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Business Continuity Planning for Co-Owners

Imagine that on the eve of your wedding, you make a plan to divorce your spouse, on friendly terms, in about 15 years. During those 15 years, you agree to work diligently and successfully to build a business. On the preordained day that your marriage ends, you announce that you are willing to give your soon-to-be ex-spouse one-half of your company's business value in cash. Additionally, you let your ex-spouse value your company, because those are the terms of the agreement the two of you signed a year after you were married.

Though this scenario may seem ridiculous, you may have done something quite similar in your business with your co-owners.

Few owners begin working together with an expectation of future acrimony, much less litigation. Fewer still give thought to one day leaving the business—even on friendly terms. Indeed, most exits are not precipitated by a disagreement among co-owners; instead, owners leave for a variety of reasons and simply want to do so with their share of business value.

Remember: One day, you will leave your business.

Over time, in business as in marriage, partners can grow apart. We've all witnessed the resentments, discord, and wastefulness of a friend's needlessly nasty divorce. Business divorces can be equally unpleasant, but with an added twist: Owners may be unable to leave the business, or force a partner to leave, without appropriate tax and legal planning.

When an owner or co-owner wants out, what will happen? Chances are that when owners and co-owners turn to the company's Buy-Sell Agreement, they will find that it is woefully out of date. They also may find that it controls the terms of their exits from their businesses not only upon death but also during the owner's lifetime.

If you haven't looked over your company's Buy-Sell Agreement since you signed it, dust it off and check at least four key provisions:

1. Lifetime and death transfers of ownership:

- When must an owner sell or offer to sell?
- When *must* a co-owner (or the company) buy, and when does the co-owner or company *have the option* to buy?

1. How will the value of the company and the value of a departing owner's interest be determined?
2. Does the agreement mandate the use of an independently determined fair market value at the time of transfer? If not, the valuation will favor either the buyer or seller. It will not treat co-owners evenhandedly.
3. What are the terms (length, down payment, interest, and guarantees) of the buyout?

We generally assume that Buy-Sell Agreements control the transfer of an owner's interest when he or she dies or becomes disabled. However, they usually do much more, and if owners don't appreciate how much more, disaster looms. Consider the following scenario:

At his annual physical, Steve Hughes complained that he was bone-tired. After a battery of tests, Steve's doctor observed that, while there was nothing physically amiss, Steve did seem depressed. After some introspection, Steve was able to articulate that he had no interest in continuing as a partner in his successful CPA firm. Like many owners, Steve had lost the passion and commitment to the business that still stoked his younger co-owners. He decided to sell out before his partners demanded it.

Steve broke the news of his departure to his two partners and noted that their Buy-Sell Agreement controlled only a buyout at death and an option for the company to buy Steve's stock if he were to sell it to a third party. Attempting to sell a partial interest to a third party is always a difficult proposition, but economic challenges made that course of action impossible.

Steve and his partners were left in a classic dilemma: The remaining shareholders wanted to purchase the departing shareholder's interest so that future stock appreciation—due solely to their efforts—would be fully available to them. Conversely, because 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, the departing *shareholder (now an inactive owner) rarely receives significant income in the form of distributions or dividends.*

Naturally, Steve wanted and needed maximum value for his interest, while his co-owners were convinced that the company's cash flow could not support Steve's buyout.

In light of this scenario, owners must examine their business continuity agreements immediately: If the owner is the one leaving, is the agreement as fair as it would be if the owner were the one left behind?

When you sit across the bargaining table from your business partner(s) for the first time, you will want that table set with a fair valuation method, a thoughtfully designed lifetime buyout provision (that may well reduce the cash flow required for a buyout by 20–30%), and manageable payment provisions. Since it is exceedingly difficult to design these provisions when the buyer and seller are at the bargaining table, owners should agree to and document the valuation, cash flow, and tax and payment provisions long before potential discord and differences of outlook arise.

Your first step toward avoiding the problems described in this article is to conduct a thorough review of your business continuity agreement, and we are happy to help you do so. If you would like a more extensive checklist and additional information about this most important of all business documents, please contact us.

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