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# An Agreement Is Not A Plan

When co-owners are united in striving toward common business goals such as growing revenue, building business value and increasing cash flow, the business dynamics can be wonderfully positive and strong. Contrast that bright picture with what can happen when the goals of the owners diverge.

As you read further, ask yourself if the real issue facing owners in our examples is the misalignment of goals or a lack of planning for the day one owner wants to leave.

## Owner Disability and Other Lifetime Transfer Events

What happens when one owner of a closely held company wants or needs to leave the company or sole owners want or need to leave theirs?

The reasons owners cite for leaving include everything from simple boredom to more dramatic and unexpected events such as the disability of an owner. As an example, let's use an owner's disability to illustrate some of the significant issues that arise when one owner needs to leave a company.

When disability strikes, companies undergo 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 usually evaporates. This is the problem Steve Hughes, one of three equal shareholders in a growing advertising agency, confronted.

*At age 38, Steve had a stroke and, as is the case with many stroke victims, his recovery*

*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 Steve's stock if he were to try to sell it to a third party. It was silent on an owner disability or the more common situation of owners choosing to leave the company. This glaring omission left the company and Steve in a classic dilemma.*

*The company, or rather the remaining shareholders, wanted to purchase Steve's stock so that its future appreciation in value, now due to their efforts alone, would be fully attributed to them.*

## Consequences for Steve's Family

After the difficulty of the stroke and recovery period, Steve's family was still in a difficult position.

- *Steve's family soon realized that owners of stock in closely held companies rarely receive substantial benefits in the form of dividends or distributions because companies either accumulate or distribute (to active shareholders) profits 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. Steve's co-owners learned that their efforts to increase the value of the business would reward them and Steve in equal measure.*

## Solving the Remaining Shareholders' Problem

Steve's co-owners can buy Steve's stock, but because they'd made no plans to do so, there are a number of obstacles.

1. There is a difference of opinion between buyer and seller related to the value of Steve's stock.
2. Steve's two co-owners want to pay as little as possible over as long a time period as possible because they (or the company): a) will pay with after-tax dollars; and b) they want to preserve capital rather than spend it on a non-productive asset such as stock of the company.
3. Steve's family wants to receive full value for Steve's stock as quickly as possible.

Before Steve's stroke all co-owners were in sync. Steve's disability, however, produced radically different owner wants and needs. To deal with this conflict, advisors must address four major issues with their owner-clients:

- Agreement on business value
- Funding for the buyout
- Agreement on payment terms for the buyout
- The income-tax consequences to the remaining owners on their payments to the

A buy-sell agreement drafted before Steve's disability could have managed all these issues simply because all shareholders would have made the agreement when they shared the same ownership objectives. And, they didn't know who would be exiting first!

## Solving Steve's Problem

Steve needs lifetime income for himself and his family. Even if the shareholders successfully resolve the buy-out issues listed above, the underlying problem remains: How can Steve maintain his former compensation level?

Let's assume Steve's pre-stroke, annual compensation was $250,000 and his interest in the company was worth $1,000,000. An all-cash sale might yield Steve after-tax investment capital of about $800,000. Can Steve expect a rate of return on his invested sale proceeds that matches his previous annual income from the company of $250,000 per year? The buy-sell agreement likely does not address this issue.

Many advisors believe their job is finished when owners sign a well-drafted buy-sell agreement. Steve would not agree.

Had Steve engaged in the Exit Planning process he would have quickly realized that a sale of his ownership during his lifetime (or at death) would probably leave him and his family with a fraction of the income they are now spending. Planning would focus on closing this income gap using his employment and buy-sell agreements, disability insurance, the creation of a wage continuation plan and other appropriate means.

We realize that otherwise well-drafted documents, such as buy-sell agreements, can create more problems than they solve. It is important to look at both the specific provisions of the agreement and put it in context by looking at the big picture and all possible scenarios that may occur. In this case that means we carefully address all of the ramifications of both lifetime and death buy-outs — for the business, the departing owners, and the remaining or surviving owners. We can talk with you about each scenario and the outcomes that you'd like to see, and then collaborate with your advisors to make sure that your agreements and planning are consistent with your goals.

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