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LAGOS
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BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

Mistakes Business Owners Make

With Business Continuation Plans

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A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Many life insurance and financial professionals market their products and services to the owners of closely held businesses. The world of successful entrepreneurs can be rich with challenges and opportunities.

Experienced professionals have their own usual entry points for starting conversations with business owners. Some start with questions about the possibility of disability, leading to a discussion about the virtues of disability-income coverage. Others have pension-related products in their pockets, and the business discussion often ends up centering around tax deductions for the company.

We wrote in 2018 about starting the business continuation process with a closely held business owner. But what if a business owner has already begun to make plans for selling the business that seem to be heading in the wrong direction? What if a sale has started but is now falling apart? Could some of our clients who are in a selling mood be leaving money on the table?

Please continue reading to learn more.

Regards,
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Mistakes Business Owners Make With Business Continuation Plans

One of the jobs of the financial professional who is working with a closely held business owner is to be an accountability partner as the client makes continuation plans. If sensible business-continuation plans are put in place beforehand, the risks to family and business can be minimized. Financial professionals who are effective business-transfer coaches can do much good for their clients.

Understand that our business-owning clients are not just making plans to transfer at death. A significant percentage should be considering a lifetime sale—perhaps as soon as now. We should be prepared to help them with immediate sales, as we can

- be part of the team that suggests tax-efficient sales strategies,
- help make sure details are not being overlooked, and
- become effective stewards of after-tax sales proceeds.

So, why doesn't every life professional work in this market? The answer is probably because it can be *really hard* to do a good job. One of the reasons that giving effective advice is difficult is that many of our entrepreneur clients do not easily acknowledge when they might be making a serious business mistake.
In this issue, we have identified some of the mistakes business owners make as they begin to make business continuation plans. As financial professionals work with business owners on continuation plans, the pitfalls described below should be considered and avoided.

CONTINUATION MISTAKES

By the time many people decide to sell their businesses, they have often missed good opportunities to make their business more salable or valuable. Therefore, they don't receive top dollar for their businesses—whether selling during lifetime or after death.

Unrealistic Estimate of Business Value

Business owners often get the potential value of their business wrong. If they are in a selling mood—or making plans for the future—having an incorrect value in mind can be a problem. Too high an asking price, and it may scare real successor owners away. Too low a value might result in the client leaving money on the table.

Just like anything else of value (think house or car), there are standardized methods of valuing a business. The value of a business is usually a multiple of the cash flow the business is capable of generating, plus the value of assets that may accompany the sale (real estate, equipment, and inventory). What a business is *not worth* is what the owner needs to pull out in order to retire, pay off a house, support surviving family, or put kids through college. Understanding what the business is realistically worth is important as plans are made to sell.

Someone who is marketing a business for sale in the near future may decide to invest in a formal business valuation to help support a reasonable asking price for the entity. A business owner planning to sell to co-owners or a key person may be able to avoid the expense of hiring a valuation expert, as the parties involved in the transaction have more direct knowledge of how much the business is worth to them.

A financial professional working with the owner or owners of a company needs to understand how the owner has arrived at any business valuation and should act as an accountability partner if the valuation seems to be inaccurate.

Failing to Respect the Business as an Entity Separate from the Owner

Many of our business-owning clients treat their companies as an extension of their personal domains. That's understandable, as it can be quicker to get things done when a one-owner company ignores barriers between business and family.

However, when the owner's personal affairs and the business are strongly intertwined, it can be hard to separate them when the time comes. Furthermore, when the company's financial results are masked by the melding of personal objectives, getting value for the business can be hard.

Here's an example. While many business owners take advantage of an opportunity to take tax deductions for expenses of the business (like vacations, health insurance, meals, and car or phone expenses), all of these ultimately make the business financials look much worse. Proving that several thousand dollars of business-paid expenses are actually *business profit* can be difficult. If a prospective buyer does not agree that the business owner's family spending can be directly translated to operating profit, any offering price may be lower than desired.

