



BUSINESS CONTINUITY

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 to owners tend to use a lot of buzz words when we talk about business continuity. We ask, "What happens if the owner 'passes on' or 'leaves the scene?'" We talk about the consequences of an owner's death upon 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 at the prompting of an insurance or legal advisor who warns that unless owners take prudent measures, they will leave their families unprotected in the event of death or permanent disability.

Business continuity, however, 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 must address those family concerns through proper estate planning. Business continuity is, on the other hand, 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.

This article discusses the multiple problems – facing sole owners and owners in multi-owner companies – that an owner's death or disability creates for the business, for the other owners (if any), and sometimes, for the family. It also proposes solutions to each of these problems.

MAKING SURE THAT YOUR BUSINESS CONTINUES IF YOU DO NOT

The thought of what will happen to our businesses should we die is, at most, fleeting. In that brief 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 term and in the long term, should its most important component, its owner, die or otherwise become incapable of continuing in the company.

Ownership succession is the most obvious problem facing a company but it is one of four vital issues:

- Continuity of Business Ownership
- Company's Loss of Financial Resources
- Loss of Key Talent – You
- Loss of Employees and Customers

Let's look at how each problem affects both sole-owner and multi-owner companies.

PROBLEM: CONTINUITY OF BUSINESS OWNERSHIP

Sole Owner Company

Continuity of business ownership is the critical issue in a solely-owned company. In fact, there is no continuity unless you take steps now to create a future ownership group or owner.

Bonding Capability. Construction companies are just one example of firms that need and rely upon bonding capacity to bid and obtain much of their work. Your 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 yours. Inability to secure bonding can mean the end of your company.

Obligations Under the Lease. If you lease space or equipment, it is likely that you personally guaranteed the lease. While the lessor may be unable to do anything to terminate the lease (provided payments stay current) he is unlikely to renew the lease without the successor owner's guarantee backed by personal assets.

Capitalization Shortfall. Business owners periodically personally capitalize their companies because they keep little money in their companies. There can be sound liability and financial reasons for doing so. Your exit, however, 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, personally, are a principal source for 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.

PROBLEM: LOSS OF KEY TALENT - YOU

Sole Owner Company

Your death likely has the same impact upon your business as does the loss of any key person. Your talents, experience, 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 successor management to weather this storm.

Multi-Owner Company

Multi-owner companies seemingly avoid many of the problems endemic to single-owner companies. But, 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 the key person. 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:

- Was the marketing guru on whom the other owners were dependent to provide new clients;
- Oversaw the operations of the company; or
- Maintained most of the industry, customer or other key relationships.

PROBLEM: LOSS OF EMPLOYEES AND CUSTOMERS

Sole Owner Company

A common and natural consequence of an owner's death is the speedy emigration of employees and customers unless an existing continuation plan is immediately implemented. 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 as the case study below demonstrates.

Case Study

Clint was a successful and 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 that might impact his family or business. And then one day, as he bent over to unbuckle his ski boot, he dropped dead. Tragic as Clint's death was to his family, his failure to make any plans whatsoever for the businesses was a death-blow to his company. No one knew what Clint's wishes were with respect to continuing or selling the businesses. No one, (within his family especially) knew the overall business financial condition, administrative status or operational concerns. The key employees knew only one thing for sure: the businesses would not long survive Clint's death. So, these employees promptly found new employment; thus hastening the inevitable shutdown of Clint's once-vital businesses.

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 upon a company. In a death scenario, the surviving owners must be capable of keeping both the employees and the customers. Simply having a successor owner is not sufficient. These successors must be able to maintain cash flow as well as the confidence of the business's employees and customers. Confidence is best gained by having a written, well-capitalized continuity plan.

SOLUTION: CONTINUITY OF BUSINESS OWNERSHIP

Sole Owner Company

How can you prevent the type of disaster that befell Clint's family? First, 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's 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's continued existence. Secure their continuation by compensating them at a substantially increased level (usually 50% to 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 providing monthly or quarterly bonuses, usually over a twelve to eighteen-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, to employees or to family members.) The stay bonus provides a cash incentive for your important employees (perhaps 20 to 50 percent of the total workforce) to stay, hence its catchy name.

