

MERCER CAPITAL'S

Value Matters™

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Life Insurance Proceeds in Valuation for Buy-Sell Agreements

Many buy-sell agreements are funded, in whole or in part, by life insurance on the lives of individual shareholders, who may be key managers, as well. Life insurance is a tidy solution for funding when it is available and affordable. It is important, however, to think through the implications of life insurance from a valuation perspective whether you are a valuation expert, a business owner or both.

The proceeds of a life insurance policy owned by a company naturally flow to the company. Should life insurance proceeds resulting from the death of a shareholder be considered as a corporate asset solely for the purposes of funding the repurchase liability created by a buy-sell agreement? Alternatively, should the life insurance proceeds could be considered as a separate corporate asset, i.e., as a non-operating asset, to be included in the calculation of value for the deceased shareholder's shares?

This decision as to the treatment for any particular buy-sell agreement is one that warrants discussion and agreement. Absent specific instructions in a buy-sell agreement, appraiser(s) may have to decide how life insurance proceeds are to be considered in their determination(s) of value. What they decide will almost certainly disappoint at least one side and may surprise both.

Two potential treatments of life insurance proceeds are noted above. Let's consider them specifically, and then look at examples of their treatment and the differing impacts that the treatments have on all parties to a buy-sell agreement, including the selling shareholder, the remaining shareholder(s), and the company.

» *Treatment 1 – Proceeds are a Funding Vehicle.* This first treatment would not consider the life insurance proceeds as a separate, non-operating 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 the liability created by the operation of 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.* An alternative treatment would consider the life insurance proceeds as a corporate, non-operating asset for valuation purposes. In valuation, the proceeds would then be treated as a non-operating asset of the company. This non-operating asset, together with all other net assets of the business, would be available to fund the purchase

WHAT'S IN A NAME?

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We have NO affiliation with either of these firms.

We are a business valuation and investment banking firm founded in 1982. We operate under a strict code of ethics and our reputation is untarnished.

For more on the SEC's action against those other firms, [click here](#).

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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.

Obviously, parties to an agreement could make a decision for treatment of life insurance proceeds between these two extremes, but that is beyond the scope of our example.

AN EXAMPLE: HIGH POINT SOFTWARE

The choice of treatment of life insurance proceeds can have a significant, if not dramatic, effect on the resulting position of a company following the receipt of life insurance proceeds and the repurchase of shares of a deceased shareholder. The choice of treatment also has an impact on the resulting positions of the selling shareholder and any remaining shareholders. Consider the following example:

- » Harry and Sam own 50% interests of High Point Software, and have been partners for many years. Both are key managers in this small, but successful enterprise.
- » The buy-sell agreement states that the Company will purchase the shares of stock owned by either Harry or Sam in the event of the death of either. The agreement is silent with respect to the treatment of life insurance proceeds. The agreement calls for the Company to be appraised by Mercer Capital (wishful thinking, perhaps, but I'm writing this example).
- » The Company owns term life insurance policies on the lives of Harry and Sam in the amount of \$6 million each.
- » Assume that Harry is killed in an unfortunate accident. Assume also that the Company is worth \$10 million based on Mercer Capital's appraisal prior to consideration of the proceeds of term life insurance owned by the Company on the life of Harry, and that earnings have been normalized in the valuation to adjust for the expense of the term policies.
- » Before finalizing the appraisal, Mercer Capital carefully reviews the buy-sell agreement for direction on the treatment of life insurance proceeds. It is silent on the issue. We call a meeting of Sam and the executor of Harry's estate to discuss the issue, because we know that the choice of treatment will make a significant difference to Harry's estate, the Company, and to Sam personally as the remaining shareholder.

We do not have to resolve this issue because it is a hypothetical situation. However, the example illustrates the importance of reaching agreement on the treatment of life insurance proceeds for valuation purposes when buy-sell agreements are signed. The valuation impact of each treatment is developed below in the context of the High Point Software example.

Treatment 1 – Proceeds Not a Corporate Asset

Table One summarizes the pre- and post-life insurance values and positions for High Point Software, Harry's estate and Sam if life insurance proceeds are not considered as a separate, non-operating corporate asset in valuation.

On Line 3, we see that High Point Software is worth \$10 million before consideration of life insurance, and both Harry and Sam have 50% of this value, or \$5 million each. Upon Harry's death, the company receives \$6 million of life insurance and recognizes the liability of \$5 million to repurchase Harry's stock. The post-life insurance value is \$11 million (Lines 4-6).

To download a complimentary chapter from Mercer Capital's upcoming book, "*Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?*", visit www.mercercapital.com

Lines 7-10 reflect the repurchase and retirement of Harry's shares. The remaining company value, after repurchasing Harry's shares for \$5 million, is \$11 million. Since Sam owns all 50 shares now outstanding, his post-transaction value is \$11 million. Harry's estate has received the \$5 million of life insurance proceeds from the sale of 50 shares for \$5 million, which is the amount he would have received had he and Sam sold the company the day before he died.

