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Back Doors-
the End of the Business Relationship

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I. **Introduction**. It is common for the owners of company to consider the relationship between the partners/members of the company to be a special relationship and as a part of this special relationship to include restrictions on transferability of ownership interests within the entity formation documents.

However, it is also reasonable to assume most business relationships will, at some point in time, come to an end, thereby requiring some form of transfer to take place to accommodate the end of this special relationship.

This may arise in the context of a purchase by an existing owner in connection with a planned event, such as a defined buyout arrangement based on milestones in the advancement of the business, or by triggering events that are unplanned such as the occurrence of (1) death of a member, (2) disability of a member, (3) default by a member, (4) divorce of a member and their spouse, (5) discharge (termination) of an owner as an employee, or (6) the disengagement (retirement) of a member (the **6 D**'s).

In anticipation of these events, it is beneficial to consider in advance how the parties might separate their interests ***before*** the parties have an immediate reason to part the company since the process of separating the interests may be clouded by disagreement and/or hostile emotions.

Whether the transaction is structured as a purchase and sale between existing members or a sale to an outside owner, the terms of the arrangement will need to address many of the same issues. Some of these issues include addressing the debt structure of the company and its related covenants, tax issues relating to capital accounts, releases, and indemnities to address the assumption of pre- and post-sale obligations.

In many cases these arrangements are further complicated by defining the nature of the triggering event.

The purpose of this paper is to outline some of the more common "back door" triggering events and highlight some of the issues that may arise in connection with each scenario.

WARNING !!!! As you review this outline, the author wishes to emphasize that the many examples of language provided is only for the purpose of illustration. Partnerships and Company Agreements are, by their nature, agreements which afford a great deal of flexibility in drafting and operation. As you draft entity documentation to address your particular transaction, the form of agreement should be tailored, as specifically as possible, to address the needs and desires of the parties involved. The provisions provided as a part of this outline are, by necessity, generic in nature and should be viewed only as a reference to this outline.

II. **Triggering Events Not Requiring the Valuation of the Company.**

In certain circumstances the triggering event may simply be that the parties no longer wish to be in business together. This may arise for a host of reasons that could not be anticipated at the time of formation. As originally quoted by Allen Saunders and popularized by John Lennon, we all recognize "*life is what happens to you while you're busy making other plans*." While we may not know why or under what circumstances it will happen, there is a high likelihood that it will, and business owners are wise to plan for it in advance. The formation documents for a new company should provide a controlled method of separation of a member as well as a mechanism for the market to set the price for the disposition of the ownership interest of the departing partner/member as opposed to a third-party valuation.

Common triggering events that rely upon the market to set the price of the company or the ownership interest include:

(a) Offer to purchase business that triggers a right of first refusal;

(b) Right of first offer; and

(c) Exercise of a push-pull agreement.

III. **Right of First Refusal.**

A right of first refusal ("RFR") allows a party who would like to end their relationship with the company to simply take their interest to the marketplace. With proper arrangements the remaining parties will have a right to acquire this interest first before it is sold, but the RFR process allows the party who wants to exit the arrangement the benefit of using the marketplace to value the interest. In setting up the RFR process the parties need to consider a number of factors, including the following:

(a) What constitutes a third-party offer? (term sheet or agreement to accept);

(b) Carve outs for related or affiliated parties or relatives;

(c) Carve outs for who a member/partner may never sell to;

(d) How to address confidentiality obligations while addressing third party offers;

(e) The problem with partial offers;

(f) Time period for exercise of RFR;

(g) If the RFR is passed, is it continued in the future even if a deal is not made;

(h) Does the buyer take subject to the provision for future re-sale of acquired interest;

(i) Matching terms, financing, and similar issues;

(j) If third party offer is not consummated, in what period does it become stale;

(k) What if the terms change after the offer has been made;

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