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Think about it

What every financial professional needs to know about reviewing buy-sell agreements: Part one

Part one

This is the first of a two-part *Think About It* series on reviewing buy-sell agreements. This issue provides:

- An overview of buy-sell planning.
- A description of buy-sell structures.
- A consideration of the types of triggering events that may be included in buy-sell agreements.

Next month's issue will discuss valuation issues and special buy-sell concerns. It will also include a formal sample checklist that the non-attorney professional can use in reviewing the buy-sell agreements of business owner clients.

Introduction

Our closely held business owner clients usually rely on their businesses for lots of things:

- To provide income for the owner's family.
- To support the families of employees.
- To leave a family legacy either
  - By allowing family members to take over one day
  - To turn the business into money at death or retirement.

Financial planning professionals work with business owner clients to protect the business, and make sure the owner's goals are met. A properly drafted and implemented buy-sell agreement can act as a key estate and business planning tool for the professional and client.

The point of this two-part article is not to make the reader an expert in drafting buy-sell agreements, but rather to enhance the value the professional brings to the business owner client and other members of the estate and business planning team. While the checklist approach described is not intended to be comprehensive, it can be used by the planning professional as a tool to learn more about the client and his business.

Being able to review a client's buy-sell agreement and making sure it meets the client's objectives is an important skill for the planning professional. A thorough review increases the planner's credibility — with both the business owners and their advisors—and often uncovers opportunities for additional needs for financial products and services.

How can you tell if an existing buy-sell agreement is properly drafted and implemented?

The rest of this issue is dedicated to laying out a checklist approach to the buy-sell review. The main questions that a financial professional needs to answer are:

- Is the buy-sell structure appropriate under the circumstances?
- Have the business owners included all the necessary buy-sell triggers to the agreement?
- Does the agreement include a valuation method for the business that makes sense?
- Does the buy-sell agreement integrate with business operations and governance in a consistent way?
- Does the buy-sell agreement integrate with the personal estate planning strategies of the owners in a consistent way?

To start the process of reviewing a client's buy-sell arrangement, it's critical to get a copy of the buy-sell agreement. It's also critical to gather the details of the buy-sell implementation, including all other business operating documents, employment agreements, insurance policy information and contact information for the client's legal and accounting professionals.

Finally, a full review should include a thorough conversation with each of the owners of the busines together and separately. You can use the checklist that will be part of next month's issue as a tool in helping to facilitate the conversation.

What's the biggest mistake a client can make in putting together a buy-sell plan? If the owners decide that they don't need to put together or fund a buy-sell agreement, it's a recipe for disaster.

Buy-sell structure

The first thing to check in reviewing the buy-sell agreement is: "Who is doing the buying when a triggering event occurs?"

If the company itself is doing the buying, the structure is a redemption, or entity purchase. If it's the owners who are buying, the agreement is probably a cross-purchase arrangement.

If it's a non-owner employee or non-owner family member or friendly competitor that is in line to make a purchase happen, then the arrangement is a one-way buy-sell.

And finally, if there are multiple methods of purchase inside the agreement, it's probably a "wait-and-see" buy-sell.

Which kind of agreement is best for a particular client? The good lawyer's answer is, "It depends."

Read on for a fuller description of what it depends on.

Redemption

Here's how a redemption arrangement works.

Say that Al and Bob are equal owners of ABC, Inc., a regular corporation with a fair market value of $1,000,000. Al and Bob enter into an agreement, together with their company, under which the company agrees to do buying in the event of a triggering event.

To fund its obligation to buy the shares of a deceased owner, the corporation buys $500,000 of insurance on the life of Al, and an equal amount on the life of Bob. The corporation is the owner and beneficiary of the policy.

At Al's death, ABC, Inc. receives $500,000 of life insurance proceeds. It uses those proceeds to purchase Al's 50% interest in the company, and Al's heirs transfer Al's stock back to the company in exchange for the $500,000 payment.

The biggest mistake a client can make in putting together a buy-sell plan is if the owners decide that they don't need to put together or fund a buy-sell agreement, it's a recipe for disaster.

