CAPITAS FINANCIAL

Buy-Sell Agreement

HOW DOES IT WORK?

A buy-sell agreement is a written contract between two or more owners of a business, or among owners of the business and the entity. It sets out rules and expectations about what will happen in the event of the death, disability, divorce, insolvency or retirement of any owner (a "triggering event"). The purchase and sale of interests of the business at a price determined under the agreement is dependent on the occurrence of certain triggering events. Additionally, the structure will dictate whether this is a right or obligation.

A buy sell agreement can assist in:

- Protecting the business by preventing transfers of ownership to unqualified or unwanted persons (e.g., ex-spouses of a divorcing owner or heirs of a deceased owner).
- Providing a mechanism for owner(s) to define how their business interest will be transferred as well as the liquidity mechanism for settlement of the agreement.
- Usually includes a formula or procedure for determining the sale price.
- May establish a funding mechanism to facilitate the purchase of an owner's interest.
- May be used to fix the value of the business for estate tax purposes, subject to IRS requirements.

WHO NEEDS A BUY-SELL AGREEMENT?

A buy-sell agreement provides a plan for the orderly transfer of any owner's business interest. You should consider a buy-sell agreement for your client's business if:

- Your client has two or more owners.
- Your client wants to provide protection in the event of any owner's retirement, divorce, disability or death.
- Your client wants to provide a means for an orderly transfer of any owner's business interest.

HOW ARE THESE AGREEMENTS FUNDED?

Funding methods can include:

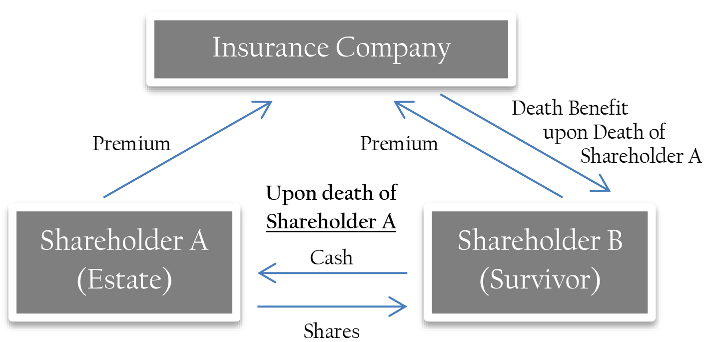
- **Installment payments:** The purchase price is paid to the seller over a period of time.
- **Borrowed funds:** The business may be able to borrow funds through commercial loans allowing the business to redeem an owner's interest.
- **Sinking fund:** Over time, a business may build up a fund earmarked for redeeming an owner's interest.
- **Insurance:** The proceeds from a life insurance or disability buyout policy can fund the agreement.

Factors that typically influence the choice of funding methods include the size and structure of a business and its tax bracket, the number of owners involved, their ages, tax bracket and percentage of ownership, levels of cash and/or credit available to the business entity or to the owners as well as the type of buy-sell agreement.

WHAT ARE THE MOST COMMON TYPES OF AGREEMENTS?

The most appropriate agreement depends on several factors, including how your client's business is organized and the number of owners in the business. The three most common designs are:

- **Cross purchase.** In a cross purchase arrangement, each owner of the business agrees to purchase some or all of any other owner's interest after a triggering event occurs. For the clauses of the buy-sell agreement that specify the death of an owner as a triggering event, one of the most common funding vehicles is life insurance. Each owner holds policies on all of the other owners. In the illustration below, Shareholder A holds a life insurance policy on Shareholder B and vice versa. Both are responsible for paying premiums associated with the policy to the insurance company. Upon a triggering event occurring – in this example, the death of Shareholder A – the proceeds of the insurance policy would be received tax-free by Shareholder B and provides him or her the liquidity needed to purchase Shareholder A's interest in the business.



- **Entity purchase.** An entity arrangement is an agreement between the business and the owners. The business redeems (i.e., buys back) a shareholder's interest when the triggering event occurs. For clauses of the buy-sell agreement that specify the death of an owner as a triggering event, one of the most common funding vehicles is life insurance. The business owns policies on each owner.

