CLAYTON CAPITAL PARTNERS

Exit Planning NAVIGATOR

Exit Planning Strategies for the Entrepreneur

Issue 122

Planning for Departing Owners

The Value, Funding and Payment Aspects of Lifetime Ownership Transfers

In the last issue, we introduced you to 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 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

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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 is 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.

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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