Business Perpetuation Planning:
How Secure Is Your Future?

By Michael Marroccoli

Do you really know what's going to happen tomorrow or next year? If you own a business and have a partner or other stockholders, this is a question you really need to ask yourself: What happens if one of my partners dies?

In my 25 years of practice in consulting with business owners and providing advice on business perpetuation and risk management issues to transportation companies, this topic is one of the most overlooked. It could also potentially be one of the most critical issues to the survival of a business partnership, whether it is privately held or run by a multigenerational family. Why? Because everyone knows they should tackle the issue, but everyone puts it off—thinking it's never going to happen to them. But it does happen, every day, and the results can be devastating if the proper steps are not taken to ensure a smooth transition in the change of ownership, and the payment of a fair market value to the deceased partner's heirs. I have seen many extremely successful businesses and families destroyed, because they lacked the foresight to institute a sound buy-sell agreement between the stockholders or partners.

Fact or Fiction

The story below is fiction; however, the scenario is very real, and the resulting consequences are often too real for anyone who has not planned for successful business perpetuation. At the end of the story I will provide you with facts, and steps that are a must for anyone who is in a business partnership or is a stockholder in a closely held corporation.

The Story:

Robert and Bill met 15 years ago while they both worked for one of the most successful limousine companies in the Northeast. Robert was the operations manager, who had a strong financial background. Bill was hired by Robert and was one of the leading salespeople in the company. After working together for 5 years, the two had become friendly, and their families often socialized together. They both understood the business, and thought they had a good model for successfully launching their own limousine company. Using some of their own savings as startup money, and investment capital from a small business loan, they took a leap of faith in their own abilities and started a corporate limousine service. Within 5 years the company's profits and operations were exceeding all of their expectations. Then one July night, Robert received a call that would change his life and his dream: Bill had a heart attack and died.

Robert was shocked. He couldn't believe that his partner and friend was gone. After the tearful funeral, Robert continued sending paychecks to Bill's widow, Becky, for a few months. With the success of the company, he knew he could continue to pay her for at least a year with no problem. But he could not just continue to pay her forever, and he had to hire a new sales manager to fill Bill's role. But what to do next, and when to do it, was a dilemma that was keeping him up at night. The following week, Robert received a call from Becky, saying she wanted to come work for the business. She said that she had spoken to her lawyer, and that she was now the owner of Bill's 50 percent of the company stock. Robert unexpectedly now had a new partner. Robert's company and lifeblood was disrupted and adjusting to Becky was tough, often fighting about employees, decisions on re-investing in the business, buying new vehicles, etc.

Robert told Becky he wanted to buy her out, and gave her an offer that he thought was fair. Becky's response was that the offer did not come close to the value of the business, and she was suing him for breach of fiduciary duty, mismanagement of the company, and a laundry list of other accusations. Robert called his lawyer, and the rest was history. A prolonged legal battle proved costly to both parties. Robert, faced with the distraction of the litigation, began to feel the stress of the case wearing him down, which affected his performance in running his limousine service. It also affected the relationship with his family. Within the organization, employee morale began to suffer, and several key employees left to go work at a competitor. The revenue of the business fell drastically, while the cost of doing business was still going up. This was a nightmare of the greatest proportion for Robert. The business he had worked so hard to successfully build was in critical condition.

Robert was forced to settle with Becky if he wanted to move on with his business and his life. He made monthly payments to Becky, downsized the business, and re-tooled his own lifestyle to meet the income level he expected to be able to draw from the business while he tried to re-build over the next 3 years. But now at 60 years old, this was not where he had envisioned he would be in those lofty dreams just a few years

ago. And what about Becky? She had to settle for an amount which was significantly less than Robert's original offer. In addition, both parties had spent over $100,000 in legal fees to protect their interests in the business.

What Went Wrong?

FACT: If Robert and Bill had a properly executed buy-sell agreement, Robert would still own a very profitable limousine company, and Bill's wife would have received a fair market value for her husband's part of the business, significantly more than the settlement amount she received.

FACT: A properly executed buy-sell agreement funded by life insurance would have provided Robert and Bill a way to fund this buyout with discounted dollars, at just a fraction of the actual cost. For a few thousand dollars per year they could have avoided this nightmare scenario, and protected the value of the business they had worked so hard to build.

Family First

I hear various excuses from people as to why they haven't set up a business perpetuation plan. Being part of a family business is no excuse for failing to set up an insured buy-sell agreement. This mindset lends itself to the most devastating of all consequences. Why? Because it usually results in not only the destruction of a profitable business, but often the destruction of a family; resulting in emotional scarring that lasts for generations. A great majority of companies in this industry are family-owned, and often the children take over for the parents as they grow older. Imagine a father and his two sons running a limousine service for years until the father suddenly passes away. What is the plan for his wife? How do the sons decide to split the ownership, stock, and responsibilities in the company? Disagreements between the brothers will certainly affect their families and the business.

With a buy-sell agreement, family members are assured of an equitable distribution of the value of the business. The value is agreed upon, and there are no surprises. Even if your partners are your brothers, sisters, parents, aunts, uncles, or best friend, you need to set up a buy-sell agreement. Every day the media report on relationships that have been torn apart over disagreements about money; this underscores the importance

of protecting all parties by taking the time to have this legal agreement in place. While a business is important, relationships with your loved ones are certainly more important. Failure to have this plan in place will most likely lead to strained relationships and a lot of heartache.

Steps to Take

I first suggest that you see your attorney, or find one that has some experience in creating a buy-sell agreement. All partners should sit down and agree to a purchase price of the business in the event of the premature death of one of the owners. This will assure that the business will have a smooth transition, and that heirs will receive a fair market value for the business. A signed agreement by all parties will provide you with peace of mind.

Second, put a valuation formula in your agreement. This can tie the value of the business to gross revenues or earnings before taxes in the preceding 12-month period. Then use a multiple of either of these numbers, depending on which provides the most realistic fair market value. This will assure that the value is current at the time the buyout is triggered. Whether you use a set price or some formula, schedule a yearly review of the valuation: also make sure that the agreement reflects a purchase price that is equivalent to the fair market value, and is agreeable to all stockholders or partners. See your accountant for tax advice.

The third thing I suggest is to purchase life insurance to fund the buy-out. You can fund this buy-sell transaction with discounted dollars by using life insurance as a funding vehicle. Depending on the ages of the partners or stockholders, you may want to consider term insurance simply to fund the buy-out, or permanent insurance like whole life or universal life which builds cash values or policy equity to fund an early buy-out or to supplement retirement income. For pennies on the dollar, you can solve this problem and protect your business interest.

You've spent countless hours and years of hard work to build a successful business that provides you and your family with security. Now spend a few hours with your lawyer and your insurance professional, to make sure your plans, dreams, and hard work are not destroyed for the lack of a simple plan. **LD**

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