# Employee Equity Provisions in Organizational Documents

~ Zachary B. Buffington

Most successful privately held businesses understand and appreciate the value of talented individuals. As a result, the owners and executives of those organizations recognize the need to attract, retain, and incentivize high-quality employees. One way to do this is to issue or grant an equity interest in the organization. While providing an equity interest to key individuals can serve as an effective short-term and long-term business strategy, owners and executives also need to look at the change in ownership from a legal perspective. Together with designing the appropriate form of equity to be issued or granted to its employees, the organization should dust off its governing documents (operating agreement, partnership agreement, shareholders agreement, bylaws, and similar documentation) and consider what amendments and updates are necessary.

As owners and executives, you must think through numerous topics and potential pitfalls when you review the governing documents in connection with plans to add a new employee-owner. You may find that certain areas require modifications, and you may need to add new provisions. For example, it is important for the organizational documents to define the employee-owner's rights to receive dividends or distributions and to specify any limitations on the employee's voting rights and authority. You can often establish different dividend and distribution rights, as well as different voting rights, among owners, where tax laws permit, by having more than one class of shares or units. The governing documents also should address whether the employee-owner will be required to participate in capital calls and, as a result, be required to contribute funds along with the other owners to help the organization pursue new investments or pay off liabilities. Non-competition obligations, non-solicitation obligations, and other restrictive covenants may be appropriate, depending on the nature of the services the employee provides, the market and industry in which the business operates, and other factors. In addition, the governing documents should include necessary securities representations and warranties by the employee.

The preceding paragraph touches on only some of the employee-equity provisions frequently included in the governing documents of a privately held business, and there are many other topics that should be discussed. The purpose of this article is to focus on two of the most fundamental topics an organization should consider when it provides an equity interest to an employee: (1) restrictions and limitations on the ability of the employee-owner to transfer his or her equity interest, and (2) buy-sell rights with respect to the employee's equity interest, which arise upon the occurrence of certain significant events.

### Restrictions on Transferability of Equity Interest

In your role of business owner and executive, when you decide to issue or grant an equity interest to an employee, your intent is for that particular individual to be an owner of the organization. You generally do not intend for a third party or outsider to somehow acquire the equity interest at a later date. To prevent a transfer of shares or units against the intent of your organization, you should ensure that the governing documents include reasonable restrictions and limitations on the ability of an employee-owner to sell or transfer his or her equity interest.

Many organizations include right of first refusal provisions in their governing documents to help protect against an unwanted sale or transfer. Typically, a right of first refusal gives the organization the option, but not the obligation, to purchase the employee-owner's shares or units before he or she may sell to a third party. The employee-owner is prohibited from selling to a prospective buyer unless and until the opportunity to purchase the equity interest, for the same purchase price and on the same terms, is first offered to the organization.

Similarly, organizations want to prevent creditors of an employee-owner from acquiring any type of ownership interest in the business. Therefore, the governing documents should make clear that the employee has no right to pledge his or her equity interest as collateral and no right to subject his or her shares or units to a lien, mortgage, or security interest. Under a properly drafted governing document, any pledge or encumbrance in violation of this prohibition would trigger a right of the organization to purchase the employee's shares or units (as discussed below).

### Buy-Sell Provisions Applicable to Equity Interest

As with restrictions on the transferability of an employee's equity interest, buy-sell provisions also are a fundamental part of your organization's governing documents. Buy-sell provisions help to anticipate and plan for certain significant events and to ensure the preservation and continuity of the organization following the occurrence of those events. The significant events (often referred to as "triggering events") can include the death or disability of the employee; the bankruptcy of the employee; a prohibited sale, transfer, or pledge of the employee's shares or units; the retirement of the employee or his or her termination of employment with the organization; and other events that would cause the business to reconsider the equity arrangement with the employee. Moreover, a sale of substantially all of the organization's assets or a sale of a majority ownership interest in the organization could trigger buy-sell rights and obligations (Governing documents also commonly include "drag-along" rights, which enable the majority owners to require the minority owners to participate in an equity transaction, and "tag-along" rights, which enable the minority owners to join with the majority owners and participate in a transaction.)

