What Happens if You Outlive Your Business Partner?

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From strategic plans to marketing plans, business owners rely on almost every available tool to ensure the success of their enterprise. Almost every tool, but not quite. Believe it or not, surprisingly few owners of small business and professional enterprises maintain a buy-sell agreement, one of the most important covenants in business.

A contract whose simple name belies its significance, a buy-sell agreement ensures orderly transfer of ownership in a company or partnership. Without such an agreement, events such as death, disability, retirement, and disagreements among owners or major shareholders can devastate a company as totally as an uninsured natural disaster.

Here's just one example of what can happen: Three brothers owned a successful chain of movie theaters in the Midwest. All three were approaching retirement. Like many entrepreneurs, they wanted to pass the business on to their children. The problem: Who deserved what share? Not all of the children had worked in the company. Did they deserve equal shares or shares according to experience? The brothers couldn't agree. With rancor they dissolved their corporation and divided the theaters equally among the children. Within five years, the fifty-year-old family enterprise died, all for lack of a simple buy-sell agreement.

The continuing success of a small business or partnership greatly depends on the existence of a buy-sell agreement. Without such an agreement, owners invite chaos when one leaves the business. More businesses risk chaos than you might think.

Only three percent of the small business owners (100 or fewer employees) surveyed for a 1999 industry report maintained insurance-funded buy-sell agreements, according to the Life Insurance Marketing and Research Association. C. Edward Fletcher, director of the University of Cincinnati's Center for Corporate Law, attributes this type of situation to natural, but unwise, assumptions made by partners who start a business together. "Individuals make many assumptions based on friendship or mutual respect at the beginning of a business relationship," notes Fletcher. "They don't realize how stressful business can become, causing friendships -- and even family relationships -- to erode."

A "good" agreement anticipates what will happen when it is put to use. "Unfunded, poorly defined, or nonexistent buy-sell agreements create serious problems," notes Sonja Hayes, J.D., L.L.M., advanced marketing attorney for GenAmerica Financial Corporation, St. Louis, Missouri. She offers these examples:

- A company has no readily available funds to buy a retiring owner's share of the business, so it must borrow or otherwise locate the money.
- An owner dies. The business doesn't have any buy-out provision in place. The deceased owner's spouse or child, has no business experience, but tries to get involved.
- The permanent disability or death of an owner creates a conflict between other owners who want the business to survive and the absent owner's family members, who want to cash out.

To avoid such problems in your business, begin the process of buy-sell planning by acknowledging the need for a viable agreement, then addressing the following issues in a subsequent legal contract.

HOW TO STRUCTURE A BUY-SELL AGREEMENT

Individual state laws define the regulatory framework of partnerships and corporations, but such regulations are basic. Buy-sell agreements are unique to every business and its specific structure. "When people do business together in any form, they must contemplate possible buy-sell scenarios and deal with them in advance," asserts Hayes.

Buy-sell agreements deal with issues large and small. The following are often addressed in contracts, Hayes notes: "Do other shareholders have first rights to purchase available shares? Can shareholders transfer shares without permission from other shareholders? What happens to the company and its assets if a partnership or corporation dissolves? What if an owner dies or is disabled?"

Tax responsibilities, liabilities, and other matters addressed in a buy-sell agreement differ, per an organization's structure. Many companies exercise a stock redemption plan, which dictates terms under which the corporation can buy back stock; other companies use a "cross purchase" plan, a stock acquisition agreement among individuals. Rely on experts to help you with such details.

Valuation

Before partners or shareholders establish a price for a share of the business, they must determine its fair value. Appraisal companies that specialize in business valuation and full-service accounting firms can help. Valuation involves more than numbers on a ledger sheet. "Value is created by many things, including name recognition, contracts, reputations, market position, oral contracts, product or service quality, and business relationships," says Hayes. It's best to determine valuation before -- not after -- the time comes to sell all or part of a business.

Funding

Ideally, a fully funded buy-sell agreement helps achieve one or more of these objectives:

- Purchases a deceased, disabled, or retired shareholder's piece of a business.
- Pays estate taxes.
- Equalizes the estate of children who don't participate in a family business.

Owner disability also should be addressed in a buy-sell agreement. Owners, key shareholders, or partners in a small business should be covered by disability income insurance. Many business owners are hard-pressed to define disability. What constitutes total disability? How much time must go by before an injured owner is considered permanently disabled? Business owners must find answers that best meet their individual needs and situations, keeping in mind that terms of disability insurance policies vary and may be specific to certain occupations.

For example, a business owner who wants to save about $1 million in twenty years needs to save $25,000 annually in a sinking fund, assuming a seven percent annual return, to reach that goal. The annual outlay to achieve the same results via an investment-oriented life insurance policy would be similar but with one huge advantage: The owner of the insurance policy has a $1 million death benefit from day one. By comparison, after three years, an owner saving via a sinking fund has about $55,373 in cash. After fifteen years the savings reach about $603,000.

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Planning for an owner's premature death is not the most pleasant subject to address, but is one of the most important elements in a buy-sell agreement. Some owners fund buy-outs from business proceeds, which can negatively impact the enterprise's bottom line. Others sock money into a so-called "sinking fund," a systematic savings program that also can strain a company's resources. Many others incur debt to honor a buy-out.

Life Insurance: An Ideal Way to Fund Buy-Sell Agreements

Experts agree that life insurance is an ideal way to fund a buy-sell agreement. Today's life insurance contracts offer the flexibility and performance of other types of investments and provide one feature that no other investment has: *death protection.*

Business owners should first concern themselves with death coverage, dealing with cash accumulation needs as a business matures. Most importantly, business owners must acknowledge their potential financial needs as early as possible.

"Business is often as emotional as marriage, and it's wise to know how to get out," Hayes advises."Without a buy-sell agreement, a company is a potential battleground in which its value can be drained and only lawyers are enriched. It's better to think through these issues when relations are good than when emotions can get in the way."

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