
LESSON 4.3 DEATH OF A BUSINESS OWNER AND THE BUY-SELL AGREEMENT

Too many business owners see themselves as invincible. They are not. No one likes to think about the possibility of dying. A business owner has not only their own family to think about but the well-being of the families of all of their employees. By the end of today, you will be able to use knowledge of the various issues created by the death of a partner, business owner, or shareholder, as well as buy-sell agreements that can help a client develop a process of business succession.

There are many different types of businesses and many different business structures. Some businesses are run by a sole proprietor or single business owner. A business could also be run by partners; still others are run by shareholders. Today we are going to look at the impact of the death of a sole proprietor, general partner, limited partner, and shareholder on a business.

The Sole Proprietor

The business that is owned or run by one business owner who is the sole proprietor is possibly at the highest risk for failure when there is no succession plan in place. The death of the sole proprietor may have a variety of unanticipated results. One of those is the loss of value or the goodwill given to the business. Often the sole proprietor has stayed in business by developing relationships and using knowledge of the customer base to inform decisions made. The loss of that active business owner often results in a loss of trust and goodwill that brings with it a loss of business value.

Because a successful business consists of more than its physical assets, this loss diminishes the value of the business. This may result in the business being sold for less than it was worth when the owner was alive. A major asset of any business is the favorable reputation the business has built up over the years that results in the willingness of customers to continue doing business with the business entity. The death of the proprietor will likely jeopardize the goodwill of the customer base.

Another reason the real value may not be fully realized has to do with the price a buyer would be willing to pay for the physical assets. Prices at liquidation sales are often much lower. Buyers know the executors must sell the business assets quickly and that they are usually not in a position to demand the full market value that the assets might command in an ongoing business situation.

If the business does not immediately sell, an executor could be used to operate the business temporarily. It is important to understand that the executor may be held liable for

losses. The person serving as executor must fully understand the day to day business of the deceased owner to do a good job. It is important to remember that the employees of the business are going to feel uneasy if no clear transition is planned. It is always possible that the business interest could be transferred to others through the owner's will. This can prove disastrous if the heirs do not understand the business or have the same credibility as the owner. Finally, the business interest could be sold to employees as an on-going business. In this case, the price would be the concern.

Finally, no matter what the path, the creditors will be interested in the business succession. Based on the types of loans and notes the business carries, the creditors may exercise the right to call those notes due upon the death of the owner. This means that all loans taken out under the business or deceased owner could be due immediately.

Partnerships

There are two types of partners: general partners and limited partners. General partnerships occur when the partners all make contributions to the day-to-day working of the company. They share the authority to make decisions. They also share the financial and legal liability. The death of a general partner affects the day-to-day operations of a business in an extreme way. The first step after a general partner dies is moving the business into dissolution or continuation. In the absence of a continuation agreement, the death of a general partner, by operation of state law, usually dissolves the partnership in which the deceased was a member. Which means, if the general partners have not fully planned a way of moving forward, the death of one of them means the death of the business.

If a continuation agreement is in effect, the partnership can be reorganized; survivors could accept decedent's heirs into the business or the decedent's heirs could sell their interest to an outsider or to the surviving partners. If there is no continuation agreement, the business moves into dissolution and a winding up process. Because the partnership creates an agreement in which the partners are bound together, share profits, and have a voice in management, the death of a partner dissolves all the aspects of business partnership.

This does not necessarily mean the termination of the business. The partnership must continue until the winding up of the partnership's affairs is completed. In this case, surviving partners become the liquidating trustees and must, without delay, perform such functions as completing partnership transactions entered into before the partner's death, collecting accounts receivable, paying partnership debts, converting the remaining assets to cash, and paying the deceased's share of the partnership funds to the heirs.

A limited partnership is a partnership in which one or more of the partners are not involved in the day-to-day operations of the business. These partners are often called “silent partners.” As you can imagine, the death of a limited partner is not as impactful as the death of a general partner. Although in this partnership, death does not dissolve partnership, the business may still move into a termination phase. If this is the course of action, the surviving partners will assume the same roles as when a general partner dies. Keep in mind that in a limited partnership, it is possible for survivors to buy out the heirs and move forward.

Shareholders

There are two types of shareholders. There are majority shareholders, those who hold more than 50% percent of the company's shares. In contrast, there are minority shareholders, those who hold less than 50% of the company's stock. When a majority shareholder dies, the surviving shareholders and the heirs of the deceased shareholder are faced with several possibilities. The first option is that the surviving shareholders could continue the business with the heirs. In a corporation, unlike in a partnership, the owners may be forced to accept persons they do not want as co-owners. The second option is that the surviving shareholders could buy out the heirs or vice versa; the purchasing party must have the cash on hand to make the purchase. The final option is the heirs or the surviving shareholders could sell their stock to outsiders.

With the death of a minority shareholder the deceased minority shareholder's immediate family will often find that their income from the corporation has stopped if that income was in the form of the deceased officer's salary. The heirs' minority interest will not be enough to guarantee that another family member will become an officer or employee of the corporation, nor is the minority interest large enough to force dividend payments. From the surviving shareholders' point of view, there may be no reason to pay dividends or give a job in the corporation to someone who is not familiar with the business.