A potential buyer will have more faith in the business they're buying if the seller can show a well-organized set of books that show solid financial performance. If the business does not have a qualified bookkeeper or CPA helping with records, the owner may be setting himself up for a less than optimum value on the business.

Some business owners may not be properly operating the business in a way that respects the business entity. For example, they may enter into business contracts that do not properly name the business entity as a party to the agreement. If the business owner hopes to sell to an unrelated party for top dollar, business documents and operations need to be tight and transferrable.

Waiting Too Long

The owner of a closely held business will get top dollar for a business when it is profitable, has a good track record, and a buyer can see that the business is doing well. Often, business owners hold on to their businesses too long and begin either to lose money or to sink money into the business trying to resurrect the glory days.

By the time they decide to sell, it's too late to work out a good deal. When a business is no longer profitable and not on a good path, low offers may be the only ones available.

Business owners who are planning to transfer business interests at death may likewise wait too long to put a sensible structure in place. Some will want to transfer business interests to family at death. However, if proper testamentary documents are not put in place to facilitate the transition from one generation to the next, family members may squabble over details—putting extra stress on the business and potentially causing its failure.

Other business owners will want to sell to partners, key people, or third parties at death. In those situations, it is even more important to have detailed written plans in place for the transfer before the time comes.

For Sale by Owner

When a local business goes on the market for sale, that can be big news—and not always in a good way. If the company's employees have not been part of the sales process, they will likely be suddenly uncertain about their employment—creating a risk of flight. The big news may create an opportunity for the business's competitors who will suddenly do everything they can to steal existing customers. The company's suppliers may suddenly tighten credit because of the uncertainty of the future of the business. The business's customers may be surprised by the news and be tempted to move their loyalty elsewhere.

An owner selling a business on her own will likely lose any element of confidentiality of the sale of the business. At the very least, it's a distraction to the business, and at the worst, it can be disastrous.

Selling Parts of the Whole

Some solo business owners may not be ready to part with their entire business, so they look for opportunities to take on a partner. This may be done to infuse some capital into the business or to take over some of the workload. In our experience, the strategy usually doesn't work the way it is planned.

The owner of the business who was previously able to make decisions on his own would need to take into account the perspective of the new co-owner. Differences in management style, work ethic, and philosophy of managing the business can vary greatly between two partners. Additionally, even the ethics and values of two partners can be very different. For example, one partner may want to adhere strictly to income-tax rules, while the other owner may prefer to be more aggressive in interpreting tax laws.

Once a new owner is brought into the business, it can become difficult to subsequently sell the whole company because it generally would require the agreement of both.

Announcing a Transfer Too Soon

When a lifetime sale to a third party occurs, both buyer and seller are usually excited to announce the transfer of the business. However, owners should generally wait to tell employees and customers until after the sale has actually closed—for potential drawbacks similar to For Sale by Owner above.

Many deals that seemed to be done fall through due to some unforeseen event. Last-minute issues with financing, liens on the business, or loss of a key customer can all happen literally days or even hours before a closing. If the employees or customers are already aware of the sale, then the owner has a lot of backpedaling to do to get his business back on track.

Giving a Key Employee Too Much Control

As business owners begin to plan to transition out of their business, they will look for potential buyers. Successful businesses often have key staff members that run the day-to-day operations and are familiar with the intricacies of the business and industry. This makes these staff members natural choices to succeed the seller as the new owners once the time is right.

However, to make sure that nonowner managers are adequately prepared to make the transition, many steps must be taken leading up to the sale. A major pitfall that traps business owners is that near their retirement they often become absentee owners. goal or want for entrepreneurs to be able to not work full-time every day and still reap the benefits of ownership, the business owner should be careful not to lose sight of what is happening in their business.

A careful succession plan should begin months or even years before an actual business sale takes place. To effectively do this, the business owner must stay involved enough in operations to understand what is happening in the business and the industry.

For example, what if a nonowner manager takes over all of the important management decisions of the business, along with the responsibility of maintaining relationships with vendors and customers? These managers often know the revenue and expenses of the company and understand the profitability of the company. What would prevent that manager from leaving to start his or her own business?