Treatment 2 – Proceeds Are a Corporate Asset

Table Two summarizes the pre- and post-life insurance values and positions for High Point Software, Harry's estate and Sam if life insurance proceeds are considered as a separate non-operating corporate asset in valuation.

Line 3 indicates the same \$10 million pre-life insurance value of \$10 million as in the treatment where life insurance is not a corporate asset. Now, however, the \$6 million of proceeds from the policy on Harry's life is treated as a non-operating asset and added to value, raising the post-life insurance value to \$16 million, and the

TABLE TWO: PROCEEDS ARE A CORPORATE ASSET

	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	(\$8,000)		
7 Post-Life-Insurance Value	\$8,000		
8 Repurchase Stock	(\$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.	\$8,000	\$0	\$8,000
13 Post Life Insurance Proceeds		\$8,000	
14 Net Incremental Liabilities	(\$2,000.0)		

This result is the same as above. However, Harry's estate receives \$8 million as result of the purchase of his shares, rather than \$5 million. Note that the company's value has been reduced from the pre-death value of \$10 million to a post-death value of \$8 million (Line 12).

The decrease in value is the result of Harry's value of \$8 million, which is in excess of the life insurance proceeds of \$6 million, suggesting that the company had to issue a note to Harry's estate for the remaining \$2 million (Line 14). So the company is in a more leveraged position as result of the buy-sell transaction than it was before. Sam, on the other hand, owns 100% of the remaining value, or \$8 million, rather than \$11 million in the prior treatment.

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 and Post Life Insurance Value (\$m)	\$10,000	\$5,000	\$5,000
4 Life Insurance Proceeds	\$6,000		
5 Repurchase Liability	(\$5,000)		
6 Post-Life-Insurance Value	\$11,000		
7 Repurchase Stock	(\$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.	\$11,000	\$0	\$11,000
12 Post Life Insurance Proceeds		\$5,000	
13 Net Incremental Assets	\$1,000		

interests of Harry's estate and Sam to \$8 million each (Lines 4-5). After recognizing the repurchase liability of Harry's shares (\$8 million), the post-life insurance value of High Point Software is \$8 million (Lines 6-7).

The shares are repurchased and new ownership positions are calculated on Lines 9-11. Harry's ownership goes to zero, and Sam's rises to 100% of the now 50 shares outstanding.

WHAT'S FAIR?

It should be clear that the decision of how to treat life insurance for valuation purposes is important for all parties. Which treatment reflects the intentions of the parties? The fact is that life insurance proceeds create an asset that is unrelated to the operation of a business. The parties, therefore, should decide on the treatment of that insurance asset just like they decide on the investment or distribution of the company's earnings.

Was it Harry and Sam's intention for Sam to end up with \$11 million in value while Harry's estate only receives \$5 million if life insurance is not treated as a corporate asset? Sam and the company receive an increment in value, 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, when life insurance proceeds are treated as a corporate asset, both Sam and Harry's estate benefit from the increase in value from the proceeds. However, the company is saddled with additional debt to repurchase Harry's shares at the moment of its greatest vulnerability, the death of one of the two key owner-managers. Is that the intention of the parties? The answers to these questions may not be immediately clear.

CONCLUSION

What is clear from this example is that the issue of the valuation treatment of life insurance proceeds is far too important not to be addressed specifically in buy sell agreements. If an agreement is silent on the issue and the life insurance proceeds are significant in relationship to the value of a business, rest assured that there will be an issue – probably litigation – when a significant shareholder dies.

With out-of-date fixed price agreements where value rises over time, the parties to that agreement make a bet that “the other guy” will die first. And one of them will be right! With life insurance proceeds, there is something of a similar bet if life insurance is treated as a funding vehicle only. In this case, however, the seller who dies first will get what his stock was worth before life insurance proceeds. His only “loss” is in not sharing in the incremental asset created by the insurance.

Parties to an agreement may feel differently about this “loss” or incremental gain depending on whether a company is entirely family-owned or the ownership is comprised of unrelated parties. However, regardless of they feel about it, the Internal Revenue Service may have a say about the treatment of life insurance proceeds in family-owned businesses.

The bottom line. If a buy-sell agreement is funded in whole or in part by life insurance, take the time to review the agreement to see what it states regarding the treatment of proceeds in the event of the death of a partner/ shareholder. If it is silent, now would be the best time to get together with all parties to the agreement and to discuss the impact of life insurance.

Valuation advisers should be called upon and asked to make calculations like those above – or they can be made internally by corporate personnel based on an assumed value for the business. Armed with this information, the parties should decide now what will happen to the incremental asset created by life insurance proceeds?



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