Because of the minority shareholder's right to inspect the books and vote with their shares, the family could still cause inconvenience for the surviving shareholders. If the heirs sell their shares to an outsider, especially a competitor, the outsider might harass the controlling shareholders from within the corporation. The most practical solution is, of course, for the heirs to sell their interest to surviving shareholders, provided the survivors have the cash to make the purchase. The heirs may choose to try to sell their stock to outsiders. Often, however, there is no market among outsiders for close corporation stock, especially when it is a minority interest.

LLC Member

The last group we will discuss is the LLC member. First we need to define a LLC. An LLC is a Limited Liability Company. This is a way to structure a company in which the owners, called members, are not personally responsible for the company's debts and legal liabilities. The LLC does not pay taxes, but the members are responsible for listing the business profits and losses on their personal income tax returns.

When an LLC member dies, the operating agreement determines whether the LLC is continued or dissolved. The operating agreement also typically determines the ability of a member to transfer their membership to another person. If the members do not address the death of a member in the operating agreement, the consequences may be governed by the remaining members' decisions and state laws. Most state laws will default to dissolution of the LLC.

At this point you are seeing how important it is for every business and company to have a plan that addresses the death of an owner, partner, shareholder, or member. It truly can mean the life or death of the business. Let's see how well you can apply what you have learned. You have five minutes to work with a neighbor to address the scenario and answer the question.

Ralph owns a very successful fast food franchise and has recently taken on a partner in the business. Ralph is 55, a widower with two grown sons. His new partner, who bought into the business, is Jason, age 35, married with three young children. Jason's wife is an attorney currently serving as counsel for a group of local physicians.

Use knowledge of the various issues created by the death or disability of a partner to help develop a process of business succession for Ralph and Jason. What issues would you discuss with these new partners?

You will want to suggest that the new partners set up a continuation agreement. If a continuation agreement is in effect, the partnership can be reorganized; survivors could accept decedent's heirs into the business or the decedent's heirs could sell their interest to an outsider or to the surviving partners. If there is no continuation agreement, the business would move into dissolution and a winding up process.

The Buy-Sell Agreement

One of the tools you could discuss with Ralph and Jason that would enable either partner to move forward with the business if one of them died is a Buy-Sell Agreement. The **Buy-Sell Agreement** is a legally binding agreement used to reallocate a share of a business

should an owner die or leave the business. A Buy-Sell Agreement is an appropriate course of action to mitigate issues caused by death, disability, retirement, or termination of employment.

The first thing that must occur in the development of the Buy-Sell Agreement is the **valuation of the business**. The IRS has distinct guidelines for developing the value of a business. While it is possible to follow IRS guidelines in making the valuation, it is impossible to say for certain that the IRS will be in 100% agreement when the estate is settled. That is why the valuation itself should be left to the specialists in the field (IRS Revenue Ruling 59-60).

There are eight factors used in the valuation of a business. First is the history and the nature of the business. How has it performed historically? Second, there is the condition of the national economy and the specific industry the business is involved in. Does it appear that business conditions connected with the economy are favorable? Does it seem to be a good time for this type of business? Next in the valuation process is the financial condition of the organization. Is the business barely making payroll and paying bills? The next factor is closely related. Does it look like this business will be able to earn money? Just what is the earning capacity of the business? The sixth factor is the goodwill of the clientele. This is also known as the perceived reputation of the company. The seventh and eighth factors are connected to the stock value of the business. The seventh factor is the price of the previous sale of stock and the eighth and final consideration on valuation is the fair market value of publicly traded stock in a comparable business.

Once a determination of value has been made, a plan for financing the transaction must also be in place. Just how would a person pay for the share of another in the situation of buy-sell? That is, if the surviving partner needed and wanted to buy out the deceased partner's heirs or designated beneficiaries, how would they come up with the money?

Financing the Buy-Sell Agreement

The first option is with personal funds. This is not entirely realistic. Most successful business owners do not have large sums of liquid assets lying around. They normally have their money "working" or tied up in the business. Therefore, they would have to liquidate assets to be able to come up with the necessary cash. It is a plan that most likely will not work.

The second option for buying out a deceased partner's share of a business is called a sinking fund. This is a method of depositing funds on a regular basis so as to accumulate

the amount necessary to fund the buy-sell. Such a fund will be inadequate if the death of a partner is premature or unforeseen. Also, the time of need is uncertain and any such investments would be subject to tax on the growth and to the claims of creditors. Whether it will work or not is really a gamble.

The third possibility is for the buyer to borrow money to buy out the business. Due to the perceived instability of the situation, the buyer may not be able to get a line of credit large enough to cover the purchase. Additionally, the interest cost may make borrowing prohibitive.

The final option is funding the buy-sell agreement with life insurance. The owners can actually purchase a policy that would cover all of them, so that if one of them dies, the policy pays. This secures complete financing of the buy-sell agreement from the beginning. Remember that the proceeds from a death benefit are income-tax-free. Depending on the type of insurance and the way it is structured, the cash value of the contract could be used to fund a buyout due to disability or retirement. Because the cost is known and can be budgeted for, this is the most economical method. Because the value of the life insurance contract can be counted in the assets of the company, credit is strengthened.

The insurance professional has an important role in the succession planning of his or her clients. It is vital for the insurance professional to fully understand the basics of the Buy-Sell Agreement. He or she must know how life insurance fits into business and succession planning. The insurance professional must be able to encourage collaboration of a client with competent legal and accounting advisors and must be able to work with the succession planning team.

The professional who is knowledgeable can have a key place in helping business owners, partners, and shareholders plan for the future, not only for their families and heirs, but for the employees who work in the businesses they have a stake in.