The company holds Al's former stock as treasury stock, and Bob now owns 100% of the outstanding shares in ABC, Inc. Is a redemption agreement the right kind of buy-sell arrangement? Here are some reasons why it might be:

- It's simple to understand and implement.
- The business keeps control of the funding mechanism — insurance or cash.
- If owners are added to the company later, it's usually relatively simple to adapt the agreement to new circumstances.
- Life insurance payable to the company at death probably does not inflate the taxable estates of any of the owners. If the business is organized as a regular C corporation, there are plenty of reasons why a redemption agreement may not be the best fit. These include:
  1. There's a danger that a redemption will be treated as a taxable dividend to the heirs, particularly where family owns the business. (But a taxable dividend to some currently might not be a bad thing.)
  2. The surviving owner — Bob in the example above — doesn't get the benefit of a step-up in basis for his interest in the business.
  3. For certain bigger C corporations, the corporate alternative minimum tax (AMT) might cause roughly 15% of the cash value growth or death benefit be lost to the AMT.

For S corporation businesses, the first drawback above may also apply. The second issue may be relevant in part, and the third is a non-factor for S corporations.

Finally, for businesses organized as partnerships or partnership-style LLCs, there's no danger of dividend treatment, nor is the AMT issue a concern. Therefore, only the step-up in basis issue for the surviving owner needs to be considered in certain cases.

Cross purchase

Here's how a cross-purchase arrangement should work.

Say that we're still considering ABC, Inc., with Al and Bob as owners. Al and Bob enter into an agreement, under which each of the owners agrees to do buying from the other owner upon a triggering event.

To fund his obligation to buy Al's shares upon Al's death, Bob buys $500,000 of insurance on the life of Al. To fund his obligation, Al buys a like amount on the life of Bob. Each shareholder is the owner and beneficiary of the policy on the other.

At Al's death, Bob receives $500,000 of life insurance proceeds. Bob uses those proceeds to purchase Al's 50% interest in the company, and Al's heirs transfer Al's stock back to Bob in exchange for the $500,000 payment.

Bob now owns 100% of the outstanding shares in ABC, Inc.

Here are the reasons for a company to prefer a cross purchase agreement:

1. The surviving owner(s) get a basis in the purchased stock equal to what they pay — making a subsequent sale less subject to capital gains tax.
2. Since the company doesn't own the insurance, the corporate AMT is a non-issue.
3. There is no danger of dividend treatment of the purchase of stock, since the money is coming from the company co-owners, rather than the corporation itself.
4. There are also plenty of reasons why a cross purchase arrangement might not be a good fit. These include:
   - If there are more than two owners of the company, it can be hard to place, manage and administer all the needed insurance policies in the correct way. And a multiplicity of policies adds to overall expense.
   - If there's a change to the company, configuration of ownership, or insurance, there are plenty of opportunities for transfer for value problems to arise inadvertently in corporate buy-sell reconfigurations.

Wait-and-see

The wait-and-see buy-sell arrangement, a term coined by attorneys Steve Leimberg and Morey S. Rosenbloom, sometimes referred to as the optional buy-sell, is sometimes implemented as a way for the owners of a business to hedge their tax bets.

Using ABC, Inc. as a test case, here is how they might implement a wait-and-see buy-sell:

- Upon a triggering event (let's assume the death of Al once again), the business has a 30 day option of buying all or any portion of Al's shares from his heirs.
- If ABC, Inc. does not redeem all of Al's shares, Bob has 30 days after the business's option expires to buy any remaining of Al's shares.
- Finally, if Bob does not exercise his option, ABC, Inc., must redeem any remaining of Al's shares from Al's heirs.

Life insurance may be owned by the company or by each shareholder on the other. The policyowner should also be the beneficiary.

To get money into the right hands at the death triggering event, the parties should anticipate the idea that money can be loaned to provide the needed cash. For example, if ABC, Inc. gets the death benefit, it might loan the money to Bob for the purchase of Al's shares.

Depending on the structure of the life insurance and later structure of the buyout, there may be tax results to the parties consistent with redemption or cross-purchase.

One-way

One-way buy-sell agreements are usually implemented in proprietorships or single-owner corporations or LLCs. These agreements are usually between the owner and a key employee, or between the owner and a friendly competitor. They are called "one-way" agreements because they're only triggered in one direction—if something happens to the current owner of the business.

One-way buy-sell agreements work in a manner similar to cross-purchase agreements, in that the death trigger is usually funded with life insurance owned by the key person or the friendly competitor. In the event of the single owner's death, the third party collects the proceeds and buys the business from the deceased owner's heirs.

Triggers

Triggers are those events that cause a buy-sell agreement's buyout provisions to be put in motion.

Those financial planning professionals who work with business owner prospects on buy-sell planning usually focus on three triggers for a buyout:

- Death
- Disability
- Retirement

It's easy to understand why the focus of planners is usually limited to these three triggers. The financial planning professional has access to insurance or financial products that can facilitate the buyout in the event of one or more of the three triggers.

