

EFFECTIVELY UTILIZING BUY/SELL AGREEMENTS FOR PRIVATELY HELD BUSINESSES: PART FOUR

Any privately held company with more than a single owner needs a buy/sell agreement. Simply put, a buy/sell agreement outlines the terms of how the ownership of the company will pass from one owner to another under various circumstances. That is 'simply put', but crafting a buy/sell agreement is anything but simple. In a continuing column, I will discuss the common decision points of a typical buy/sell agreement and how we have helped clients resolve the problem.

In the first column, we discussed the issue of valuation. In the second, we discussed the various events that would trigger the buy/sell agreement and the decisions that need to be made in each of those events. In the third installment, we discussed the various payment term options that should be considered. In this final installment we will discuss funding considerations.

In this case study, we will change Client ABC to be a heavy/civil contractor with 2 equal and unrelated owners. A new client to the firm, we were astonished to find out that they had neither a stockholders agreement nor a buy/sell agreement. Without a written buy/sell in place, any change in ownership has the potential for costly litigation.

Both partners wanted the Company to be retained by the survivor upon the death of the other. Without a buy/sell agreement in place, the shares of the deceased shareholder would pass to his spouse and the survivor would have a new partner in the business. And without a pre-determined value, the buy-out process would prove costly.

Our first step in developing an agreement is to determine what they owners wanted to happen in the event of either one of their deaths. It was agreed that other than death, the decision of either one wanting to leave the company would result in an orderly liquidation of the business. At the death of either owner, the survivor would purchase the stock of the deceased from his estate at a pre-determined value.

Second step was to determine the value to be used in the agreement. As discussed in Part One of this series, the owners discussed the various options: appraisal at date of death, certificate of value updated annually, book value based on most recent financial statement, or an adjusted book value.

Both owners desired for their families to receive a fair value for their ownership and, at the same time, wanted the survivor to be able to continue company without imposing a financial hardship. Based on the amount of heavy equipment, and that all of their work is obtained through public bids, they agreed to value the company at book value plus an adjustment for the fair market value of the equipment. At date of death, the most recent year end financial statement would be the basis for book value. For the equipment, the

company will have an appraisal completed every two years. Any new equipment after the latest appraisal will be added at its current net book value.

The last step is to determine how the payments for the buyout will be made. Both owners want to avoid being left with financial obligations while continuing the operations as a sole owner.

A popular funding mechanism is through life insurance. Both owners are relatively young and in good health and based on the projected value of the company, it is feasible to provide 100% funding through life insurance. Any insurance proceeds in excess of the value of the company will be paid to the estate of the deceased. Any shortfall will be paid over a 5 year period.

In addition, we were able to set up this entire arrangement in a 419(e) welfare benefit plan which will allow the payments needed for the life insurance to be tax deductible. Payments to a 419(e) plan are tax deductible as long as they comply with the rules and regulations of the internal revenue code. If both owners survive until retirement, the 419(e) plan will provide for a wide range of post-retirement medical expenses of both owners and the money coming out of the plan is not taxed to the retired owner, a real win-win.

There is no one answer that fits every situation. The critical lesson is that every company needs some type of ownership and management succession plan. With a carefully thought out and agreed-to plan in place, all that's left is the execution if and when needed. Without one, those with vested interests may not agree to what should happen, and that rarely ends well.