

A BETTER WAY

Preserving Business Value When Key People Stop Being Part of the Business - After a Merger¹

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Entrepreneurs often join with others to build a business. When they are smart, these partners³ recognize the need for succession planning and exit strategies. In general terms, they need to agree while everything is going well on how to handle things when the enterprise hits such bumps in the road as the premature exit of key people without interrupting ongoing operations, liquidity or profitability for the continuing entrepreneurs. By reaching agreement in advance, they expect to maximize value and fairness while minimizing financial exposure and disagreement.

When that business is the result of several existing enterprises deciding to merge together, often while there is some centralized, common control, each of the original partners retains some autonomy, including financial decision-making. Typically, they want to define and implement a buy-sell agreement which includes some key person benefits for both the enterprise and the individual owners who are active in the business.

Basic buy-sell agreements frequently build on the expectation that each partner would buy-out the departing (or departed) owner. Enterprises fund these agreements with life insurance policies on each key person. When there are two partners, there are typically two such policies: A owns a policy on B and B owns one on A. For three partners, you'd need six policies. A merger involving more partners could lead to quite a large number of policies. And when each enterprise entering into the merger has its own respective set of buy-sell commitments (arising, for example, from gifts of stock from parents to children), the intertwining planning challenges can get even more complex.

The Solution

In this situation, the entrepreneurs may consider using an "Escrowed Buy-Sell Plus Plan". This solution is an integrated cross-purchase arrangement with additional death benefit proceeds to both the enterprise and designated heirs of key persons. The escrowee holds one policy per insured and credits each partner with an allocated interest in the policies covering the others. After a triggering event, the escrowee collects death benefit proceeds and delivers them

¹ **Important note:** *This information is designed to provide a general overview with regard to the subject matter covered. The author and publisher and host are not providing legal, accounting, or specific advice to your situation. You should consult with the professional advisors of your choice for specific advice.*

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³ For purposes of this article, the phrase "partner" simply means fellow business owners, whether "shareholder" of a corporation, "partner" of a partnership, "member" of a limited liability company, or other legal ownership arrangement.

to the decedent's fiduciary in exchange for the stock or other ownership interest.

An Escrowed Buy-Sell Plus Agreement is a formal plan to provide for the orderly transfer of ownership following the death of a business owner, or other triggering event. Owners agree in advance on the process and outcome regardless of who dies first. Separate agreements govern the respective rights and obligations of each owner with regard to related parties who are not active in the business.

In simple terms, the Agreement creates a series of mutual obligations among fellow business owners to buy stock from each other or each other's estate.

The tax rules that apply in this situation are complicated. Basically, the various players need to form a central partnership with each other, distinct from the entity which operates the enterprise. Each of the partners separately has or will have a partnership with the respective related owners. The result is a partnership of partnerships. There are some corporate formalities to take care of as well.

This arrangement can easily accommodate both equal and unequal ownership interests.

By funding the plan, the partners know they will have:

- an assured market for each partner's interest;
- a mutually agreed method for determining the selling price of each partner's interest
- a legally recognized method for setting the estate tax value of an owner's business interest
- a market recognized method for assuring employees and creditors of business continuation
- liquidity to achieve their objectives as they have defined the results

The plan has two basic parts. First, the partners together sign a written agreement providing for the purchase and sale of each partner's interest, designating an escrow agent ("escrowee") to hold all certificates of interest in the company subject to the plan. And second, the escrowee purchases life insurance on each partner in an amount equal to the value of the respective partner's ownership interest. The escrowee serves as owner, payor and beneficiary of each life insurance policy. After the death of a partner, the escrowee uses insurance proceeds to purchase the decedent's ownership interest at the price determined in the agreement. The agreement defines the price as either a specific dollar amount or the result of a valuation process. The escrowee should be independent of the partners.

When each partner in turn has gifted or otherwise shared ownership interests to family members or others not active in the business, that partner in turn should set up a buy-sell arrangement within the separate mini-universe. This separate agreement helps preserve the underlying promises among the enterprise partners regarding business continuity and the usually restricted nature of ownership transfers.

Naturally, there are additional points to consider. The partners need to work with their professional advisors to address legal, tax (both income tax and estate tax), funding and other issues. This consultation is important for both set-up and ongoing review/assessment.

By setting up an "Escrowed Buy-Sell Plus Plan", entrepreneurs will achieve such

benefits as equity and fairness, enterprise security, tax exposure management and peace of mind.

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For side bar:

Some related issues - to address up front or later

1. Consider triggering events other than death, such as what if you live: deal with disability, retirement, quit or involuntary termination.
2. Forecast income tax and estate tax impacts on both the enterprise and the owners - work with CPA(s) and other professional advisors.
3. Consider funding options, ranging from split dollar, to a limited liability entity (perhaps family limited partnership), tapping lines of credit, and internal sinking funds, among others.
4. Address cost allocation proportionate to ownership interest vs equally vs weighting for insurability underwriting factors such as age and health
5. How long do you want to pay in?
6. Do you want proceeds paid out in lump sum or over time?
7. Should you consider separate classes of ownership, such as voting and non-voting stock?
8. Review applicability of Securities and Exchange Commission rules to avoid violating securities laws and exposure from what might be future disgruntled former partners or employees.