Patching Holes in Business Continuity Plans

To many owners, **business continuity planning** consists entirely of:

1. creating a buy-sell agreement early in the company's existence and
2. filing it away.

Even if the buy-sell is well drafted, it's likely too simplistic to handle the complexities of a co-owner leaving a successful business. If the buy-sell agreement is not well drafted, it is like quicksand: It appears to provide reliable footing for a smooth exit, but can end up sinking the company—and its owners—when one owner exits, whether voluntarily or involuntarily.

As a business owner, how can you avoid stepping into the quicksand of an inadequate continuity plan and instead be assured that you and your co-owner's exits are successful?

This white paper discusses some of the common deficiencies—or holes—present in business continuity and describes strategies to patch those holes.

The seven most common holes are:

1. Business continuity plans that overlook challenges to the business.
2. Business continuity plans that neglect the decedent's family.
3. Buy-sell agreements that are too simplistic.
4. Buy-sell agreements that ignore common lifetime exits.
5. Buy-sell agreements that use cookie-cutter valuation formulas.
6. Buy-sell agreements that are outdated.
7. Buy-sell agreements that are poorly implemented.

Addressing and patching these holes will help you, your family, and your company adjust and adapt to both planned and unplanned exits, making it more likely for you to exit on your terms. Let's begin by patching the first hole: overlooking challenges to the business.

HOLE 1: BUSINESS CONTINUITY PLANS THAT OVERLOOK CHALLENGES TO THE BUSINESS

In reality, most business owners' continuity plans consist solely of a buy-sell agreement. The most common problem with many of these plans is that they don't include provisions to address the challenges that a business faces upon an owner's death; they simply give instructions for how and to whom the business should be sold. When an owner dies, the party to whom the business is transferred tends to run into two problems that the continuity plan does not address: the loss of financial capital and the loss of the departing owner's expertise and talent. Let's look at how the loss of financial capital can be a business-continuity hole that needs to be patched.

Loss of Financial Capital

Sue Ellen Saint-Saens, an Owner-Based Planning Advisor first met Joel Canfield soon after Frank Sobel, Joel's 51% co-owner, died. Joel told her that, as a key employee, he had purchased 49% of Sobel Construction Inc. (SCI) over several years. He was president and ran the business, allowing Frank to retire. Sue Ellen learned that SCI undertook one or two large construction projects each year—projects that required a performance bond and a line of credit.

As founder and majority owner, Frank had personally guaranteed the performance bonds, and his personal assets served as collateral for the company's line of credit. After Frank's death, Joel was willing to provide his personal guarantee, but his nominal personal assets, couldn't satisfy the bank's outside collateral and guaranty requirements. Without bank financing, SCI could not continue to do business.

In this example, Frank and Joel addressed only part of the business-continuity problem: SCI's buy-sell agreement stated that the company would be transferred to Joel upon Frank's death. Additionally, Frank's insurance advisor had purchased enough insurance for the transfer to occur smoothly, which allowed Joel to pay Frank's estate for Frank's 51% of the company. However, the continuity plan failed to consider the matter of ensuring the surviving owner had financial capital to continue the business.

Frank had personally guaranteed the performance bonds and had sufficient assets to serve as collateral. Joel, on the other hand, did not have enough assets to satisfy lenders. As a result, SCI was forced to shut its doors.

Without access to capital, many companies cannot continue to function. As a responsible owner, how can you overcome the false security of an inadequate continuity plan?

Loss of Talent

A loss of talent, whether by death, disability, or departure, can be a massive hurdle for owners with inadequate buy-sell agreements. In SCI, as in most closely held businesses, survival depends on the company's rainmaker (Joel) while another co-owner is responsible for a different area of the business, for example, operations. What happens if the rainmaker dies?

As we've seen, Frank and Joel—like many business owners—had a buy-sell agreement that addressed to whom and how the business would be transferred upon an owner's exit, but failed to address the survival of the business following one owner's exit. Thus, upon Joel's unexpected death, SCI no longer had the one person who could assure that the business's cash flow and value would continue to grow.

Without its primary rainmaker, SCI was unsellable because it had no transferable value. Had Frank died, key talent would be lost but the business might have survived, albeit with diminished value and questionable long-term prospects.

