BUSINESS CONTINUITY PLANNING

WHITE PAPER

GUYTON GROUP

Strategies for Your Wealth

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Introduction

Successful owners are usually optimistic people, somewhat averse to dwelling on the more unpleasant aspects of business. Contemplating one's demise certainly qualifies as an unpleasant aspect. Consequently, advisors tend to use a lot of softer phrasings when they talk about business continuity. They ask, "What happens if the owner 'passes on' or 'leaves the scene?'" They talk about the consequences of an owner's death on the business in theoretical, third-party terms: "Should an owner die, . . ." Unfortunately, these oblique references gloss over the central fact that you, the owner, must take care of business *now* in case *you* (rather than some anonymous third party) die tomorrow.

This white paper discusses business-continuity planning in a way that you may not expect. Typically, when owners think of business continuity, they do so after being prompted by an insurance or legal advisor who warns that unless they take prudent measures, they will leave their families unprotected in the event of death or permanent disability.

However, business continuity is not principally concerned with making sure that an owner's family is taken care of in the event of the owner's death or disability. As an owner, you address family concerns through proper Estate Planning. Business continuity is a means of handling a variety of transfer events and consequences that impact *the business* and the remaining (or new) owner when the original owner leaves.

Make Sure That Your Business Survives If You Do Not

The thought of what will happen to our businesses should we die is, at most, fleeting. In that moment, we seldom think beyond making sure our families are protected should the unthinkable happen to our *co-owner*. Yet, business continuity, in its most fundamental sense, has *nothing* to do with protecting an owner's family. It is about preserving and protecting *the business*, in the short and long term, should its most important component, its owner, die or otherwise become incapable of continuing in the company.

Ownership continuity is the most obvious problem facing a company, but it is one of four possible continuity problems:

1. Loss of continuity of business ownership.
2. Company's loss of financial resources.
3. Loss of key talent (i.e., you).
4. Loss of employees and customers.

Let's first look at a typical ownership situation and then at the four problems that an owner's departure creates in both sole-owner and multi-owner companies.

Case Study

Clint was a successful, hard-working owner of two successful businesses. Like most entrepreneurs, he tended to make all the decisions himself. At age 43, he knew he was far too young to be concerned with his death or disability and how those events might impact

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his family or business. Then one day, as he bent over to unbuckle his ski boot, he dropped dead.

As tragic as Clint's death was to his family, his failure to make any plans whatsoever for his businesses was an even larger business tragedy. No one knew what Clint's wishes were with respect to continuing or selling his businesses. No one (especially within his family) knew the businesses' overall financial conditions, administrative statuses, or operational concerns. The key employees knew only one thing for sure: The businesses would not survive for long after Clint's death. So, these employees promptly found new employment, thus hastening the inevitable shutdown of Clint's once-vital businesses.

Problem I: Loss of Continuity of Business Ownership

Sole-Owner Company

Continuity of business ownership is the critical issue in solely owned companies. In fact, there is no continuity unless sole owners take steps now to create a future ownership group or groom a successor.

Multi-Owner Company

Continuity of ownership is not an issue when a buy-sell (or business-continuity) agreement, funded by life insurance or disability buyout insurance, has been implemented. The problem is that most owners and their advisors fail to keep their buy-sell agreements up to date and, as a result, those agreements often create more problems than they resolve.

Solutions to Problem I

Sole-Owner Company

You can prevent the type of disaster that affected Clint's family if you create and implement a plan to allow the business to continue after you are gone. Since there is no co-owner, you must provide for the business' continuity—even if owned by your estate or a trust for the benefit of your family—by securing the continued services of your important employees. Do everything you can to prevent your employees from leaving, because they are indispensable to the business' continued existence. Secure their continuation by compensating them at a substantially increased level (usually 50–100% more than they ordinarily receive). This is best accomplished through the use of a Stay Bonus.

A Stay Bonus is a written, funded plan that provides monthly or quarterly bonuses, usually over a 12- to 18-month time frame, for employees who remain with the company during its transition from your ownership to new ownership. (This applies whether the business is transferred to a third party, employees, or family members.) The Stay Bonus provides a cash incentive for your important employees (perhaps 20–50% of the total workforce) to stay.

