

TWO BUY-SELL DESIGN PROBLEMS

Business owners are often faced with the question, “Do I need a buy-sell agreement?” The answer is “Yes, but only if the buy-sell agreement is properly designed and drafted and fits your situation.” The right buy-sell agreement can form an important part of a business succession plan and an estate plan. However, a poorly designed buy-sell agreement can create problems rather than solve them. Here are two examples.

Tom was the sole stockholder of his company. The company had two other key employees, Bill and Lydia. Tom was advised to purchase \$1 million dollars of life insurance so that the two key employees could purchase his stock upon his death. As is often the case, the key employees did not have the funds to pay the premiums. Therefore, the company had to pay the two employees bonuses each year so that they would have funds to pay the premiums. Bill and Lydia were properly set up as the owners and beneficiaries of the policies, and an agreement was drafted that would require them to use the proceeds from the insurance to purchase Tom’s stock upon his death.

When Tom died unexpectedly at age 48, Bill decided that he would rather keep his share of the insurance proceeds than pay for the stock, because the corporation was worth much less than \$1 million dollars. Tom’s estate was forced to sue Bill to recover the funds and eventually settled the case for \$470,000, giving Bill just enough money to pay his legal fees.

There are two problems in this scenario. First, the insurance was significantly more than the value of the company. This was done because Tom needed \$1 million of liquidity in the event of his death. But it provided a substantial incentive for Bill to seek a way to avoid paying the insurance proceeds to the estate. Second, Tom, through his company, bore the expense of the premiums even though he did not control the policy. For these reasons, it would have been far better for a person in Tom’s situation to buy the \$1 million of insurance in his or her own name and control the proceeds. With the estate’s liquidity needs met by the policy, the executor of the estate would have been free to reach whatever sweetheart deal was necessary in order to continue the business with the two key employees running it. Any proceeds from the sale would be an unnecessary but welcome benefit for the heirs.

Another common mistake is using a valuation method for the business in the buy-sell agreement that is not certain or not easily determined. Whenever a valuation formula depends upon an appraisal, trouble can result. The trouble may not be too significant if the appraisal is of real estate, but if the value of the business is determined by a business appraisal, trouble can result. In a recent case involving a buy-sell agreement that set the value based on an appraisal of the business, the parties involved spent more in legal fees and expert witness expenses than the actual value of the business itself. A formula that is certain and readily understood by the parties is a better way to set the value of the business, even if the formula yields a value that may be somewhat different from “true fair market value.”