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 thought and planning (and money to pay salaries!) will ensure the continuation of the business. The second linchpin 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 employee(s) or others who can be given the responsibility to continue and to supervise business operations, make financial decisions and oversee internal administration. Name today these individuals on the attached Business Continuity Form.
- Name advisors and others (such as a friendly competitor) who should be consulted in the ownership transfer process. (Again, put these names on the Form today.)
- If it is your wish that the business be sold, state that intention and list the names and contacts of businesses who have expressed an interest in acquiring your company or who you think would make an appropriate successor/owner. Do so on the Form. You may wish to indicate that it is 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. Is there a better time than the present to do so?
- Finally, give the completed Business Continuity Form to your spouse 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) for the remaining owners to acquire the deceased's interest in the business. Having said this, chances are, your buy/sell agreement has not been recently reviewed, does not reflect current business value and does not completely address the many possible transfer events such as:

- Death,
- Disability,
- Transfer to a Third Party,
- Termination of Employment,
- Retirement,
- Involuntary Transfer Due to Bankruptcy or Divorce, and
- Business Dispute among Owners.

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

As may be apparent, the biggest risk to the continuation of businesses that are co-owned is not the death or disability of one of the owners. Rather, it is that the above-listed events are considered once and memorialized in an agreement. All further thought and action on the subject are shelved – along with the agreement.

SOLUTION: COMPANY LOSS OF FINANCIAL RESOURCES

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 for 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 term, after your death, it needs more than life insurance. It will need successor management, 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.

But any long-term solution, such as having a successor management in place today, cannot succeed without having adequate funds from the outset. And 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—guess who?—and
- Adequate capitalization, supplied by you.

These resources propel the business through difficult times into a brighter future. It is highly unlikely that successor 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 (with life insurance) buy/sell agreement (including a current valuation) just buys out the deceased owner's interest. By itself, it does not place one penny in the company's bank account. For that reason, 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 to provide it with adequate ongoing capitalization. These insurance proceeds will enable the business to grow and prosper without you and your personal balance sheet.

SOLUTION: LOSS OF KEY TALENT – YOU

Sole 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 a 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 person life insurance or other source of cash will suffice. You must create value (within the company and distinct from you) in the form of successor 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, train employees to perform the same or parts of the same

role as the dearly departed. 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 the death or disability of an owner) the underlying need is the same: capable employees must be available 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 survive or at least thrive without him, the owner is forced to remain operating the business until successor management is located and trained.

When an owner dies, however, the absence of the successor management is more devastating because you are not available and 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 as well as provide that replacement management with a significant cash incentive plan.

As you well know, finding and training your replacement can take years. Why not prepare your company today for an ownership transition? 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 very key employee you have brought into the company. Perhaps, however, it will 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.

In a real sense the continuity of a business is a transition of ownership from you to equally capable individuals of an operationally and financially sound company. In the situations we have discussed here, (primarily death or disability of an owner) life insurance can instantly provide significant financial strength. But the business also requires talented, motivated key successor management. And for that, there are no quick fixes. The benefit of starting today to find that key successor management is that you will be building value within the company that will be converted to cash when you leave it. Leave it, we hope, alive and healthy.

SOLUTION: LOSS OF TALENT – EMPLOYEES AND CUSTOMERS

As Clint's situation illustrates, the death of an unprepared owner ignited 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.

Why do employees leave? Usually 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 but a recognized successor, employees and customers grow uneasy. With uneasiness comes migration to a new employment and to other vendors.

These financial and personal concerns must be quickly quelled by implementation of a preconceived, funded continuity plan. Employees must know that a plan exists that guarantees their compensation and clearly names your successor. With these assurances, most employees and customers will stay with the company.

Sole Owner Company

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

- A written (funded by life insurance) Stay Bonus Plan (described above in the Solution to Problem One) communicated to employees when it is prepared;
- A succession of management plan that you prepare, now, naming the person to be in charge; and
- A decision made now, by you, regarding the sale, continuation or liquidation of the business in the event of your demise.

Multi-owner Company

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 deals with the latter. In the case of transfers during an owner's lifetime, you have the luxury of time to find and to train your replacement. Not so in the case of death. In order to survive your demise, your company must have ongoing management and adequate cash (almost always subsidized by insurance on your life) to survive:

- Continuity of Business Ownership
- Company's Loss of Financial Resources
- Loss of Key Talent –You
- Loss of Employees and Customers.

In the short run, money is required to:

- Effect a buy-out;
- Provide capitalization;
- Replace your balance sheet with respect to lenders; and
- Provide cash incentives to entice your employees to stay.
- For management to provide for loss to business value owner brought to the company; the management team must be capable and motivated to grow the company & incentives to stay long after your demise. In the long run, a successful business is one you can either sell for top dollar and exit in style, or one that can survive, in style, your exit.

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