Ideally, owners will not die before exiting. In reality, they do. To reduce the damage:

- Identify risks. Ask yourself, "If my co-owner or I were to die or leave tomorrow, how would the company quickly and adequately replace us?" Most likely, the answer will be that you need to either recruit new management or train and groom existing management or key employees to take the reins.
- Create a replacement plan. Should a key employee/owner exit your business unexpectedly, the company must immediately replace him or her with someone equally or more skilled. When Joel died, there was no one readily available to step into his role, so Frank had to look outside the company for a replacement. Finding a talented management level employee quickly can be difficult because most are content in their current positions and well compensated.
- To attract talented people, consider providing
    - a challenging position with a path to ownership, and
    - compensation that is significantly higher than what a prospective employee is currently earning.

The easiest way to provide above-market compensation is to purchase appropriate life insurance on each co-owner and on the lives of all other key employees. That way, if there is a death, funding is available.

Quickly replacing a departing co-owner with an experienced substitute minimizes disruption and may even be the difference between continuing and selling your company or liquidating it. Funds from life insurance (assuming co-owners are insurable) enable companies to hire the best available replacements. Life insurance can also provide the funds necessary to maintain a business until the new rainmaker is able to fill the hole in the business' operations.

The ideal solution to filling the hole caused by the failure of a buy-sell agreement to provide for the death, disability or other lifetime exit of a co-owner is one emphasized in our owner-based planning practice: Develop, incentivize and retain a top-notch management team. Much of our planning practice is devoted to helping you make yourself replaceable and your business more valuable!

HOLE 2: BUSINESS CONTINUITY PLANS THAT NEGLECT THE DECEDENT'S FAMILY

One aspect often overlooked in continuity plans is the financial security of an owner's family following that owner's unexpected death. Since most continuity plans only replace the value of a decedent's interest in the company with cash, they ultimately fail to fulfill that person's goal of financial security for his or her family. Consider the following example:
Bob and Dan were equal co-owners of Bob & Dan's Construction, a relatively new business worth, according to a recent appraisal, $5 million. Bob and Dan each received annual salaries of $375,000. salaries. The business' cash flow had grown to $1 million, some of which the owners left in the business to fund its healthy growth, and some of which was distributed to the owners and invested outside the business.

The two created a buy-sell agreement as advised by their attorney and insurance advisor and funded it with life insurance on each other's lives. The agreement provided that a co-owner's estate would receive $2.5 million upon his death in return for the transfer of his 50% interest in the business.

One day Bob was killed in a hit-and-run accident. His estate received $2.5 million (the full value of his ownership interest) from the insurance policy that Dan had on Bob's life. Their buy-sell agreement worked exactly as written but possibly not as the two owners had intended. The result was disastrous for Bob's family.

Before Bob's death, he, his wife, and three children lived on his salary. After Bob's death, his family's principal asset was the $2.5 million insurance payout. Bob's widow's financial planner suggested a reasonable withdrawal rate from the insurance proceeds to be 4%, or $100,000 per year. Even though Bob's estate received the full value of his interest in the business, his family's annual income plummeted from **$375,000** to **$100,000.**

This example shows the unintended consequences of most continuity plans. While Bob and Dan took the right step in creating a buy-sell agreement and purchasing life insurance, the amount that Dan purchased could not support Bob's family as Bob's original salary had. On top of that, Bob's family lost Bob's share of the company's cash flow which was another $500,000 loss.

How can you assure your family's financial security if you die before your targeted exit date? The most obvious patch to this gaping hole is also often the most initially expensive: Buy life insurance on yourself and own it outside of the business.

Consider Bob and Dan: For Bob to have insurance coverage that would allow his family to recoup all losses (salary and EBITDA), he would need an additional $16 million in insurance coverage (assuming a 4% withdrawal rate).

Since owners considering Exit Planning are generally older, this amount of insurance, if available, is often impossible to obtain.
When insurance coverage cannot cover all lost income, consider the following designs to provide additional income to a deceased owner's family:

- Provide income continuation for a set number of years via a wage continuation plan after an owner's death. In Bob and Dan's case, the company could have been obligated to pay Bob's family (or Dan's family if he predeceased Bob) $150,000 or more per year for 10 to 15 years.

In family-owned businesses, maintain some level of ownership for the benefit of the decedent's spouse or family. This allows the spouse to continue to receive S distributions for their lifetime.

