

Death, Divorce, Retirement of a Business Partner Ways to Protect the Remaining Partner

What would happen to your business if your business partner died, divorced or retired? How would you protect the business from an unknown third-party becoming your new business partner? How would you prevent a bitter ex-spouse of your partner from becoming your new partner after a divorce? If you wanted to buy-out the departing partner, what would the price be? Are you convinced that you and your partner would readily agree on the purchase price? What would the source of funds be for buying out your partner? A well-drafted buy-sell agreement can effectively resolve these issues without the enormous costs of a court battle.

What is a Buy-Sell Agreement?

A buy-sell agreement (also known as a shareholder agreement or a member control agreement) regulates the transfer of business ownership. First, it generally prohibits transfers that are not approved by all of the owners. This prevents undesirable persons from becoming co-owners in the business. Second, the agreement provides for efficient ownership transfer in the case of certain events such as death, disability, divorce and retirement. If one of these events occurs, the remaining owner and/or the business will typically have the legal option to buy-out the departing owner for a defined period of time. Frequently, in the case of death, the agreement will actually require the remaining owner to purchase the deceased owner's shares. This helps to ensure that the financial needs of the deceased owner's family are met.

What is the Purchase Price of the Buy-Out?

In the event that a buy-out event occurs (such as death or disability), the agreement will provide a cost-efficient way to determine the purchase price. Typically, if the owners have agreed on a purchase price at the annual shareholder

meeting, that price would be used for that business year. If the owners have not agreed on or cannot agree on a purchase price, the agreement will have an appraisal process where professional business appraisers determine the value of the shares to be purchased. An out-of-court method for determining value is worth its weight in gold because it avoids the enormous legal and accounting costs of valuation litigation.

How is the Buy-Out Funded?

Suppose the buy-out price is \$500,000 or more. How will these amounts be paid without financially crippling the business or its remaining owners? If an owner dies, the entire buy-out price is normally paid in full at death because it is funded by life insurance policies upon each of the owners. In cases of disability, divorce, or retirement, the buyout price is often paid out over a number of years from the normal cash flow of the business. The payment obligation is usually evidenced by a promissory note. Repayment is secured by a guaranty and a stock pledge agreement.

Summary

A well-drafted buy-sell agreement is necessary in a business with two or more owners. Without one, the success and value of the business is threatened by costly and time-consuming legal disputes between owners about ownership transfers and the value of the business. Koepke & Daniels provides ways to protect businesses and their owners from these problems.

The information in this newsletter is intended as a general discussion and it is not, nor is it intended to be, legal advice or the solicitation of employment. Kevin M. Koepke, the author, is the Chairperson of the Business Law department. Kevin focuses on business law and shareholder issues. You can reach Kevin with questions at: (763) 201-1201 or kkoepke@koepkedaniels.com www.koepkedaniels.com