusion, buy-sell agreements are designed to provide objective means of transferring ownership in controlled and pre-determined ways under specified circumstances that may be difficult.

- In the absence of a workable agreement, the remaining shareholders and the corporation may be placed in the unenviable position of negotiating under adverse circumstances with former friends, their families, or their estates.

- Such negotiations, which would occur after the interests of the parties have diverged, are difficult, fraught with uncertainty, and often lead to litigation.

Workable buy-sell agreements are the cure for the potential problems enumerated above.

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