Your Buy-Sell Might Be Great If You Die, But What Happens If You Live?

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What happens to a company when one owner becomes disabled? For example, the company has a buy-sell agreement that covered the death of an owner, but fails to adequately address the cash flow implications of a lifetime event (divorce, disability, bankruptcy or retirement of a shareholder).

Few owners (or their advisors) give much thought or analysis to the likelihood of a lifetime transfer. Instead they focus all of their attention on dealing with the least likely event—an owner's death. Yet, in our experience, lifetime transfers occur much more frequently, and when they do can cause huge problems.

Typically, owners create buy-sell agreements that may work well in the event of a shareholder's death, but forget that the same provisions (such as a first right of refusal at a pre-determined price should one owner wish to transfer ownership to anyone) will govern in the case of a lifetime transfer. Because these agreements are designed for one event and used for another, the result is, at minimum, an impetus for re-negotiation, and at worst, a nightmare.

Let's look how two owners' exclusive focus on death crippled them when the thing they least expected happened.

H&T Custom Tack almost didn't get out of the corral. Harry and Tom had talked about pooling their resources (Harry's thriving tack business and Tom's reputation as one of the best custom saddle makers in Texas) for years when Tom's twin brother had a heart attack at age 55. Tom realized that life was too short to keep talking about creating a partnership and the two decided to merge their talents at last.

Along with all of the other documents that Tom and Harry's attorney insisted on was a buy-sell agreement that established the price and the terms of the sale or purchase. Embedded in its creation was the assumption that one of them (probably Tom since he was eight years older than Harry(would die and Harry

would purchase Tom's ownership using life insurance proceeds.

The good news was that Tom answered the wake-up call to improve his life and lifestyle. He not only created a successful company, he replaced his daily drive across town to grab a chicken-fried steak or cheeseburger with brisk walks to the new vegetarian salad joint. He joined his wife for long bike rides on weekends and boasted that he'd never felt better.

The "bad" news was that before either of them could ride off to join the Big Rodeo in the Sky, Harry began to think about retiring and selling out. A quick look at their buy-sell agreement told Harry that he had to sell his stock to Tom based upon the price they had established when they assumed that there would more than adequate funding because of the life insurance policy.

Harry and Tom's problems were just beginning. Because the price established in their buy-sell agreement had little to do with the fair market value of the company when one of them wanted to sell out, the price the buyer would pay was likely to be substantially higher or lower than the company's current value. This means that one or the other partner would suffer.

Some owners resolve this problem by agreeing to ignore their buy-sell agreement and to hire a Certified Business Appraiser to establish a fair market value for the company. Harry suggested this route, but Tom insisted that they abide by their original agreement. First, Tom did not want to put a damper on the future growth of the company by siphoning off its cash flow toward Harry's buy out. Second, the value in the buy-sell agreement was significantly lower than the company's current value.

Harry felt he had proposed a fair alternative, resented Tom's intransigence and didn't want to sell his ownership interest for what he believed was an artificially low price. As you can imagine, the two partners stopped speaking.

Harry's issue with the price was just the first hurdle. Because Harry and Tom had presumed that only death would separate them, they had done no planning to minimize the tax consequences of a lifetime sale. Further, since they assumed that the survivor would use life insurance proceeds (rather than company cash flow) to fund the buyout of the deceased shareholder's interest, they had established a very short—only four-year—timeframe to pay for the purchase. Finally, their buy/sell included no "forced buyout provision" to resolve irreconcilable differences between the owners.

In short, the only way for Harry to leave the company with the amount of cash he felt he was owed was to die. Until he could do that, he was left owning a company whose performance he had absolutely no reason to improve.

The best, and perhaps only, way to prevent this impasse with your company is to address, *today*, potential problems caused by a buy-sell agreement drafted years ago for a transfer event (death) that is not the event (lifetime transfer) most likely to occur.

If you suspect that your agreement may be inadequate, review it immediately…before one owner decides it is time to ride off in the sunset. Please feel free to contact us if you need help identifying and resolving any

problems with your current buy-sell agreement.

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