Typically, the Stay Bonus is funded with life insurance in an amount sufficient to pay the bonuses over the specified time period. The life insurance may be owned by the company or outside the company in an estate tax–sensitive trust. The plan is communicated to the important employees when it is created so that they know a plan exists and, consequently, that

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thought and planning (and money to pay salaries) will ensure the continuation of the business.

The second factor of single-owner continuity planning is to do exactly what Clint didn't do: *communicate your continuity wishes now*. At a minimum, you must communicate, in writing, your wishes as to what should be done with the business upon your death or permanent incapacity:

- Designate key employees or others who can be given responsibility to continue and supervise business operations, make financial decisions, and oversee internal administration.
- Name these individuals today through a business-continuity form. We have examples of this form, so if you would like a copy, please contact us.
- Name advisors and others, such as a friendly competitor, who should be consulted in the ownership transfer process. (Again, the idea is to put these names on a business-continuity form.)
- If it is your wish that the business be sold, state that intention. List the names and contacts of businesses that have expressed an interest in acquiring your company or who you think would make an appropriate successor/owner. Do so, in writing, on a business-continuity form. You may wish to indicate your desire that the business be sold to key employees, continued in the family, or liquidated. The choice is yours, but you must make it while you are alive. There is no better time than the present to do so.
- Finally, give the completed business-continuity form to the person you trust the most (e.g., spouse, child) and copies to your advisors.

Multi-Owner Company

From a continuity standpoint, the nicest thing about having multiple owners is that the business will continue if one of the owners dies, provided measures are taken—usually in the form of an up-to-date, adequately funded buy-sell agreement—to allow the remaining owners to acquire the deceased’s interest in the business. However, chances are that your buy-sell agreement has *not* been recently reviewed, *does not* reflect current business value, and *does not* completely address the following possible transfer events:

- Death.
- Disability.
- Transfer to a third party.
- Termination of employment.
- Retirement.
- Involuntary transfer due to bankruptcy or divorce.
- Business dispute among owners.

Finally, it is likely that your buy-sell agreement *does not* fully address each transfer event (e.g., firing an owner) from the perspective of whether the company or the other owners have an option or a mandatory requirement to reacquire the ownership interest.

As may be apparent, the biggest risk to the continuation of co-owned businesses is not the death or disability of one of the owners. The biggest risk is that the abovementioned events are considered once and memorialized in an

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agreement. All further thought and action on the subject are shelved, along with the agreement.

Problem II: Company's Loss of Financial Resources

Sole-Owner Company

Sole owners typically give little thought to the loss of financial resources (represented by the owner and his or her financial statement) used for the benefit of the business. Without a replacement for that financial strength, the business may not survive, despite a plan in place for its continuity of ownership. More specifically, an owner's sudden death or incapacitation can cause other stakeholders to discontinue their relationships with the business. These relationships include the following:

- **Bank financing.** If you have personally guaranteed the company's line of credit or permanent financing, your sudden death or departure will cause the bank to re-examine its lending relationship with your company.
- **Bonding capability.** Construction companies are just one example of firms that need and rely on bonding capacity to bid and obtain much of their work. Your sudden death will likely cause bonding companies to refuse to extend bonding unless the financial statements of those left in charge are as strong as yours. An inability to secure bonding can mean the end of your company.
- **Obligations under leases.** If you lease space or equipment, it is likely that you personally guaranteed the leases. While lessors may be unable to do anything to terminate the leases (provided payments stay current), they are unlikely to renew them without the successor's guarantee backed by personal assets.
- **Capitalization shortfall.** Business owners periodically capitalize their companies personally because they keep little money in their companies. There can be sound liability and financial reasons for doing so. However, your exit may prevent your company from obtaining ongoing and adequate capitalization from any other source. Your deep pockets go out the door when you do.

Multi-Owner Company

If you are a principal source of financial funding (bond guarantees, line of credit guarantees, etc.), your death 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.

