When a Co-Owner Leaves Too Soon: Understanding the Lifetime Ownership Buyout Agreement

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 this with what can happen when, suddenly perhaps, things change.

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?

There are many possible reasons for leaving; reasons range from boredom to more dramatic and unexpected events such as the sudden disability of an owner.

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 Clint Fletcher, one of three equal shareholders in a growing advertising agency.

Case Study

At age 38, Clint 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 that he would never be able to return to work.

Clint'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 Clint were left in a classic dilemma-the company, or rather the remaining shareholders, wanted to purchase his stock so that its future appreciation in value, due now to their efforts alone, would be fully available to them. Conversely, as Clint'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, Clint's family would not get what it needed most: cash to replace the salary he was no longer earning. His partners faced the prospect that their efforts to increase the value of the business would reward Clint as much as themselves.

This dilemma could be solved only by a buyout of Clint'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.

The Fletcher buyout faced several problems arising from the now-divergent goals of the owners. Prior to Clint's 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.

Further, the remaining owners want to pay as little as possible over as long a time period as possible because they (or the company):

- Will pay for acquiring that value with after-tax dollars; and

- Want to preserve, not spend, capital on a non-productive asset such as stock of the company.

Before Clint's stroke there was mutual agreement and understanding among the owners. After his disability, there are radically different owner wants and needs. The result: owner discord and impaired business performance.

Four Major Issues

Typically, there are four major issues that arise in situations like this:

- Agreement on the business value
- Funding for the buyout
- Agreement on the payment terms of the buyout
- Payment to the departing owner with the least income tax consequences

A buy-sell agreement drafted before such transfer events occur and when mutual ownership objectives unite all owners can anticipate and manage each of these issues.

For more information or to learn how L. Harris Partners can help you plan your exit:

Phone 952.944.3303
tom.siders@lharrispartners.com
www.lharrispartners.com