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BUSINESS CONTINUITY

Considerations: What's Important?



Business continuity planning focuses on *preserving* and *protecting* a business from an unexpected “triggering” event that interrupts ownership structure and/or business operations. While it is unpleasant to think about death and/or disability, it is critical to be prepared. This article will discuss the important issues that a comprehensive business continuity plan should address, and potential solutions for each.

BUY-SELL AGREEMENTS

For multiple owner companies, a shareholder agreement, also known as a buy-sell agreement, may be one of the most important legal documents an owner will ever sign.

The agreement typically provides for ownership transfer upon a “triggering” event, purchase price/terms, funding options, and other necessary business continuity protections.

Consider when business partners first start a company. Planning begins with common goals such as growing revenue, value, and cash flow. Contrast this bright picture with what can happen when the goals of owners suddenly diverge.

For example, one partner might become a buyer and the other, a seller. One might expect maximum price, while the other would justify minimum price. One owner might prefer profits stay in the business to fuel operations, while the other might need that money to survive.

It is vital to ensure buy-sell agreements are properly drafted and executed to help mitigate such disparities and provide direction for business continuity.

Types of Buy-Sell Arrangements

Well drafted and properly funded buy-sell arrangements protect business owners' interests *and* help facilitate business continuity. These arrangements can be structured in a variety of ways, but generally fall into one of the following categories:

- **Stock redemption or entity purchase** – Under this approach, the business has the first right, or obligation, to buy the departing or deceased owner’s interest upon a triggering event.
- **Cross purchase** – This agreement exists between owners. Under this approach, the remaining or surviving owners have the first right, or obligation, to purchase the interest of a departing or deceased owner.
- **“Wait-and-see” or hybrid agreement** – This is a combination agreement that usually places the responsibility for the purchase on the business but gives owners the option of buying a departing or deceased owner’s interest if the business is unwilling or unable to do so. The “wait-and-see” approach also allows the owners to defer the choice between an entity purchase and a cross purchase agreement until a triggering event occurs.
- **“One-way” or unilateral agreement** – This arrangement exists between a business owner and a willing buyer, typically a key person and/or family member working in the business.

forced to join the deal. They must sell their interests at the same price per share. This provision protects majority shareholders by not encumbering a sale due to a resistant minority owner.

- **Tag-along provision** – This applies the same idea as the drag-along provision but is worded accordingly to protect a minority investor. A tag-along provision forces the majority shareholder to let the minority shareholder “tag-along” in the sale at the same terms and price.

While the aforementioned are not all inclusive, it is important to regularly review and revise buy-sell agreements as circumstances and objectives do change.

BUSINESS CONTINUITY: OTHER IMPORTANT CONSIDERATIONS

Loss of Financial Resources

Owners often represent a principal source for the company’s financial stability (bond guarantees, line of credit guarantees, etc.).

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The best structure depends upon several factors, including a business’ entity type, number of owners, tax implications, etc. Here are some important provisions to include:

- **Coverage of all triggering events, not just death/disability** – Other events causing ownership to potentially change hands include retirement, termination, divorce, bankruptcy, illegal acts, and business disputes, to name a few. Provisions for all of these should be included in a well drafted buy-sell agreement.
- **Valuation method** – Company value may be identified as book value, capitalization of earnings, formula, mutually agreed upon value, appraisal, etc.
- **Terms of purchase are identified** – Promissory note provisions typically include time, interest rate, and down payment percentage; a provision for life insurance funding is also commonly included.
- **Drag-along provision** – This provision requires that if the majority shareholder chooses to negotiate and sell his/her stake in the business, then minority owners are

A sudden death or incapacity can put enormous pressure on the business to perform or face the risk of third parties refusing to lend or make guarantees on behalf of the company. The following financial relationships could be at risk:

Bank Financing

If owners have personally guaranteed the company’s line of credit or permanent financing, a sudden death or departure will likely cause the bank to re-examine its lending relationship with the company. They reserve the right to “call” the loan upon a real or perceived change in financial condition.

Bonding Capability

Construction companies need and often rely on bonding capacity to bid and obtain much of their work. An owner’s sudden death will likely cause the bonding companies to refuse to extend bonding unless the financial statements of those left behind are as strong as the original owner’s. Inability to secure bonding could lead to the demise of the company.



What's Important?