If life insurance is unavailable, reduce the purchase price and make up the net shortfall with wage continuation. A company's cash flow is better used to pay deductible wages than to purchase ownership with after-tax dollars. While Wage-continuation income is taxable to the decedent's estate, and that estate is likely in a lower tax bracket than the surviving owner of the S corporation.

While each patch could fix the hole in a business-continuity plan, none is ideal. Ideally, you would:

- Include your spouse in initial planning meetings so that he or she understands how your untimely death or incapacitation will affect him or her and the family.
- Review your lifetime goals and ask yourself whether you want those goals to be fulfilled should you die or become incapacitated prematurely.
- Determine whether a gap exists between the financial resources available upon your death (including the money received from the sale of ownership pursuant to the buy-sell agreement) and the financial resources your family will need to maintain its lifestyle should you die.

- Schedule these discussions with your co-owner and Owner-Based Planning Advisor now, before an unexpected event occurs and all co-owners know who will be the surviving owner.

These actions can help protect your family's financial well-being should you exit your business before your planned exit date. Now, let's turn to the more specific problems that owners commonly face: holes in their buy-sell agreements.

HOLE 3: BUY-SELL AGREEMENTS THAT ARE TOO SIMPLISTIC

As we've seen, continuity plans have a tendency to overlook several problems common to a business transfer. They can also ignore more complex issues like the unwieldy problem of mandatory vs. optional ownership-transfer provisions.

Ownership transfers between owners typically include mandatory and/or optional purchase provisions and follow one of three patterns:

1. ***The seller must sell; the buyer must buy.*** This pattern is normally used in insurance-funded transfers where one of the co-owners dies or becomes permanently disabled. Insurance is used to fund all or part of the purchase price. Mandatory sale and purchase provisions are also used to compel minority owners to sell their ownership when terminating their employment and the company or majority owner to purchase the minority owner's ownership.
2. ***The seller must sell; the buyer has the option to buy.*** Again, this method can be used in acquiring a minority owner's interest.
3. ***The seller and buyer each have the option to sell and buy, respectively.***

These provisions can be tricky to navigate, but one way to map the course is to consider the difference between a funded and unfunded purchase price.

However, lifetime transfers are far more common than after-death transfers. These transfers are unfunded, meaning that after-tax cash flow must be used to pay for an ownership interest. This often results in the use of optional provisions (i.e., seller has the option to sell; buyer has the option to buy) in buy-sell agreements. Optional provisions are not an effective strategy for either buyer or seller because neither has the ability to force a decision.

There is no single buy-sell agreement that will adequately cover each and every lifetime and after-death transfer scenario, so patching the "too simple" hole in your buy-sell agreement takes two steps.

First, we strongly encourage you to begin Owner-Based Planning.

Second, if you are on the fence about beginning Owner-Based Planning, you can still: a) talk with your advisors to determine the implications behind mandatory vs. optional provisions, and b) find out how companies and owners can best handle the burden of confronting mandatory lifetime buy-sell provisions.

HOLE 4: BUY-SELL AGREEMENTS THAT IGNORE COMMON LIFETIME TRANSFER EVENTS

Buy-sell agreements often do two, and only two, things:

1. Provide transfer instructions upon the death or incapacitation of an owner.
2. Provide a right of first refusal to the remaining owner(s) when a co-owner wishes to sell his or her ownership interest to an outside party.

Oftentimes, buy-sell agreements do not address or are woefully suited to handle more common lifetime transfer events, such as:

- Involuntary transfers caused by personal bankruptcy or divorce.
- Forced termination of an owner's employment.
- Irreconcilable differences between owners.

The goal of continuity planning is to assure that all owners are treated equitably. We encourage you to update your buy-sell agreements to achieve this goal before you need to. It's much easier to negotiate terms when no one has anything at stake than to do so when emotions run hot. Let's look at the implications of each of these common events.

Involuntary Transfers Caused by Bankruptcy or Divorce

In both of these events, an owner may be forced to transfer ownership to either a creditor or an ex-spouse, respectively. Thus, buy-sell agreements should stipulate that when owners finds themselves in these situations, the business (through co-owners or key employees) has the right to acquire their interest.

The best way to patch this hole in your buy-sell agreement is to consult capable legal counsel—an integral member of your Owner-Based Planning Team.

