

Preparing Buy-Sell Agreements

By Harris Markhoff, Esq. and Michael Markhoff, Esq.

There are occasions in preparing Buy-Sell Agreements when the standard technique is not the only solution. On numerous occasions, when preparing insured Cross Purchase Agreements for two stockholders in a business corporation, one of the stockholders will raise the issue as to whether it is really equitable to the stockholder who dies first.

What the stockholder is really expressing is an obvious inequity when using an insured Buy-Sell Agreement. The insured Buy-Sell Agreement may create a windfall for the survivor.

Let us illustrate this statement with an example. As a hypothetical, A and B each owns 50% of Widget Corp. with a fair market value of \$2,000,000. The standard technique in a cross purchase insured Buy-Sell Agreement is to have each stockholder own a \$1,000,000 policy on the life of the other stockholder.

Under this fact pattern, if A dies first, B will collect \$1,000,000 representing one-half of the fair market value of Widget Corp. and will remit those proceeds to A's estate representative in

exchange for purchasing A's stock in the corporation.

At first blush, it would appear that A has received one-half of the fair market value and there is no reason for anyone to be concerned about an inequity. However, if you analyze the situation from the survivor's standpoint (stockholder B), stockholder B now owns a corporation which is still worth \$2,000,000 despite A's death. The \$1,000,000 purchase price was paid outside the corporation with life insurance proceeds.

In effect, B has purchased this corporation in the ultimate leveraged transaction. He has purchased one half of a \$2,000,000 business at a cost of paying life insurance

premiums on a \$1,000,000 policy.

When an extremely observant client realizes the situation, he will ask the attorney how to remedy what he perceives to be a windfall to the survivor and an inequity to the first stockholder to die.

Under most Buy-Sell Agreements, there is a provision that when the first stockholder dies, if that stockholder

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owns a life insurance policy on the surviving stockholder, then the surviving stockholder is given the option to purchase the policy on his life by paying the cash surrender value to the estate of the first stockholder to die.

This would exacerbate the inequity because Stockholder B, who is the surviving stockholder, not only owns a \$2,000,000 corporation but also now has \$1,000,000 of life insurance coverage which he may not otherwise be able to obtain at his advanced age without (assuming he is insurable) paying a higher premium.

In an attempt to level the playing field, we have been using a technique whereby we provide in the Buy-Sell Agreement that when the first stockholder dies (stockholder A in this example), his estate has the option to retain the life insurance policy on stockholder B. We actually specifically bequeath that policy in A's Will to A's credit shelter trust.

You now have a situation where A's credit shelter trustees have to make a business decision to continue paying premiums on the insurance policy insuring stockholder B or cashing in the policy or selling it to stockholder B.

If A's trustees elect to retain the policy and continue the premiums, then at stockholder B's death, A's credit

shelter trust will receive an additional \$1,000,000 free of income tax and free of estate tax.

In effect, both stockholders would have received \$2,000,000 for their respective interests in Widget Corp.

There is another technique to try to level the playing field. In addition to two \$1,000,000 life insurance policies owned on a cross purchase basis insuring each of A and B, one could purchase a second-to-die policy insuring A and B owned by an Irrevocable Life Insurance Trust. That trust would then provide that when the second stockholder dies, the proceeds (\$1,000,000 in this fact pattern) would be remitted to the estate of the first stockholder to die.

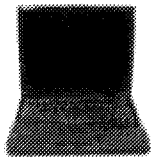
The above fact pattern is not that unusual and should be considered by any practitioner preparing Buy-Sell Agreements. ■

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