

GOLDEN BULLETS

Ryan M. Wilson

Fraser Trebilcock Davis & Dunlap, P.C./Lawyers

124 West Allegan Street, Suite 1000

Lansing, MI 48933

Telephone: (517) 377-0897

Fax: (517) 482-0887

Email: rwilson@fraserlawfirm.com

THOUGHT YOU'D LIKE TO SEE THIS:

ALTERNATIVES FOR FUNDING BUY-SELL AGREEMENTS

This is about funding, that is, financing a buyer's obligation under a business buy-sell agreement. Please feel free to share this with a relative or friend who owns an interest in a business.

A buy-sell agreement, a legal document requiring a departing owner to sell and the business and/or remaining owner(s) to buy the departing owner's interest should be funded by a method that will facilitate a trouble-free transfer of a business interest in (at least) the following four contingencies: (1) at the withdrawal of an owner at a time before retirement, (2) at normal retirement age, (3) in the event of an owner's long term disability, and (4) at an owner's death.

Ideally, the method used to provide funds to meet one or more of these contingencies would have a relatively low cost, be simple to understand, easy to administer, and not adversely affect the working capital or credit position of the business.

Most buy-sells are funded with life insurance because it is the only means of guaranteeing that death, the event which creates the need for cash, also, creates the cash, to satisfy that need.

But there are, of course, alternatives which can be used to create funds to purchase a business interest, a cash sinking fund, borrowing from a bank, and installment payments.

Cash Sinking Fund: Cash has the apparent advantage of being simple and requiring no immediate outlay. The problem is that the purchaser does not know precisely when or how much cash will be needed (or who the survivor will be), and thus must always keep a large after-tax cash reserve available. Inevitably, cash sinking funds are inadequate, because death or long-term disability of a working shareholder is always, premature.

Borrowing: Borrowing has the advantages of being simple and requiring no outlay until death or disability occurs. The question is: Will a bank lend money to a business that has just lost its most important asset, the person who made the corporation what it was? If the bank makes the loan, will the terms or rates be reasonable and affordable from the borrower's viewpoint? How will the cash flow demands of repaying the loan impact the operation and credit-worthiness of the business? How much will the total loan cost?

Installment Payouts: An installment sale is simple and a relatively small outflow is required each year. Seemingly nothing is needed until death occurs so action can be put off for many years. But the installment payout method merely delays the pain and obfuscates the full extent of the problem. From the buyer's perspective, an installment sale merely spreads out the obligation but does not provide the cash to effect the buy-out. The longer the term of the payments and greater the obligation, the more adverse the affect on the credit rating of the business. From the seller's (or seller's family's) point of view, an installment payout does not provide the large sums of cash often needed for estate settlement costs, living expenses, and debts. Furthermore, it entails great risk since it leaves substantial sums at the risk of a business which has just lost a key employee.

Life Insurance: Adequate life insurance makes it possible for a stockholder's surviving spouse or children to immediately receive the full fair market value of the decedent's business interest and bail out of the business before it could lose value. The presence of life insurance is excellent evidence to bank loan officers and other creditors that the shareholders are financially responsible. Premiums can be viewed loosely as advance installment payments which are easily budgeted so the event of the buy-out doesn't hurt the cash flow of the business. If the buyout occurs during lifetime, the cash values of a life insurance policy can be used to help provide a portion of the purchase price. These cash values can be obtained from the policy on a tax-favored basis either by policy loan, withdrawal, or by a partial surrender of the policy. There is, of course, a cost; premium dollars are an outlay with a delayed economic benefit. But this is far offset by the great peace of mind attained by all parties when the buy-sell is fully and properly funded.

AS ALWAYS, PLEASE FEEL FREE TO CALL TO DISCUSS THESE AND OTHER MATTERS OF INTEREST.

Myth: If I died without a Last Will and Testament, my property would go to the State.

Truth: If you died without a Will, property in your individual name passes according to the intestate statute of the State of your residence. Generally speaking, property passes to your closest relatives, i.e., spouse, children, grandchildren, parents, siblings, etc.

IF YOU PREFER TO RECEIVE "GOLDEN BULLETS" BY EMAIL, PLEASE SEND A NOTE TO ME AT: rwilson@fraserlawfirm.com. Thanks.

"Golden Bullets" is provided as a source of general information about current developments in the practice of estate planning and related topics. If you have questions regarding this issue or estate planning in general, please contact me prior to taking action.

Ryan M. Wilson (517) 377-0897
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