Solutions to Problem II

Sole-Owner and Multi-Owner Companies

The problem of dealing with unexpected losses or unexpected financial complications in the business can best be met in two ways. First, simply use life insurance to fund the anticipated need. Although life insurance is part of the solution, it is a means to an end; by itself, it is simply a source of cash. Realistically, if the business is to succeed long after your death, it needs more than life insurance. It will

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need successive management that is motivated by ownership or cash (current and deferred). The only way to make certain the business continues without you is to make certain that the business is more than just you.

Regardless, no long-term solution, such as having successive management in place today, can succeed without having adequate funds from the outset. It is precisely this point that owners and their advisors overlook. The loss of an owner usually dries up the company's financial wellsprings:

- Bank financing, usually guaranteed by you.
- Equipment and other financing, guaranteed by you.
- Bonding capability, guaranteed by you.
- Adequate capitalization, supplied by you.

These resources propel the business through difficult times into a brighter future. It is highly unlikely that successive management or ownership can replace your balance sheet with theirs.

A company's loss of financial resources can be mitigated by placing money, and lots of it, in the company coffers when you depart. A fully funded buy-sell agreement, which is funded by life insurance and includes a current valuation, only buys out the deceased owner's interest. By itself, it does not place one penny in the company's bank account. Thus, few companies have adequate cash to survive an owner's death.

To address the loss of financial resources, a business—for its own current and future needs—requires insurance on your life in an amount sufficient to replace its immediate losses and provide it with adequate ongoing capitalization. These insurance proceeds will enable the business to grow and prosper without you and your personal balance sheet.

Problem III: Loss of Key Talent (i.e., You)

Sole-Owner Company

Your death likely has the same impact on your business as does the loss of any key person. Your talents; experience; and relationships with customers, employees, and vendors may be quite difficult to replace, especially in the short term. Without planning, few businesses have the financial resources or successive management to weather this storm.

Multi-Owner Company

Multi-owner companies seemingly avoid many of the problems endemic to single-owner companies. However, as it relates to the loss of key talent, this is only true if surviving owners can readily compensate for your loss. To the company, your death is the same as the loss of a key employee. If the remaining owners do not have your experience or particular talents, the business suffers as sorely as if it had been solely owned. Unless there is a key employee (co-owner or not) to fill the void, the business is wounded—perhaps mortally—upon the death of a co-owner who fulfilled the following roles:

- Marketing guru on whom the other owners were dependent to provide new clients.
- Overseer of the company's operations.
- Hub of most of the industry, customer, or other key relationships.

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Solutions to Problem III

Sole-Owner and Multi-Owner Companies

In a solely owned business, the key employee is almost always the owner. Usually, it is the owner's entrepreneurial drive, experience, and dedication that stimulate the business. Losing its key employee, *you*, is a blow from which many businesses do not recover. If your business is a mirror image of you, it is unlikely that any amount of key-employee life insurance or other source of cash will suffice. You must create value (within the company and distinct from you) in the form of successive management capable of filling the void left by your unexpected departure.

In a co-owned business, the loss of an owner is not as drastic, provided your co-owner can carry on without you. If your co-owner cannot replace you, you must train employees to perform the same or parts of the same role as you. You must take the same step if you desire to sell the business for top dollar during your lifetime. In either scenario (a lifetime sale or transfer caused by your death or disability), the underlying need is the same: Capable employees must be able to assume the responsibility of running the business. In a lifetime transfer, if the owner is ready to leave the business but the business cannot thrive or at least survive without him or her, the owner is forced to continue operating the business until successive management is located and trained.

However, when an owner dies, the absence of successive management is more devastating because the owner is not available to do anything. The best hope is to provide the company with adequate cash, in the form of life insurance proceeds, so that the business can survive until replacement management is located and trained. That cash is also used to produce a cash-based incentive plan designed to motivate and retain the new management.

In a co-owned business, the loss of an owner can severely strain the business, but the remaining owner can, especially with sufficient life insurance proceeds, find and train replacement management and provide that replacement management with a significant cash-incentive plan.