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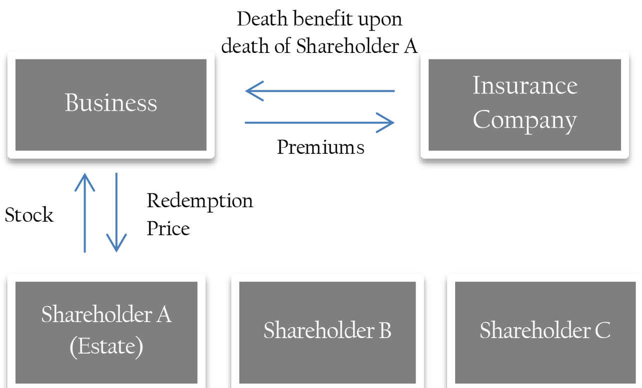
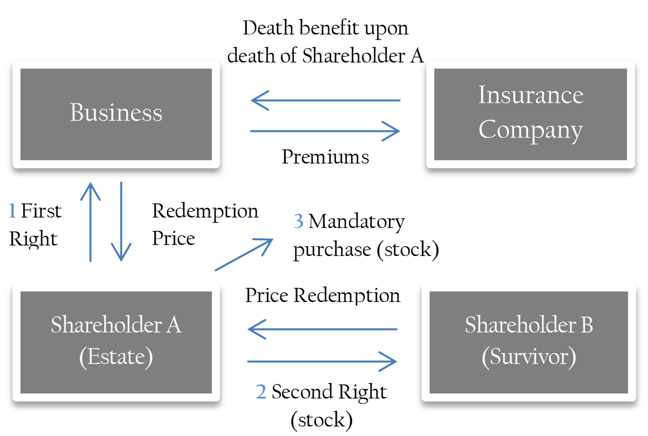
In the illustration below, the business holds life insurance policies on Shareholders A, B and C. The business is responsible for paying premiums associated with the policies to the insurance company. Upon a triggering event occurring – in this example, the death of Shareholder A – the proceeds of the insurance policy would be received by the business and provide it with the liquidity needed to purchase Shareholder A's interest in the business.



- **"Wait and see" agreement.** A wait and see agreement is a hybrid of the cross purchase and entity agreements designed to provide maximum flexibility at the time a triggering event (death, disability, retirement etc.) occurs. In a "wait and see" agreement, the process generally is as follows:

1. The business might have a first option to buy the interest of a deceased or disabled owner.
2. If the business does not exercise its option to purchase all or a portion of the deceased owner's interest, the remaining owners then have the option to buy the remaining interest.
3. If the remaining owners do not exercise their option to purchase the deceased owner's interest, then the business must purchase the interest.



For the clauses of a buy-sell agreement that specify death of an owner as a triggering event, life insurance is one of the most common funding vehicles; policies could be owned either by the business or by individual shareholders. In the last illustration, the business holds life insurance policies on Shareholders A and B. The business is responsible for paying premiums associated with the policies to the insurance company. Upon a triggering event occurring – in this example, the death of Shareholder A – the proceeds of the insurance policy would be received by the business and provide it with the liquidity needed to purchase Shareholder A's interest in the business. If the business does not exercise its option to purchase, or it only purchases a portion of Shareholder A's business interest, Shareholder B has the "second right" to purchase all or a portion of Shareholder A's interest. If this right is not exercised, the business must purchase the interest. This design adds some complexity; however, because a buy-sell agreement by its nature must deal with unexpected events, the additional flexibility can be valuable.

WHAT ELSE SHOULD YOUR CLIENT CONSIDER?

- Life insurance premiums are not a deductible expense but the proceeds received are income tax free.
- Heirs generally recognize no taxable gain or loss on the sale of stock because the deceased owner's shares receive a "stepped-up" cost basis at death.

WHAT IS THE BEST TYPE OF LIFE INSURANCE TO FUND A BUY-SELL AGREEMENT?

That depends on your client's specific situation and needs. For example, in a situation where owners have a strategic plan to sell the business in 7-10 years, it could make sense to use a 10 or 15-year level term policy as it could be more cost effective. (Premiums for term insurance will increase throughout the coverage period while whole life premiums generally remain level.) On the other hand, in a family business where owners expect to hold shares and participate in the business for their entire lifetime, permanent insurance may be more appropriate. If cost is a key factor, term insurance can help address that concern. If there is a desire to build cash value within a policy, there are various types of permanent insurance to help meet that objective.

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DOES YOUR CLIENT NEED TO COVER THE ENTIRE VALUE OF THE BUSINESS?

That would be ideal, but not always practical. Imagine your client in the position of a surviving owner: Would they rather have a death benefit large enough so that they could simply write a check to buy out the deceased owner's heirs, or have to deal with the cash flow burden of making interest and principal payments to those heirs for many years? If they were the owner who died, would they want their spouse and children to receive an immediate buyout or drawn-out payments over many years?

On either side of the equation, the ideal situation would be to insure the entire value of the business. But depending on the cost and available cash flow, that is not always possible. A balanced approach might be to target an amount of coverage that is affordable for the business and would provide a substantial down payment on the sale. Then, plan on having the business pay any remaining portion of the sale price on an installment basis over time.