Obligations Under the Lease

If the company leases space or equipment, it is highly likely that the owner has personally guaranteed the lease. While the lessor may be unable to terminate the lease (provided payments stay current), he/she may be unlikely to renew the lease without the successor owner's guarantee, backed by personal assets.

Capitalization Shortfall

Many business owners periodically capitalize their companies through the use of personal funds. As they strive to minimize reserve "earnings" on the company balance sheet for sound tax and liability reasons, an unexpected exit may prevent the company from obtaining necessary outside sources of capital.

Loss of Key Talent

Business owners understand the importance of insuring their tangible assets including their building, inventory, equipment, etc. Yet an often-overlooked asset, one even more valuable to the company's continued profitability, is its human capital.

Regardless of size, most successful companies have one or more key individuals who contribute significantly to bottom line profit. Their sudden loss would have a negative impact on the financial performance of the company. Locating, recruiting, and training their replacements also adds to the financial strain.

Loss of Employees & Customers

An unfortunate result that often follows the death/disability of a business owner is the potential loss of valuable employees and with them, perhaps the company's customer base.

Concerned about their future, valuable employees may seek positions elsewhere, thus eroding customer loyalty. They are also the most capable of finding alternative employment. Without the continued services of these valuable people, the business can suffer.

BUSINESS CONTINUITY: SOLUTIONS

Now that we have identified important issues that should be addressed within a comprehensive business continuity plan, how do you solve those concerns?

First, it is critical to *proactively* document your business continuity instructions and communicate them to all stakeholders. This may include employees, bankers, bonding companies, vendors, suppliers, CPAs, attorneys, spouses, etc.

Secondly, one must identify how these continuity issues are to be "cash flowed" or financed. Since most all require capital to facilitate and/or alleviate the problem, the challenge that arises is attempting to extract additional working capital from an entity that is already suffering from a loss of its primary source of financial stability.

The answer is business continuity insurance. Let's examine how this protection might alleviate the business continuity challenges discussed.

Buy-Sell Agreements: Life & Disability Buy-Out Insurance

Life insurance and disability buy-out insurance offers co-owners or key management the dollars necessary to purchase stock via terms of a buy-sell agreement. If adequately funded, these options ensure the deceased or disabled owner's family receives fair market value for their business interest. Payable either via a lump-sum or stream of income, the departing owner's family avoids being financially dependent upon the continued profitability of the company or its successors – or worse, feels compelled to step in and assume responsibility for generating profits in hopes of someday garnering fair market value.

Depending on the type of life insurance, cash value accumulation may also be used to prefund a "living" buyout upon an owner's retirement.

Loss of Financial Resources & Key Talent: "Key Person" Insurance

As with tangible assets, the company can protect against the loss of both key talent and key financial resources by implementing a key person insurance plan. Under such a plan, the company is both owner and beneficiary of a life insurance policy with proceeds used to reimburse the company for lost profit momentum, financial stability, balance sheet assets, etc., and assures creditors that operations can continue uninterrupted.

Loss of Employees & Customers: A "Stay Bonus"

When an unexpected death of leadership occurs, key talent naturally questions their continued financial security, sometimes resulting in their departure for "safer ground" – perhaps even with a competitor. They can often take with them their trusted customer/vendor relationships.

A solution is what is referred to as a "stay bonus," which is designed to provide valuable employees with financial incentive to remain with the company following an unexpected death or temporary disability of an owner.

A stay bonus provides a guarantee of the employee's compensation at an enhanced level (e.g., 150-200% of current compensation) for a period of 12-18 months, or at least until the company can be stabilized, sold, or liquidated. It is typically funded via life insurance on the owner's life in an amount equal to the enhanced compensation guarantee and supported through legal documentation.

CONCLUSION

Most business owners spend a lifetime building, managing, and growing their companies that evolve into dependable financial security for the owners, their employees, and the communities and industries in which they serve. Establishing a comprehensive business continuity plan enables the company's continued operations and profitability should an unexpected event occur.

Strong business continuity plans, in addition to business continuity insurance, provide stakeholders needed resources to alleviate or facilitate security measures, and can even offer solutions to funding a living buyout or retaining key talent. Advisors should also be able to offer a business continuity instruction form and/or checklist to help owners begin and, as part of a written and communicated comprehensive exit plan, can help increase the likelihood of business survival. ■

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