As you well know, finding and training your replacement can take years. Thus, you must prepare your company for an ownership transition today. Remember, at some point, you won't be in your business. We hope your absence will be due to a sale to an outsider or perhaps to the key employees you have brought into the company. However, your exit may be due to death or disability. No matter the cause, your business will survive and thrive only if you have found, trained, and motivated your replacement *before* you leave the business.

Realistically, the continuity of a business is reliant on a transition of ownership from you to equally capable individuals of an operationally and financially sound company. In the situations we have discussed, primarily the death of an owner, life insurance can instantly provide significant financial strength. However, the business also requires talented and motivated key-successor management, and for that, there are no quick fixes. The benefit of starting to search for that key-successor management today is that you will be building value within the company that will be converted to cash when you leave it.

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Problem IV: Loss of Employees and Customers

The death of an unprepared owner ignites a cascading series of events for the business. Chief among these are the departures of employees and customers. The loss of employees is followed immediately by defaults under contracts. Because of the inability to perform promised work, customers inevitably leave.

Usually, employees leave because they fear that the business will not survive, thus jeopardizing their salaries and future employment. Additionally, when the owner's leadership role is hastily transferred to anyone other than a recognized successor, employees and customers grow uneasy. With uneasiness comes migration to new employment and other vendors. These financial and personal concerns must be quickly quelled by implementing a preconceived, funded continuity plan.

Sole-Owner Company

A common and natural consequence of an owner's death is the speedy departure of employees and customers unless an existing continuation plan is immediately implemented. Employees must know that a plan that guarantees their compensation and clearly names your successor exists. With these assurances, most employees and customers will stay with the company. Without such a plan, the key and non-key employees will wonder where their next paychecks will come from. Typically, they leave for greener and more secure pastures.

When the workforce leaves, contracts cannot be completed and are breached, work is unperformed, and creditors call in their paper. Of course, the resulting losses often require payment by the owner's estate.

Multi-Owner Company

Companies with multiple owners must cope with the normal lifetime retirement of their owners. In most cases, retirement imposes a significant cash drain on a company. In a death scenario, the surviving owners must be capable of keeping both the employees and the customers. Simply having a successive owner is not sufficient. These successors must be able to maintain cash flow and the confidence of the business' employees and customers. Confidence is best gained by having a written, well-capitalized continuity plan.

Solutions to Problem IV

Sole-Owner Company

In a solely owned business, financial and personal concerns about succession are handled through the following:

- A written Stay Bonus Plan (described on pages 2–3), funded by life insurance and communicated to employees when it is prepared.
- A succession-of-management plan, which you prepare now, that names the person to take charge.
- Your decisions—made today or as soon as possible—regarding the sale, continuation, or liquidation of the business in the event of your demise.

Multi-Owner Company

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In a multi-owner company, loss of employees and customers does not usually present a problem because of the presence of other owners.

Conclusion

Business-continuity issues can be divided into two camps: those that occur while the owner is alive and those that arise upon the owner's death or disability. This paper dealt with the latter. In the case of transfers during an owner's lifetime, you have the luxury of time to find and train your replacement. This is not so in the case of death. Your company must have ongoing management and adequate cash (almost always subsidized by insurance on your life) to survive the following:

1. **Loss of continuity of business ownership.**
2. **Company's loss of financial resources.**
3. **Loss of key talent (i.e., you).**
4. **Loss of employees and customers**.

In the short run, money is required to do the following:

- Trigger a buyout.
- Provide capitalization.
- Replace your balance sheet with respect to lenders.
- Provide cash incentives to entice your employees to stay.
- Replace the loss of business value that you brought to the company. The management team must be capable and motivated to grow the company and incentivized to stay long after your demise.

In the end, a successful business is one that you can either sell for top dollar and exit in style or one that can survive your exit in style. A failure to plan for business continuity can irreparably damage your business' sale value and prevent you from exiting in style.

Please contact us if you have any questions or would like to receive a business-continuity form.

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