MUST YOUR CLIENT GET AN APPRAISAL TO DETERMINE THE VALUE OF THE BUSINESS BEFORE EXECUTING A BUY-SELL AGREEMENT?

Obtaining an appraisal is usually smart, but not absolutely essential. At a minimum, they need a "ballpark estimate" of what their business value is so they can design a sensible agreement and acquire an adequate amount of insurance to fund it. But in many well-drafted buy-sell agreements, the price is "to be determined." It is more common for buy-sell agreements to include a formula valuation clause, or provide the price will be determined by an appraisal at the time the triggering event occurs. So they don't always have to peg an exact value for the business at the time you are creating the buy-sell agreement.

Your client's business may be their most important asset, so it makes sense to learn about valuation from as many reliable viewpoints as they can access. Their CPA is a good place to start when trying to get a handle on value. If they belong to a trade group or industry association, that organization may be able to provide some guidelines about how buyers and sellers determine value for businesses like theirs. If your client has contacts with other owners in their industry who have acquired or sold similar businesses, they should discuss whether they are willing to talk with them about how they arrived at a value for those deals. They might find free or very low cost valuation tools online (remember, these are usually worth what you pay for them). They should certainly strongly consider working with an experienced business appraiser who can provide an in-depth analysis of the factors that drive value in their business.

WHY NOT JUST USE A "RULE OF THUMB" VALUE THAT IS ACCEPTED IN THE INDUSTRY?

Your client may be shortchanging themselves by using a "rule of thumb" value. Rules of thumb reflect an average and perhaps their business is above average. For example, if they have a particularly valuable location, offer a unique product or service, or regularly achieve above-average profitability, a rule of thumb formula will not reflect the true value of their business.

DOES A BUY-SELL AGREEMENT NEED TO TREAT ALL OWNERS THE SAME WAY?

Not necessarily. Different circumstances may call for different structures. An agreement for two founders, with similar ages and 50/50 ownership, will probably treat both owners the same. But if your ownership group includes, for example, a couple who owns 95% and a son-in-law with a 5% ownership interest, the rights and terms that apply to that minority owner might be very different. There could also be reasons to apply different terms to owners who are very different in age or financial condition, who have different roles in the business, or who have ownership interests but are not active in the business.

It is often appropriate to have different rules apply for different "triggers." Here's a hypothetical example: Your client might want to provide for a mandatory purchase of shares if an owner dies. But what if someone voluntarily resigns, and they suspect that person intends to start a competing business? If their buy-sell agreement requires an immediate purchase of the departing owner's shares, remaining owners could face a cash crunch – not to mention that they have just helped fund their ex-partner's new business. In that situation, perhaps it would be better to mandate a long-term installment payout for voluntary departures before normal retirement age.

The divorce of an owner poses similar thorny problems. They probably don't want the ex-spouse to remain as an owner, but they also want to avoid placing the burden of paying for the buyout on the company or the other owners who are not getting the divorce. Their attorney and CPA can help them recognize and anticipate situations that call for special planning, and craft a buy-sell agreement that fits the unique needs of their business and ownership structure.

Is a buy-sell agreement the same thing as having a business succession plan?

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Not usually; it depends on the circumstances. In most cases, the buy-sell agreement is more of a contingency plan. It serves as an agreement about what we will do "in case of emergency," if something goes wrong, or off plan. Often, the terms of the buy-sell agreement will have very little to do with their long-term succession and exit plan, whether that entails transferring a business to children, selling to a key employee, or someday taking the business public.

However, there are some circumstances where a buy-sell agreement functions as a long-term succession plan. For example, in a professional practice with multiple owners, a buy-sell agreement could function over many years as a rulebook that governs how new owners are selected, how they buy into the business, and how they exit the business and sell their ownership interests at retirement.

HOW IS THIS STRATEGY IMPLEMENTED?

It makes sense to use a team of professionals to create a buy-sell agreement.

- Your client's attorney will design and draft the legal document which is central to this planning strategy.
- Your client's CPA can provide valuable insights relating to valuation, tax structure, and the cash flow consequences of different funding mechanisms. A professional appraiser can help with valuation issues.
- You can assist them in acquiring life insurance to fund their buy-sell agreement.

Every few years, meet with the team of their advisors (attorney, CPA, appraiser, financial advisor) to review the agreement and related insurance coverage. Assess whether the structure of the agreement still makes sense, as their business has changed. Review the formula or procedure that is used to determine value. Make sure that insurance coverage is still adequate if the value of the business has changed. Review how their policies are performing.

Business owners are faced with many day-to-day demands, and it can be difficult to find the time to address long-range planning matters. But an outdated or under-funded buy-sell agreement is of little value. It's worth the effort to review these issues regularly.

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