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Value Matters™

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Treatment of Life Insurance Proceeds in Buy-Sell Agreement Valuation

Life insurance is sometimes purchased by corporations on the lives of their shareholders. Frequently, the reason for the purchase of life insurance by a corporation relates to its buy-sell agreement with its shareholders. The November 2006 issue of *Value Matters™* was titled "Life Insurance Proceeds in Valuation for Buy-Sell Agreements." That article discussed two polar treatments of life insurance proceeds in buy-sell agreement appraisals:

» **Treatment 1 – Proceeds Are Not a Corporate Asset**. One treatment would not consider the life insurance proceeds as a corporate asset for valuation purposes. This treatment would recognize that life insurance was purchased on the lives of shareholders for the specific purpose of funding a buy-sell agreement. Under this treatment, life insurance proceeds, if considered as an asset in valuation, would be offset by the company's liability to fund the purchase of shares. Logically, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back into income as a non-recurring expense.

» **Treatment 2 – Proceeds Are a Corporate Asset.** This treatment would consider the life insurance proceeds as a corporate asset for valuation purposes. In the valuation, the proceeds would be treated as a non-operating asset of the company. This asset, together with all other net assets of the business, would be available to fund the purchase of shares of a deceased shareholder. Again, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back into income as a non-recurring expense.

The November 2006 article provided an example of the two distinct treatments for a sample software company owned by Harry and Sam. Harry died. Tables One and Two are sufficiently self-explanatory to illustrate the polar results:

INSIDE

		Company	Harry (Estate)	Sam
1	Stock Ownership (Shares)	100	50	50
2	Stock Ownership (%)	100%	50%	50%
3	Pre and Post Life Insurance Value ($m)	$10,000	$5,000	$5,000
4	Life Insurance Proceeds ($m)	$6,000		
5	Repurchase Liability ($m)	($5,000)		
6	Post-Life-Insurance Value ($m)	$11,000		
7	Repurchase Stock ($m)	($5,000)	$5,000	
8	Retire / Give Up Stock	(50)	(50)	
9	Remaining Stock	50	0	50
10	New Stock Ownership (%)	100%	0%	100%
11	Post-Life Insurance Value of Co. ($m)	$11,000	$0	$11,000
12	Post Life Insurance Proceeds ($m)		$5,000	
13	Net Incremental Assets ($m)	$1,000		

TABLE ONE: PROCEEDS ARE A FUNDING VEHICLE

		Company	Harry (Estate)	Sam
1	Stock Ownership (Shares)	100	50	50
2	Stock Ownership (%)	100%	50%	50%
3	Pre-Life Insurance Value ($m)	$10,000	$5,000	$5,000
4	Life Insurance Proceeds ($m)	$6,000	$3,000	$3,000
5	Post-Life Insurance Value ($m)	$16,000	$8,000	$8,000
6	Repurchase Liability ($m)	($8,000)		
7	Post-Life-Insurance Value ($m)	$8,000		
8	Repurchase Stock ($m)	($8,000)	$8,000	
9	Retire / Give Up Stock	(50)	(50)	
10	Remaining Stock	50	0	50
11	New Stock Ownership (%)	100%	0%	100%
12	Post-Life Insurance Value of Co. ($m)	$8,000	$0	$8,000
13	Post Life Insurance Proceeds ($m)		$8,000	
14	Net Incremental Liabilities ($m)	($2,000.0)		

TABLE TWO: PROCEEDS ARE A CORPORATE ASSET

It should be clear that in Table One, where life insurance proceeds are treated as a funding vehicle (with excess proceeds remaining with the company, Sam ends up with substantially more value than does Harry's estate. In Table Two, where life insurance proceeds are treated as a corporate asset, Harry's estate and Sam share equally in the post-transaction value.

What did Sam and Harry intend when they caused the company to purchase life insurance on both of their lives? If they memorialized their agreement in their buy-sell agreement, the appraiser would know of that intent and could provide the valuation accordingly. If, on the other hand, the buy-sell agreement was silent or unclear regarding treatment, the appraiser could have difficulties.

A REAL CASE

A recent case dealt almost exclusively with the issue of the intent of the parties where the buy-sell agreement was deemed unclear regarding how life insurance should be treated.

In this case, there were two 50-50 partners in three corporations. There was life insurance on the lives of each owned by the corporations. The players included:

1. The Estate
2. The Surviving Shareholder
3. The neutral appraiser (selected by two other appraisers who were chosen by the Estate and the Surviving Shareholder.
4. A review appraiser retained by the Surviving Shareholder.
5. A real estate appraiser selected by the neutral appraiser, whose appraisals were unchallenged.

The case included a number of allegations, including actions by the Surviving Shareholder that the court found inappropriate. We address only the valuation issues here for two companies. The third company had a recently agreed-upon value in what was called Exhibit A to its agreement. The buy-sell agreements (all were essentially identical) stated in Section 1:

> **Purpose**. [...] the Shareholders and the Company believe that it is in their best interests for the Company to remain closely held. Accordingly, they wish to provide for the orderly transfer of ownership of the Shares if any one of the Shareholders dies, becomes disabled, terminates employment with the Company or seeks to dispose of Shares, and *to establish a fair and equitable value for the Shares*. (*emphasis added*)

The court noted that the parties' agreements provided that the value of the companies would be determined solely on the sound judgment and discretion of the neutral appraiser, "who alone shall value the Shares and whose determination of value shall govern."

