



Business Succession Planning Case Study Part II of II

How Life Insurance Made the First Case Study Possible

Hopefully, you have had a chance to review the first case study. The first case study is actually Part 2. Part 1 begins many years ago when the Father from Part 2 began his plastics business with a physician who had an idea to produce high-tech pharmaceutical grade plastic parts. The Father had the business acumen to run the business, and the Physician had the ideas for products.

The combination of the Father and Physician worked well for many years. Over time, the Physician's sons came into the business and helped further develop the business by establishing customer relationships that were important to the business. The Physician and Father entered into a shareholder agreement early on that was funded with \$2 million of whole life insurance on each shareholder. The shareholder agreement was structured as a cross purchase agreement so that the Physician owned \$2 million of life insurance on the life of the Father and vice versa.

As the company grew, and the value began to substantially exceed the life insurance. The Physician assumed he would outlive the Father and declined to renegotiate the terms of the shareholder agreement. The shareholder agreement generally provided that the value of stock was to be calculated pursuant to a formula that was reasonably close to fair market value; however, under the terms of the formula, the purchase price was capped and would not exceed the value of the life insurance that each of the shareholders owned on the life of the other.

The Physician "lost the bet" so to speak and died first. Because the Physician and his sons were in the industry and had the key contacts with pharmaceutical companies, the Father, in addition to complying with the terms of the shareholder agreement (buying the stock from the Physician's estate for the value of the life insurance he owned on the life of the decedent--\$2 million), also paid a bonus to the Physician's sons in the form of stock in the company to keep them interested in the business since they were key employees and had very important contacts with customers.

In addition, whole life insurance policies were purchased by the company on the lives of the Physician's sons ("Key Employees") and the Father's son ("Son"), who was just beginning to get involved in the business. As an additional incentive to keep the Key Employees, the Key Employees purchased additional life insurance on the life of the Father. The life insurance proceeds were paid for by the company and accounted for as taxable compensation to the Key Employees.

Over time, the relationship between the Father and the Key Employees did not prove to be as successful as the relationship that the Father had with the Key Employees' father. For a variety of reasons, the relationship broke down, and the Father determined that, in order for the company to succeed, he needed to terminate the employment of the Key Employees. To avoid a prolonged legal battle over a number of issues, a settlement agreement was reached with the Key Employees for the purchase of their stock, which had risen in value to several million dollars. At the time, the company could not get sufficient funding to pay off the Key Employees in full, and as a consequence, the Key Employees and the Father negotiated an installment sale buyout. Part of the purchase agreement provided that the Key Employees would assign back to the Father life insurance they owned on the Father's life. However, since the Father was many years older than the Key Employees, the Key Employees insisted on additional security for the payment of the Note due them from the Father. As a consequence, the Father and the Son collaterally assigned the death benefit on their life insurance policies as security for the Notes to the Key Employees.

In addition to the above transactions, a grantor trust was used to purchase the stock of the Key Employees and own life insurance on the Father's life and the Son's life. The use of the trust to purchase the stock and own the life insurance kept the value of the stock and the value of the life insurance out of both Father's estate and Son's estate. The trust also provided substantial non-tax benefits to Father and Son, including elimination of the assets from their respective marital estates in the event of divorce.

The moral of this story is that life insurance that was purchased many decades ago, as well as life insurance that was purchased seven or eight years before termination of the Key Employees' employment with the corporation, ended up providing crucial security for the purchase of their stock, thereby avoiding prolonged litigation.

The Father and Son, who had previously viewed the payments of their life insurance as a painful but necessary expense for their business, now view the same premiums as an investment in an asset, that can provide flexibility and benefits beyond the purpose for which it was originally intended.

After completion of the foregoing transaction and the hiring of a new President and CEO for the company, the company promptly purchased a key man whole life insurance policy on the new CEO hired to run the company. The Father and Son did not need any lengthy explanations or prompting because at this point they had developed an appreciation for life insurance knowing that it can be used in a number of different ways to facilitate business transactions and succession planning.