Forced Termination of an Owner's Employment

For businesses with multiple owners—whether majority/minority or equally split—forced termination is rarely, if ever, considered in a buy-sell agreement. The complexities and inherent hostility of these situations suggest that there is no boilerplate solution to this dilemma. For example, controlling owners might want the ability to purchase a terminated owner's interest. The fired owner may want the ability to sell his or her ownership back to the company or the other owners.

All owners may simply want the agreement to require a mandatory purchase of ownership in the event of an owner's employment termination for any reason.

It is important to consult experienced legal counsel to assure that your buy-sell agreement can make a forced termination equitable for all owners involved by:

1. addressing these acrimonious conditions
2. calculating a fair value of ownership interest
3. having specific buyout terms and conditions.

Irreconcilable Differences Between Owners

Occasionally, two non-controlling (i.e., equal) owners will have a falling out for any number of reasons. Whatever the disagreement that precipitates them, these fallings out are seldom covered in buy-sell agreements, so a particularly vindictive owner may be able to halt important business decisions and operations but continue to draw a salary and enjoy the benefits of ownership.
Patching this hole requires a buy-sell provision, or nuclear option, that we call the
"Texas Shootout Provision." It stipulates that either owner may offer to purchase the other owner's interest. The second owner must then either accept the offer and sell his or her ownership interest or purchase the first owner's interest for the same price, terms, and conditions contained in the offer. Thus, the second owner has two choices: accept the offer and sell his or her ownership interest or turn the tables and buy the offering owner's ownership interest.

HOLE 5: BUY-SELL AGREEMENTS THAT USE COOKIE-CUTTER VALUATION FORMULAS

Buy-sell agreements typically fall into the trap of using generic valuations when valuing a business for sale. The problem stems from confusion or misinterpretations related to a business' likely value. Additionally, the cost of more-comprehensive valuations, such as an opinion of value from a credentialed appraiser, often causes business owners—even those who own companies worth millions—to balk.

The key to patching this hole is to put the goal of an accurate valuation in your buy-sell agreement in the context of your business's maturity. For instance, while it may make sense for a small business that is 100% reliant on its owners for revenue to use a simple agreed-upon value for transfers at an owner's death, owners of a multi-million-dollar company would be remiss using such an inaccurate valuation method.

The complexity of your company and your planning objectives will determine which valuation method is appropriate to use in your buy-sell agreement.

HOLE 6: BUY-SELL AGREEMENTS THAT ARE OUTDATED

Many buy-sell agreements are drafted early in a business's life and never reviewed again. As a business grows or changes, owners often neglect to update their buy-sell agreements in light of new business developments. Thus, when the time comes to transfer the business, many owners find that provisions no longer reflect the state of the business or their desires. These buy-sell agreements often fail to manage transfers successfully because they are reflective of a business that no longer exists.

Your buy-sell agreement should be a reflection of your company's current operating status. This is especially true for buy-sell agreements that include an agreed-upon valuation. As time passes and a business changes, so does its value. The older the initial valuation, the less reliable it is. This often leads to material unfairness.

The patch for this hole is relatively straightforward: Include a discussion of your buy-sell agreement in your annual fiscal-year- end reviews. Updating your buy-sell annually, with the help of a financial advisor or Owner-Based Planning Advisor is important. Regular reviews also reduce the likelihood of litigation between disagreeing owners.

HOLE 7: BUY-SELL AGREEMENTS THAT ARE POORLY IMPLEMENTED

In addition to seldom reviewing their buy-sells, many owners fail to update them in light of changes in ownership (persons and proportions), to life insurance policies for owners, and other developments Failing to amend provisions to reflect change can have the same prickly outcomes as using an outdated buy-sell agreement.

The patch for this hole is to look both inside and outside of the buy-sell agreement for developments that can affect its efficacy. This is a principal benefit of meeting annually with your advisors.

CONCLUSION

Many continuity plans are inadequate because they have at least one of the aforementioned holes. As Owner-Based Planning Advisors, we look at continuity plans and buy-sell agreements as tools to reach your overall goals. We've provided this white paper because, in our experience, a majority of continuity plans and buy-sell agreements are full of holes that must be patched.

Taking time to assure that your business-continuity plan, especially your buy-sell agreement, is comprehensive allows you to rely on your plans with little worry. Please contact us today to begin creating a strong business continuity plan for you, your family, and your company.

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