If there is language in an agreement of this nature, it is best that the parties have agreed, while all are in the here and now, on exactly what kind of value is desired for the buy-sell agreement. In this case, one of the parties was in the hereafter, and the interests of the Estate and of the Surviving Shareholder (and the company) were definitely not in alignment.

Section 1 of the agreement (let's speak in the singular) stated the "purpose" in initial language. Section 8 of the agreement provided for the determination of the "price" pursuant to them. The language in this section was reasonably clear, providing that there should be neither any discounts for the minority nature of any interest nor any discounts for their lack of marketability. The standard of value for the required price determination was that of *fair market value*. There was no further guidance in Section 8 either to limit or to guide the judgment of the selected neutral appraiser.

However, Section 9 of the agreement addressed the treatment of insurance proceeds. This section required that the full after-tax amount of proceeds should be applied to the purchase price, either as down payment or as prepayment of the note called for to evidence the company's obligation. There was a provision that stated that "excess insurance proceeds, if any, over the purchase price should be retained by the company."

Suffice it to say that the neutral appraiser was in position to take incoming fire from both sides. The Estate's counsel focused on the "fair and equitable" language from Section 1. Certainly, they argued, it can't be "fair and equitable" to use the life insurance proceeds as a funding vehicle.

The Surviving Shareholder's advisers focused on the fact that the agreement clearly stated that the standard of value was fair market value and that excess life insurance proceeds would remain with the company.

» If, in a determination of fair market value, there was life insurance proceeds as an asset, there was a corresponding liability to purchase the shares. Using the example of Harry and Sam above, why would anyone pay $8.0 million for 50% of the business to the Estate (Table Two) when the life insurance would be paid out to purchase the shares, leaving value of only $5 million (Table One).

» Secondly, the parties agreed that excess life insurance proceeds would go to the company in Section 9. A quick look at Table Two above indicates that it will be difficult for there ever to be excess proceeds if life insurance is treated as a corporate asset.

I was the Review Appraiser, and I thought these two arguments were fairly compelling as to the intent of the parties, but I was not the neutral appraiser. The agreements were silent as to the specific treatment of life insurance proceeds.

The neutral appraiser was uncomfortable in his role – and who wouldn't be? He provided values both as illustrated in Table One and Table Two. In court, he testified that he believed that treatment as a corporate asset provided the equitable fair market value.

In the end, the court combined the "fair and equitable" language of Section 1 with the definition of fair market value and with the agreements' provisions that the neutral appraiser's conclusions would be "binding and conclusive." The court concluded that life insurance was a corporate asset, and the case was over.

CONCLUSION

We conclude this newsletter with advice from the November 2006 issue of *Value Matters*™:

> It should be clear that the decision to treat life insurance as a corporate asset or not is an important one for all parties. Which treatment is the most "fair?" That depends on what the parties decide. Is it fair for Sam to end up with $11 million in value while Harry's estate only receives $5 million if life insurance is not a corporate asset? Sam and the company receive a windfall, but Harry's estate got precisely the amount that Harry would have received had he and Sam decided to sell the company prior to his death.
>
> On the other hand, despite the increase in value to Sam when it is treated as a corporate asset, is it fair to saddle the company with repurchase debt at the moment of its greatest vulnerability, the death of one of its key owner-managers? The answers to these questions may not be immediately clear.
>
> What is clear from this example [and the court case], however, is that the issue of valuation treatment of life insurance proceeds is far too important not to be addressed in your buy sell agreement.

To obtain your copy of the book *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* go to Mercer Capital's website at www.mercercapital.com, or fill out and fax in the attached order form.

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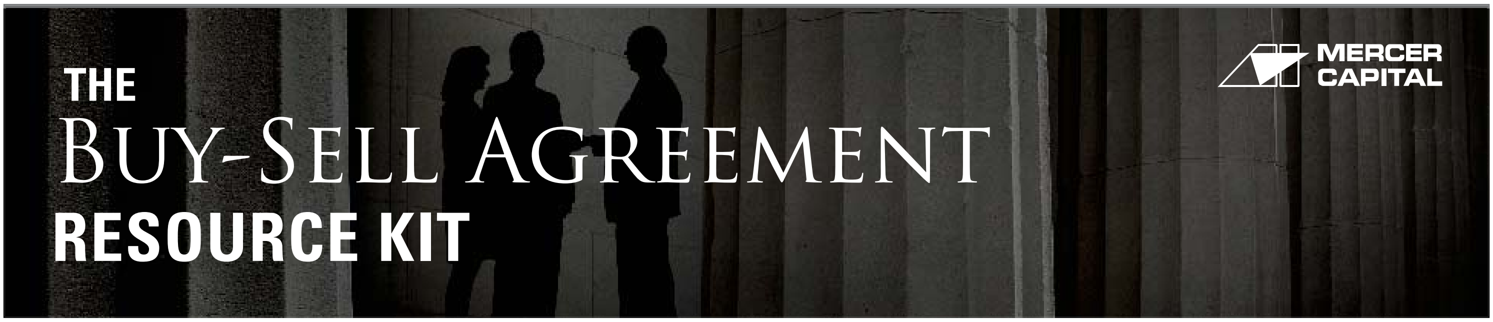

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