CHAPTER 63

Can You Afford Your Buy-Sell Agreement?

NATALIA KABBE (Naperville, Illinois)

Ernie and Don were the classic, almost archetypical, American success story. Working in their proverbial garage, they came up with a new and exciting game, one that took the market by storm. They formed a private company together and prospered, selling thousands of units, with the games going out their garage door faster than they could stock them. Both of them seemed destined for wild success. Then tragedy struck.

One frozen January morning, Don suffered a heart attack. Unfortunately, he did not survive. Upon Don's death, his half ownership of the company went to his widow. What was a tragic situation for her, turned into a crisis for the successful, but still fledgling, company. Don's widow and Ernie did not get along. While they finally reached an agreement to allow Ernie to buy her out, Ernie seriously overextended himself in the process. Ernie raised money to keep the company going by selling a significant portion of his own shares, leaving him with only a 30% stake in the company.

The new partners, two brothers, pushed Ernie out and proceeded to run the company into the ground. Ernie eventually wrested control of the company away from them, but that did not end his troubles. Out of spite, the two brothers retaliated by selling their shares in the company to Lorraine, a woman who took it as a matter of pride that she had nothing to do with games. Ernie tried to stop the sale in court, but lost. Lorraine continued to run the company into the ground and, in the end, was forced to sell the company herself. But long before that happened, Ernie had sold his shares and left the company, having lost the rights to his game and all desire to work for the company he had built.

Does this scenario sound unlikely? It shouldn't. The game in question was Dungeons and Dragons, and Ernie's full name was Ernest Gary Gygax. This hypothetical was all too real. But it could have been avoided had Ernie taken a few vital steps back when he was first forming his company.

It is not surprising Ernie and Don did not plan for their deaths. When first starting a business, the prospect of a partner dying is probably the farthest thing from your mind. There are too many other things to worry about, like designing products and selling to customers. You aren't thinking about how to get rid of your business, but how to grow it.

You, like Ernie, face two potential problems as a part owner of a closely held business, be it a partnership, corporation, or limited liability company. The first problem is how to deal with a situation where the shares of a partner may pass to someone else, whether through tragedy, such as death or disability, a falling out, or simply a decision by a partner to move on to other things. As Ernie learned, a new partner can cause conflict and deterioration of the business. A buy-sell agreement can protect the remaining partners — and the company — by allowing the other partners (or the company as a whole) to buy the shares of the departing or deceased partner. The buy-sell agreement also protects the heirs of a deceased partner, by setting a value for the partner's interest in the company. Unlike Ernie and Don, many business owners have taken this first step. But their plans may still fail due to the second problem.

The second problem, as Ernie found out, is how the remaining partners will pay for the shares. Even though Don's widow was willing to sell, Ernie lacked the finances to buy. As a result, Ernie still ended up with unwanted partners. What could have saved Ernie, and what can save you in the event of a partner dying, is life insurance specifically set up to cover the cost of acquiring your deceased partner's share of the company.

There are two basic ways to set up a life insurance policy to fund a buy-sell agreement. The first option is for each partner to take out a life insurance policy on every other partner. The life insurance proceeds are used by the partners to fund the purchase of their pro-rata portion of the deceased partner's shares. One of the biggest disadvantages of this arrangement is that it can get very complicated if there are more than a few partners because each partner must purchase a policy on the life of each other partner. Another downside is that some partners may pay more for their policies than others because the cost to insure each partner will likely vary based on age and health. The extra complication can be worth it, though, because the shares purchased by the surviving partners are valued at their purchase price for tax purposes (stepped-up cost basis).

The second option is for the company itself to take out a single life insurance policy on each partner. If a partner dies, the company buys the deceased partner's shares with the proceeds of the life insurance. The company can then either keep the shares, reducing the number of outstanding shares, or distribute the shares proportionally to the surviving partners. Having the company buy the policies is the simplest solution because only one policy is purchased for each partner. Also, because the company pays for the policies, no partner pays more than his or her fair share of the policy premiums. But this simplicity comes at a cost. The shares purchased by the company do not receive a stepped-up cost basis.

Don't find yourself in Ernie's situation. Make sure you have a buy-sell agreement in place and then properly fund the agreement with life insurance.

Natalia Kabbe is the founder of The Law Offices of Natalia Kabbe, LLC, a boutique estate planning law firm in Naperville, Illinois, serving business owners, executives, and high-net-worth individuals.