

A Surefire Method of Creating Conflict Among Co-Owners
The Importance of Buy-Sell Agreements When Disability or Other
Lifetime Ownership Transfer Events Occur

When co-owners are united in striving toward common business goals such as growing revenue, business value and cash flow, the business dynamics can be wonderfully positive and strong. The owners are moving forward together to reach common goals. Contrast that bright picture with what can happen when, suddenly perhaps, the goals of the owners diverge.

Owner Disability and Other Lifetime Transfer Events

Most closely held business owners are full-time employees (and more) in their businesses. What happens when one of the owners wants or needs to leave the company? The possible reasons for leaving are many, ranging from boredom to more dramatic and unexpected events such as the sudden disability of an owner. Let's use owner disability to illustrate some of the significant issues raised when ownership goals are no longer aligned. When disability strikes an owner, the company will endure substantial hardships, both economic and operational. More importantly, in the absence of a buy-sell agreement, the disabled owner's income stream from the company also may evaporate. This problem confronted, Steve Hughes, one of three equal shareholders in a growing advertising agency.

At age 38, Steve suddenly had a stroke. As with many stroke victims, his recovery was incomplete. Physically, he was the picture of health (his golf game even improved!); but he totally lost his ability to speak and read. Doctors told him he would never be able to return to work.

Steve's firm had a buy-sell agreement, but it covered only a buyout at death and an option for the company to buy his stock if he were to try to sell it to a third party. Trying to find and sell closely held stock to a third party is a difficult proposition anytime; his disability made it impossible. Even if his fellow shareholders had wanted to continue his salary, they did not have the resources to do so indefinitely.

As a result, the company and Steve were left in a classic dilemma – the company, or rather the remaining shareholders, wanted to purchase Steve's stock so that its future appreciation in value, due now to their efforts alone, would be fully available to them. Conversely, as Steve's family soon realized, the owners of closely held stock rarely receive current benefits in the form of dividends. The profits of a closely held corporation are either accumulated by the company or distributed to the active shareholders in the form of salaries, bonuses and other perks.

In short, Steve's family would not get what it needed most – cash – to replace the salary Steve was no longer earning, while his partners faced the prospect that their efforts to increase the value of the business would reward Steve as much as themselves. This dilemma could be solved only by a buyout of Steve's stock.

His family then could receive a fair value for his business interest when they otherwise would receive nothing until the company was eventually sold or liquidated. Meanwhile, ownership would be left with those responsible for the company's success.

As illustrated in the Steve Hughes hypothetical case study above, the Hughes buyout faced several problems. These problems resulted from the now divergent goals of the owners. Prior to the unexpected disability event, joint contributions of time, effort and capital created unanimity among owners. Now, one owner needs cash, while the company and the other owners want to retain earnings for growth – other than income paid to active owners as salary. Also, when owners were in alignment, there was a common goal to increase business value. Now, the departed owner, Steve in our example, wants and perhaps needs to be paid his full share of that increased value as soon as possible. The remaining owners, because either they or the company will pay for acquiring that value with after-tax dollars (and in any case want to preserve, not spend capital on a non-productive asset such as stock of the company), want to pay as little as possible over as long a time period as possible. Where before the event there was mutual agreement and understanding, now there are radically different owner wants and needs. Discord can easily result in situations such as these and when ownership is in conflict, the business suffers.

Typically, three major issues arise in situations like we illustrated with the Steve Hughes case study:

- Agreement on the business value.
- Funding for the buyout.
- Agreement on the payment terms of the buyout.

Each of these problems should be anticipated and dealt with by drafting and funding (where possible) a buy-sell agreement before such transfer events occur and when all owners are united by mutual ownership objectives.

Let's look again at the hypothetical case study of business owner Steve Hughes, one of three equal shareholders in a growing advertising agency. At age 38, Steve had a stroke that did not allow him to return back to work. Steve's firm had a buy-sell agreement, but it covered only a buyout at death and an option for the company to buy his stock if he were to try to sell it to a third party.

The Hughes buyout, like any lifetime buyout of a co-owner, faced three different problems, each of which should be addressed in your buy-sell agreement:

- Agreement upon value.
- Funding of the buyout.
- Agreement on the payment terms of the buyout.

Let's take a look at how these three common elements can be addressed in a buy-sell agreement during situations similar to the Steve Hughes case study.

Value

The disability, or other departure of a co-owner, may, and probably will in many cases, reduce revenue (at least for a while) and increase expenses because of the need to hire replacement personnel. At the time that the disabled (or deceased or departed in good health for that matter) owner has left, the business feels the financial strain from the departure of that productive employee. A meeting of the minds as to business value is even more difficult. The departed owner wishes to have value and his or her buy-out at the highest reasonable value, while the remaining shareholders, facing the need to divert much of the company's future cash flow to buying back the departed owner's interest in the company, wish to minimize value. The fairest method of determining value is usually to require an appraisal of value, by a certified valuation specialist, as of the date of the event causing the transfer of ownership. Unless your buy-sell agreement specifically addresses that value is to be the fair value as of the date of the event, as determined by an impartial appraisal, then one party, either buyer or seller, will be harmed and the other party will be unfairly benefited.

Funding

If your company can pre-fund, in part, the purchase of a departing owner's interest, much of the cash flow strain can be reduced. For example, to provide for the contingency of one of the owners becoming permanently disabled, the company can prepare to pay that fair value by purchasing disability buyout insurance. The buy-sell agreement, in combination with the disability buyout policy, provides the means to achieve both the disabled shareholder's goals of receiving money for his or her ownership interest, and the company's and remaining shareholders' goals of maintaining active ownership. Disability buyout insurance is paid to the business (or the other owner) in a lump sum or series of payments over several years. The company (or other owner) then pays that money to the disabled owner to buy back his or her stock.

Payment

The buy-sell agreement also addresses payment terms. Since disability insurance normally will not cover the entire buyout price, a "balance owing" usually results. Of course, most other lifetime events are not funded at all. This means the owner and shareholders must agree on the payment terms for the remaining amount owed. Typically, these terms are the interest rate, the length of the buyout period (usually three to seven years), the frequency and amount of payment, and the security to be given to ensure payment for the balance owing. Of course, it's relatively easy to draft payment terms in a buy-sell agreement. Far more difficult is coming up with the money to make the required periodic payments. Consider drafting the agreement to ensure that payments are reduced if the company's cash flow or ability to pay is temporarily reduced.

When these key elements are negotiated in advance – before any of the shareholders become disabled or otherwise determine to leave the company – fair and equitable decisions can be made. In the Steve Hughes case, it was too late. His family eventually felt compelled to sell his stock for book value – a low return for a service company. It was that or nothing. Besides, it was all that his former partner felt they could afford to pay.



The message of this article is straightforward: plan for a co-owner's departure far in advance (hopefully) of such an event that is likely to occur. It also is important to treat all owners fairly – after all you don't know if you will end up being the buyer or the seller – and document your decisions in a well-crafted buy-sell agreement.

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The example provided is hypothetical and for illustrative purposes only. It included fictitious names and does not represent any particular person or entity.

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O'Hara & Company, PC - One Olde North Road, Suite 101, Chelmsford, MA 01824 www.oharaco.com