As a general description, the buy-sell provisions in governing documents give your business entity the option to purchase the equity interest of an employee-owner in the event one of the specified triggering events occurs. (The parties could agree to make the purchase mandatory rather than give the organization the option.) The buy-sell provisions also establish preset terms and guidelines to govern how such a purchase will be carried out. Most importantly, the method for determining the purchase price, as well as the manner and timing in which the purchase price will be paid, should be agreed to in advance in the governing documents. Although buy-sell provisions typically appear similar from one business to the next, the mechanics and details will vary based on the preferences of the organization, the number of owners involved, and the circumstances that trigger the purchase option (or purchase obligation).

It is critical for you as owner and executive to accurately and clearly define what constitutes a "triggering event." Some events, such as the death or the retirement of an employee, are clear. However, other events, particularly the "disability" of an employee and "for cause" termination of his or her employment, require a more detailed definition to avoid disputes among the parties as to whether or not the buy-sell provisions are triggered. For example, one approach to defining "disability" in the governing documents is to tie the definition to the organization's disability insurance policy. In defining "for cause" termination, the governing documents should conform to the employee-owner's employment agreement so the definitions are consistent. If the employee does not have a written employment agreement with the organization, the buy-sell provisions in the governing documents should include a clear and comprehensive definition of "for cause" termination.

As mentioned above, the organizational documents should articulate how the purchase price for any purchase under the buy-sell provisions will be determined. There are several methods to establish the value of the employee's equity interest. One method is to specify the formula that will be used to calculate the value. Asset-based valuation formulas, income-based valuation formulas (such as a capitalization approach or discounted cash flow approach), and revenue-based valuation formulas (such as an EBITDA multiple approach) are formulas that privately held businesses often use. The chosen formula, of course, will depend on many factors, including the particular industry, the nature and size of the organization, and the preferences of the business owners. A second common method is to use a qualified appraiser. Under this method, the governing documents should establish a procedure for the selection of an appraiser mutually acceptable to the organization and the employee-owner. The appraiser then would determine the value of the equity interest to be sold and purchased. A third method is to periodically specify the value of the business by a written agreement of all the owners. If this method is used, an appraiser or other valuation advisor should make the determination of value on a regular basis—preferably annually or semiannually.

In addition to describing how the price for any purchase under the buy-sell provisions will be determined, your organization's governing documents also should set forth the terms and timing of the purchase. Many privately held businesses do not have excess cash available to fund a buyout of an employee-owner's shares or units. Accordingly, it is important for the organizational documents to give the business the ability to pay the purchase price over a period of time rather than pay the full amount at closing. Businesses often prefer having the option to pay 10 percent to 25 percent at closing, with the balance to be paid over a specified period, such as five to ten years. The terms and timing of the purchase could differ depending on the triggering event that results in the purchase. If the purchase option is triggered due to the "fault" of the employee-owner (for example, if the employee-owner's employment was terminated "for cause" or if the employee-owner attempted to transfer, sell, or pledge his or her equity interest in violation of the governing documents), the buy-sell provisions could include purchase terms more favorable for the organization. Under such circumstances, it may be appropriate to permit the organization to pay a lower percentage of the purchase price at closing or to pay the purchase price over a longer term of installments.

## Conclusion

Providing an equity interest to a key employee certainly can be advantageous for a privately held business. When doing so, along with evaluating the appropriate form of equity to be issued or granted, an organization must carefully review and analyze all of the dynamics involved with the addition of a new employee-owner. Thoughtful, well-crafted governing documents will help the employee understand his or her rights and responsibilities, help the organization plan for future events, and help all parties avoid some of the headaches and disputes often associated with employee-equity arrangements.


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