Our own business accountant Craig Ballentine shares this story:

> Early in my career, a successful entrepreneur client of mine told me something that made a lot of sense. He said, "A business owner is constantly training his future competition." I've seen this to certainly be true, especially in today's market. The current generation of college grads and recent grads seems to be very entrepreneurial. We can see examples of that in companies we use every day; Google and Facebook are two obvious instances.
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> Small businesses face the same risk with their young employees. Once set up with the knowledge and skills to work on their own, key personnel may see an opportunity to leave the company and start their own business in the same industry. If a business owner has become an absentee owner, then the risk is increased. The fact that the business owner paid to train the young employee may not prevent the risk of flight.
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> An exiting manager may also take other personnel with them, which can cause additional problems and hardships. For the business owner, it may be too late to save the ship. If the owner has not been involved for some time, then their customers are likely to have formed new relationships and will be less likely to remain loyal. This often happens in service companies in which key client relationships are the lifeblood of the business.

The risk of key people leaving the company to start competing businesses underscores why it's imperative to begin the succession plan long before the business owner is ready to sell. Although not thought of as a part of the succession plan, noncompete agreements and nonsolicitation agreements should be considered between the company and key personnel. These agreements with management restrict their ability to leave and start their own business and should be implemented and signed immediately upon hiring.

Nonsolicitation agreements usually prevent a former employee from soliciting any customers from the current business. Violation of these agreements can result in lawsuits and may force the violator to stop certain behaviors or pay damages.

While it is important that business owners begin to transition their business, they cannot do so in such a way that they lose total control. The best advice may be to compensate key personnel in a manner that encourages them to remain part of the team. This may mean putting together a compensation package that ties into the overall succession plan, which may include a bonus structure that is determined by company performance and the opportunity to earn ownership in the company over time.

If key personnel are properly compensated, they are less likely to leave. A good pay plan—perhaps using deferred compensation informally funded with permanent life insurance—can encourage the behaviors consistent with long-term business success and help the owner transfer the business in an orderly and profitable way.

Failure of the Buy-Sell Agreement

A properly drafted and funded buy-sell agreement can be the key to the orderly continuation and transfer of a closely held business. However, we've seen many situations where the agreement is not adequate.

AGREEMENT IS NOT MANDATORY

An important purpose of a buy-sell agreement is to create certainty about the transfer of a business interest when a triggering event occurs. Sometimes the business owner's own ambivalence about the transfer method can cause the agreement to fail.

Here's an example of language from a buy-sell agreement for a Limited Liability Company (LLC) that, in our opinion, undermines the purpose of the agreement:

> Upon the death of any Member, the estate of the deceased Member may sell to the Company all or a percentage of such deceased Member's Interest in the Company now owned or hereafter acquired by such deceased Member, and the Company may purchase all of such deceased Member's Interest as provided for in this Section:

If one of the owners of the company dies, is the deceased owner's family certain to be protected? Are the remaining owners of the LLC assured of continuing the business without interference from the deceased owner's family?

The answer to both questions is no. Since the buyout language is permissive (may purchase) rather than mandatory, the agreement seems more of a suggestion than a plan.

VALUATION MECHANISM IS TOO UNCERTAIN

We have seen buy-sell agreements where the language creates uncertainty over the business's value. That can be a barrier to a smooth transition.

For example, in *Sassower v. 975 Stewart Avenue Associates, LLC*, 2010 NY Slip Op 31700 (2010), the court ruled on the buy-sell provisions of the LLC's operating agreement. The agreement provided that in the event one of the doctors left the medical practice, the departing doctor would offer his interest in the company for sale to the remaining owners.

The agreement provided that the offer price was to be determined through an appraisal process. Both seller and buyers would hire appraisers to calculate value using a market-value approach. In the event the appraisers differed by more than 10 percent, the appraisers would select a third appraiser to come up with a binding value.

Dr. Sassower left the practice, and he hired an appraiser to value his 12.5 percent minority interest in the practice—as did the remaining owners. The respective appraisers came up with company valuations that differed by more than 10 percent. The appraisers hired a third party to break the tie.

