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CLIENT ADVISORY:

DEATH, DISABILITY AND THE CLOSELY-HELD BUSINESS

Our financial life has many stages involving short- and long-term goals. An attorney, like any other business owner, devotes considerable energy and resources to creating and growing their business. This process does not end until retirement. Corporate lawyers confront the issue of death and disability when structuring a business for a client that anticipates death, disability or liquidation. Spending time to develop a strategy to address events that will occur sometimes without notice is essential to the business owner's peace of mind. This article identifies and explores the use of a buy-sell agreement to facilitate a sale upon the death or disability of an owner.

What is a buy-sell agreement? A buy-sell agreement is an agreement between the owners of a business in which they require a future sale of interests in the business upon a triggering event, such as the death or disability of an owner. A buy-sell agreement provides a market for a business owner's interest as a means for all of the owners to control who does and does not ultimately own an interest in the business – and under what terms – after a triggering event. Buy-sell agreements can and should be tailored to the specific needs, facts and circumstances of a firm and its owner(s).

There are several forms of buy-sell agreements. One is a redemption agreement in which the business purchases or redeems the interest of the departing owner upon a triggering event. Under this type of agreement, the business itself may purchase life insurance policies on the lives of the owners or shareholders, so that when an owner dies, retires or becomes disabled, the business has liquidity readily available to purchase the interest of the departing owner.

The primary advantage in using this structure is that it is relatively easy to administer when there are multiple owners because all ownership in the life insurance policies is held by the business. A redemption agreement can also cover the disability of an owner by including a disability rider on the life insurance policy to provide flexibility and assistance in the event of the unexpected disability of an owner.

A second form of buy-sell arrangement is a cross-purchase agreement. This form of structure provides for the owners or shareholders to purchase the interest of a deceased or disabled owner. Similar to the redemption agreement, life insurance may be used to facilitate the agreement. One method of funding is for the owners to choose to purchase life insurance, possibly with a disability rider to cover the unexpected disability of an owner, on each other's lives, so that upon the triggering event they will have funds available to purchase the departing owner's interest.

Cross-purchase agreements may be less desirable when there are more than two owners since each owner would purchase insurance on the other owners, which becomes complex and burdensome to administer. Also, the payment of required premiums may be problematic due to varying ages and medical history of each of the owners.

In some cases, a hybrid arrangement makes the most sense. Hybrid arrangements include components of both a redemption and a cross-purchase agreement. For example, a hybrid agreement may provide that the business has the primary right to acquire a departing owner's interest and requires the remaining owner(s) to redeem the departing owner's interest if the business' primary right is not exercised or is not fully exercised. The income tax consequences of these different arrangements can potentially be quite complex, particularly if the business is organized as a partnership, so clients should be advised to consult with their attorneys or tax advisors before determining which arrangement makes the most sense for their specific circumstances.

Regardless of which structure is used, the funding of the agreement is critical and the question of how to fund the agreement is dependent upon the particular facts and circumstances of the business. Owners should ultimately drive the decision. One option is to self-fund or to rely on the owners or the business to use their/its own resources to fulfill their/its obligations upon a triggering event. As you can imagine, this may be less than desirable to the selling party unless the primary obligation to purchase the departing owner's interest is with the business itself and the business is very well capitalized. Relying on each owner individually to maintain sufficient resources with which to fulfill cross-purchase obligations may not provide an adequate sense of security for each owner.

Another option that is often used to provide liquidity to fulfill obligations under a buy-sell agreement, and often the most desirable option, is life insurance. The type of insurance purchased for this purpose should be carefully considered by the owners as they craft the buy-sell agreement.

The typical insurance options to fund a buy-sell agreement include term life insurance, whole life insurance and universal life insurance policies. Whole life and universal life policies may be preferable because those policies typically have a cash value component. The cash value component can provide flexibility in a buy-sell agreement because the cash value can be used as needed to fulfill the agreement if the triggering event is not death or disability. For example, if an owner retires, the cash value may be used to purchase the retiring owner's interest. (Upon an owner's death, of course, the death benefit is the primary component to fulfill the obligations under the agreement, but cash value can serve a significant purpose as well.)

Split-dollar arrangements may also be useful in a buy-sell context. Under a split-dollar arrangement, the owner and the business split the cost of the premiums and the cash value upon a triggering event. These arrangements can be complex and are beyond the scope of this article. However, it should be noted that the IRS has increased scrutiny of split-dollar arrangements since 2003, so the use of this arrangement should be carefully considered and crafted.

Determining the purchase price is another critical decision that must be made in advance by the business owners. Determining the value of each owner's interest for buy-sell purposes is a critical component of the agreement. The agreement should provide a mechanism for determining the sale/ purchase price for a departing owner's interest.

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The most common valuation methods for this purpose are using a fixed price decided upon by the owners, a formula provision or a formal appraisal. The fixed price method may be attractive at first glance because of its simplicity. The owners decide on a price and agree to it. However, this approach is not flexible and may not reflect a true value of the business in future years unless a mechanism to periodically reevaluate the appropriateness of the price is included in the agreement. A formula provision provides flexibility to value the business interest in future years and may include some combination of capitalization of earnings and book value of the business assets as variables of a formula to determine appropriate value.

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Gary R. Pannone is a Principal and the Managing Partner of Pannone Lopes Devereaux & West LLC and has been representing closely held business owners for over thirty years in the service, health care, and manufacturing industries. His areas of expertise include startup businesses, business formations, succession planning, corporate restructuring, mergers, acquisitions and joint ventures. Mr. Pannone is a frequent lecturer in the areas of board governance, ethical compliance and nonprofit organizations.

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