Preparing for the Unexpected: Lifetime Buyout of a Co-Owner

When the co-owners of a business are striving toward common business goals like growing revenue, building business value, and increasing cash flow, the dynamics can be wonderfully positive and strong. But, what happens when one of the owners wants or needs to leave the company?

Reasons for leaving range from boredom to more dramatic and unexpected events such as the sudden disability of an owner. When the latter happens, the company and the owners will most likely be faced with economic and operational hardships.

Let's look more closely at how this might play out.

Case Study

Harold Stevens was one of three equal shareholders in a growing construction company. At age 38, Harold suffered 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 he would never be able to return to work.

Harold's company had a buy-sell agreement, but it covered a buyout only 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 didn't have the resources to do so indefinitely.

As a result, the company and Harold were left in a classic dilemma: the company, or more specifically, the remaining shareholders, wanted to purchase Harold's stock so that its future appreciation in value would be fully available to them. Conversely, as Harold'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, Harold's family would not get what it needed most: cash to replace the salary he was no longer earning.

The Stevens buyout faced several problems arising from the now-divergent goals of the owners. Prior to Harold's unexpected disability, 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. His partners faced the prospect that their efforts to increase the value of the business would reward Harold as much as it would themselves.

Further, the remaining owners wanted 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 they want to preserve, not spend, capital on a non-productive asset such as stock of the company.

How Do You Avoid this Situation?

Before Harold's stroke there was mutual agreement and understanding among the owners. After his dis-

ability, there are radically different owner wants and needs. The result: owner discord and impaired business performance.

This dilemma could be solved only by a buyout of Harold's stock. His family could then 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.

There are four major issues that should be addressed in a buy-sell agreement:

1. Agreement on the business value
2. Funding for the buyout
3. Agreement on the payment terms of the buyout
4. Payment to the departing owner with the least income tax consequence

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

If you would like to discuss ways to prevent problems in a transfer of ownership, please contact one of our advisors.

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

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