While the third party was in the process of valuing the company, the appraiser for the remaining owners decided that its valuation was too high, as it failed to consider existing company debt. The court case was brought to determine the enforceability of the agreement, and whether the value of the business should be adjusted for debt or not.

The court decided that there is no universally accepted way to value a business based on a market-value approach. It also decided that it was not clear whether it was proper for an appraiser to deduct—dollar for dollar—the aggregate amount of debt from its market-value calculation. The court ruled that the parties would have to go through a full trial to determine the value of the business.

In the Wisconsin case of *Ehlinger v. Hauser*, 2010 WI 54 (2010), the parties to a buy-sell agreement could not agree on how the book value buyout price would be calculated.

Jon Hauser and Robert Ehlinger were the equal shareholders of Evald Moulding, Inc. The parties entered into a cross-purchase buy-sell agreement in 1992. The agreement provided that if one of the shareholders became totally disabled, the nondisabled shareholder would be entitled to purchase the disabled owner's shares at book value. The disability section of the buy-sell agreement provided:

> Upon a Shareholder becoming totally disabled as defined hereafter, for a period of twenty-four (24) consecutive months, the other Shareholder shall have the first right to purchase all or part of the stock owned by the disabled Shareholder. Any part of the stock owned by the disabled Shareholder not initially purchased by the other Shareholder shall then be offered to the Corporation for purchase. Any part of the stock owned by the disabled Shareholder not purchased by the Corporation must then be purchased by the other Shareholder. . . .
> If there is no disability buy-out insurance for a Stockholder, "totally disabled" as used herein shall be defined as being unable to perform all the substantial and material duties of his employment with Evald Moulding Company, Inc.; or of the occupation or profession he practiced on the date he became disabled.

In June 2001, Hauser invoked the disability buyout provision of the proposed buy-sell agreement based on Ehlinger's disability. Because that agreement used the term *book value* as the measure for determining a shareholder's interest in Evald, Hauser calculated his version of the book value of Evald—a value of $431,400.

Ehlinger agreed that Evald's book value was the measure for ascertaining the value of his stock, but he concluded that book value had been understated. The parties went to trial over the interpretation of the buy-sell agreement.

The trial court tried to determine whether book value, as defined in the agreement, was based on tax value, fair market value, GAAP value, or some other method. It decided the agreement was ambiguous on this point and, therefore, unenforceable. The appellate court and Wisconsin Supreme Court agreed.

BUY-SELL AGREEMENT'S AMBIGUOUS EFFECT ON SPOUSE

Courts have been asked to decide whether a buy-sell agreement between the nominal owners of a company may be enforced against a spouse as the successor or silent owner of a business interest. These issues often come up in the context of a divorce, when the buyout is triggered at a price that is unacceptable to the nonbusiness spouse.

Some courts have decided that buy-sell agreements are binding on divorcing spouses, even if they have not been parties to the contract. Others have ruled that without express written consent of the spouse the terms are not enforceable.

The issue of a buy-sell's validity may also arise with regard to nondivorce transfer triggers. The inactive spouse may have certain ownership rights in a business that arise in connection with community property law or marital status.

Where business owners are married, it is strongly recommended that spouses are made parties to any buy-sell agreements.

CONCLUSION

Financial professionals can be intimidated by the possibility of a business continuation discussion with the owner or owners of a closely held business. Plans can be shaped so many ways, and it's hard to know without digging deeply into uncomfortable conversations where the discussion will end up. Perhaps the fear of the unknown keeps many agents from engaging in an in-depth conversation.

Our objective in this newsletter has been to help professional advisors be prepared to add value to client discussions about business continuation plans. We have pointed out some of the mistakes business owners might make when implementing a lifetime sale or a death transfer strategy.

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Building Protecting and Perpetuating Family Wealth

LWA strives to develop and maintain sound financial plans designed to achieve our client's wealth accumulation, preservation and transfer objectives, with the goal of preserving their wealth for multiple generations. We provide these services in a confidential and consultative manner, building life-long relationships based upon education, trust, communication and service.