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- ▣ Cover Story
- ▣
- ▣
- ◆ Executive Getaways
- ▣ Features
- ◆ Players
- ▣ Around Utah
- ◆ People
- ▣ TechKnowledge
- ◆ Legal Briefs
- ▣ Executive Living
- ◆ EntrepreneurEdge
- ▣ Business Trends
- ◆ Industry Outlook
- ▣ Special Section
- ◆ Regional Report
- ▣ Focus
- ◆ Executive Health

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- ◆ Events
- ◆ Back Issues
- ◆ Archives
- ◆ Reprints
- ◆ Advertising
- ◆ About Us
- ◆ Contact Us
- ◆ Home
- ◆ Administrative Area

## Legal Briefs

February 2008

### Preventative Medicine

How a Buy-Sell Agreement Can Relieve Future Headaches

by Scott M. McCullough

John and Chris were business partners and friends operating a successful business. They never worried about succession planning or unforeseen events because they had always worked problems out as they came along. Then John died unexpectedly, his interest in the company was inherited by his wife Susan making Chris and Susan partners. Susan wanted nothing to do with running the business, but certainly wanted her share of the value of the business. Chris wanted to run the business without Susan and offered to buy her out at a quarter of the amount Susan was demanding. Things got ugly and litigation ensued. Chris could not sustain the business with his court ordered payments to Susan and closed the doors losing his retirement and Susan's financial well-being.

This tragedy could easily have been avoided with a properly drafted and funded buy-sell agreement, a binding contract between business partners that controls the ownership of the company, protects each owner from partnering with those they did not choose and provides a source of income for a partner or a partner's family following retirement or death by assuring a guaranteed buyer and bound seller upon specified events.

Triggering events that put a buy-sell agreement into effect include death, disability, divorce, disagreement, retirement, bankruptcy of a partner or the loss of a partner's professional license. Each of these events can have disastrous results if not planned for in advance.

#### Which to Choose

There are two basic types of buy-sell agreements: a cross purchase agreement and a redemption agreement. In a cross purchase agreement the partners agree that upon a triggering event the continuing partner will acquire the withdrawing partner's interest in the company. A redemption agreement is an obligation that the company undertakes to redeem a partner's interest in the company upon the occurrence of specified triggering events. A properly drafted buy-sell agreement will have the flexibility of being either a cross purchase or a redemption agreement at the discretion of the company and the partners after considering the circumstances surrounding the triggering event.

Here are a few key issues that should be discussed by partners before drafting a buy-sell agreement:

- Valuation – Partners must either agree upon the value of the business at the signing of the agreement to be re-adjusted at some interval (annually, quarterly, etc.) or they must agree upon a formula for establishing the price upon the triggering event. Additionally, partners should agree upon some reduction of the price if justified by the triggering event (i.e. the early retirement of a key partner). Factors that should be considered in determining a value may include the initial



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investment to open the business, the current operating performance of the business, the current value of assets (including goodwill), the current value of contracts and the debts and liabilities of the company.

- **Transferability** – Partners must agree what restrictions, if any, should be placed upon the transfer or sale of their individual interests in the business such as a right of first refusal, a veto power or an absolute restriction on transferability.
- **Funding** – Partners must agree on how the purchase price will be funded. Options include cash up front or a down payment with the remainder deferred over a pre-specified period of time with interest and security. Many partners choose life insurance as a funding method when planning for the triggering event of death, but may not account for other triggering events.
- **Non-compete component** – If the triggering event is something other than death, partners should consider having a geographical and time specific non-compete agreement incorporated into their buy-sell agreement.

A buy-sell agreement should be executed at the onset of the partnership or as soon as possible thereafter while business and relations between the partners are strong. Legal counsel should discuss the individual circumstances of the partners and the company and incorporate the partners' negotiated terms into the agreement. Once signed, the company's bylaws, operating agreement or partnership agreement should be amended to incorporate the new buy-sell agreement. Additionally, the agreement should include matters pertaining to transferability and funding if insurance is part of the funding plan. Finally the partners and legal counsel should meet annually to review the buy-sell agreement and re-determine the value of the company.

A buy-sell agreement is a planning vehicle that every business with multiple partners should have to secure the financial structure of the business and the financial security of the partners and their families when triggering events occur, and they surely will. As the old adage says, "if you fail to plan, you plan to fail."

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