But there are several other triggers that should be considered, and they may be equally important to the owners of the company.

- Divorce
- Bankruptcy
- Force out/firing
- Planned termination of relationship
- Retirement
- Third party buyout offer

Death

Death is usually the simplest trigger to define, understand and fund.

If one of the owners of a business dies, the family of the owner usually wants to turn the owner's interest in the business into cash. A surviving owner of the business usually wants to be able to continue operations with a minimal negative impact on the business.

Anticipating this trigger in advance puts the business in the best possible position to survive the death of one or more of the owners. Most often, the death trigger is funded with insurance on the lives of the owners. Be sure the buy-sell agreement considers the possibility of the simultaneous or near simultaneous deaths of more than one owner.

Disability

The disability of a business owner can create financial heartaches for the disabled owner, and can put financial stress on the business.

If the disability trigger is included in the agreement, it's important for the business owners to define exactly what they mean by disability. For example, is a disability lasting 90 days enough to trigger the buyout? What happens if the owner gets better and wants to re-engage in the business at a future date? What happens if the disabled owner dies before the buyout is consummated? These contingencies should be specifically addressed.

Having some type of buyout plan in effect in the event of the disability of an owner actively working in the business can be critical to the business's continued success. The parties can choose to make disability of an active owner a buyout trigger. If they do, and an active owner becomes disabled, the disabled owner's interest in the business is usually turned into cash or an income stream. That puts the disabled owner in a better financial situation.

In the event disability triggers a buyout, the business must come up with a lump sum or payment stream to make the buyout happen. Using business capital to fund the buyout may put too much financial stress on the business at the worst possible time to allow it to survive.

Some business owners choose to purchase disability buyout insurance to provide funds for purchase in the event of disability. Such insurance is not always available, and for some businesses and their owners, disability buyout insurance may be too expensive for them to afford.

Because of the financial difficulty in funding the disability buyout trigger, the owners of the company may decide not to include disability as a trigger in the buy-sell agreement. However, with disability and the other possible triggers that follow, a thorough discussion of the costs and risks of not including them in the agreement are an integral part of the buy-sell review process. It is essential to discuss the issue and weigh the costs without preconceived conclusions.

Divorce

The divorce or legal separation of a business owner can create financial heartaches for the divorcing owner, and can put incredible emotional, organizational and financial stress on the business. Usually divorcing spouses — or those who otherwise separate from committed long-term relationships — make financial claims on one another. For those whose valuable assets include an interest in a closely held business, the parties may argue about:

- The value of the business interest.
- How to divide the business asset between the parties.
- How to preserve the value of each parties' interests and the overall business.

There are often outside agreements that influence the results. For instance, a franchise may have signed an agreement specifying what will happen in the event of a divorce.

As with disability, the parties need to consider how to define "divorce" if they include it as a trigger in the agreement. For example, is the filing of a divorce action a trigger for the buyout? What about if one of the owners becomes legally separated from a spouse? Should an owner in a long-term non-spousal relationship be included in the scope of the trigger?

Often business owners opt to include some type of buyout or contingency plan in the buy-sell agreement in the event of the divorce of an owner. Making divorce — or separation — a buyout trigger can make it easier on the non-divorcing owners of the business. It may not be so good for the divorcing owner, who may prefer to remain in the ownership instead of being forced out.

The potential for hard feelings when a divorce is occurring is one important reason the parties should evaluate whether a divorce trigger is warranted when the business (and the relationship) is running smoothly.

Insurance that pays off in the event of divorce is not available. Therefore, the parties to a buy-sell agreement with a divorce trigger must plan to provide funds for purchase in the event of divorce. Usually the parties choose to fund a buyout from the business's cash flow through some type of installment (with interest) arrangement. The parties may also decide that the buyout price triggered by divorce should be different — usually lower — than the one triggered by death.

Bankruptcy

As with divorce, the personal bankruptcy of one of the business owners can force a crisis in the business.

Also, as with divorce or disability, defining what constitutes bankruptcy requires some thought. For example, should both personal Chapter 7 and Chapter 13 bankruptcies be included?

When bankruptcies are filed, the bankruptcy trustee is usually appointed to try to liquidate the debtor's interest in assets — including closely held businesses — to satisfy creditors. This insertion of a third party can handcuff

not only the debtor-owner, but also the other owners of the business.

One approach to anticipating the possibility of bankruptcy is to make a personal financial crisis a triggering event in the buy-sell agreement. Since insurance is not typically available to cover the possibility of the bankruptcy of an owner, the parties usually plan to provide the money for a buyout from the business's cash flow.

