CLAYTON CAPITAL PARTNERS

Exit Planning
NAVIGATOR
Exit Planning Strategies for the Entrepreneur

Issue 121

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 28, 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

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(continued)

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. In the next **Exit Planning Navigator®** article, we will look at each one of these common business transfer problems and identify ways in which the buy-sell agreement can prevent problems from arising, or at least provide an agreed-upon methodology for resolving such issues.

If you have any questions about establishing strong business continuity agreements and their role in helping you exit your business in style, please contact Kevin Short, Managing Director (kshort@claytoncapitalpartners.com).

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