As with other lifetime buyout triggers, the parties may opt to have the personal bankruptcy buyout price to be lower than the death price. Further, for all lifetime buyouts, the parties need to consider whether some type of non-compete provision for the selling member is appropriate.

Force out/firing

Three business owners call up their attorney and make an appointment to meet. The three tell the attorney:

"Our business is doing very well. The three of us are working hard, and sales have doubled in each of the past 5 years. Unfortunately, we have a fourth owner of the company, and he has not showed up at the office for the past year. What can we do about it?"

There's usually no simple answer to this kind of question — if it's not addressed in advance.

Fortunately, it is possible to anticipate and deal with this issue in the buy-sell agreement. One method that might have worked for the three owners in the example if they had planned in advance:

- Have each of the owners enter into an employment agreement with the company.
- Include provisions in the employment agreements for termination for cause.
- Include a buyout trigger in the buy-sell agreement for buyout in the event of termination.

Planned termination of relationship

It's also possible for the owners of a business to plan for the possibility that they just won't get along sometime in the future, and for them to build in a buyout method if that happens. One way to do that is through the use of a "shotgun" clause.

The shotgun clause allows an offering owner to offer a specific price for the other owner(s)' interest(s) in the business. Other owners must then either accept the offer or buy the offering owner's interest at the offered price.

A shotgun clause isn't for everyone, as it has the potential to be abused if one of the owners is under financial stress. However, the owners must consider whether and how to make internal strife a triggering event in a buy-sell agreement.

Retirement

It's probably fair to say that most entrepreneurs have the idea that their businesses will provide an income stream for the owner's retirement. However, financially successful retirement, using the business as the source of funds, usually won't happen unless there's a plan to make it so.

When all the owners of a business are on the same page regarding peaceful, lifetime succession, it can help make the business run smoothly. If the possibility of retirement is not anticipated early, differing business objectives between younger and older owners can cause strife. For example, when nearing the end, a retiring owner may want the business managed so that it maximizes potential cash flow. Younger owners may be more interested in the business's growth, and making investments for the future.

If the owners include a retirement trigger in their buy-sell agreement, they need to define what retirement means. For example, is retirement automatically triggered by one of the owners reaching a certain age? What if that owner still wants to remain active with the company?

Since insurance is not typically available to cover the possibility of the retirement of an owner, the parties usually plan to provide the money for a buyout from the business's cash flow. Financial professionals often anticipate that possibility at the time the buy-sell agreement is drafted. Financial products, such as the cash value of life insurance, offer a potential source of funds for the buyout — or at least a down payment.

Third party buyer

As with retirement, the owners of a given business may have differing ideas of when and how to sell their business.

Say that Commercial Construction, Inc. (CC) has two equal owners — Adam, who is 37, and Dan, who is 62. Dan and Adam are approach by a large regional construction company — Midwest Construction Management, Inc. (MCM) — which wants to make CC part of its organization. MCM offers Dan and Adam $3,000,000 as a buyout.

Dan, who is thinking about retirement, thinks the offer is fair and wants to cash out. Adam, on the other hand, has four children, and his oldest is about to start college. Adam thinks the offer is low based on his perception of CC's value. Furthermore, he has no desire to start another business from scratch, nor does he want to try to negotiate an employment contract with MCM. Adam wants to reject the offer.

While MCM is interested in buying CC, it has no interest in being a co-owner with Adam. Adam, who is relatively new to the ownership of CC, is not in a position to pay Dan $1,500,000 for his interest in the business. Based on the circumstances, the parties are at an impasse.

How might the possibility of third-party sale have been anticipated in a buy-sell agreement?

The owners might have formally agreed between themselves that unanimity among the owners is required to accept an offer from a third party. Or, they might have provided a mechanism that would have allowed Adam under these circumstances to match CC's price, but pay it over time.

While neither provision in a buy-sell agreement is necessarily a perfect solution to the fact pattern presented, at least the parties would have had a discussion about the possibility, and an agreed method for proceeding (or not).

Conclusion

Our clients need to implement buy-sell agreements that match their business, tax circumstances and objectives. They need to choose the right structure, and include the right kinds of triggers, so that they anticipate future business problems and opportunities, and allow their businesses to continue to thrive.

In the next part of this series on reviewing buy-sell agreements, we will discuss additional difficulties with establishing business valuations, balancing buy-sell planning with estate planning and managing special concerns.

Important Information:

Policy loans and withdrawals will reduce the cash value and face amount of the policy. Clients may need to fund higher premiums in later years to keep the policy from lapsing.

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