“We get along, and we plan to keep the business among the three of us.”

Business planning

Cross purchase buy sell agreements

The scenario

Megan, Sandy and Jennifer became friends during their freshman year in college. They shared a major, but they really bonded over baking crazy but delicious treats at 1 a.m. in their small dorm kitchen. After graduation, Megan and Jennifer took jobs with local companies while Sandy went off to culinary school and then took a job at a restaurant in a nearby city.

The three got together one weekend and in the process of catching up, their talk soon turned to the idea of creating a business together. Soon after, the MSJ Baking Company was born, with the three of them as equal owners. Over the next 30 years, the business grew to include six bakeries, two food trucks and various cake mixes sold commercially throughout the state. It’s now worth roughly $9 million.

Over the years, Megan remained single and focused her energies on the business and on her sister’s three girls. Sandy married and had a child, but later went through a bitter divorce and is estranged from her only daughter.

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Jennifer married and had two boys who each became successful professionals. Despite their varied personal lives, the relationship among the three women remained strong, yet they never executed a formal buy-sell agreement. At least, not until Jennifer got a positive result on a screening test for ovarian cancer (luckily, it was soon determined to be a false positive).

At age 54, the owners of MSJ now realize although they are not yet close to retirement, they are long overdue to put a formal succession plan in place.

A planning strategy

The owners meet with their attorney, Len, who suggests a cross-purchase buy-sell agreement. They would implement this by each purchasing a life insurance policy on the other two owners. Since there are only three of them, and they are the same age and in good health, this should be fairly simple and will result in a total of six policies.

Len explains that the cross-purchase buy-sell agreement will state that:

1. The deceased business owner's estate must sell the business interest to the surviving owners. This prevents outsiders from interfering with the business, since none of them want their heirs to be involved.

2. The remaining partners must purchase that interest. Megan, Sandy and Jennifer can rest easy knowing that their wishes to keep their business between themselves will be fulfilled.

Since the surviving owners are required to buy the interest after one of them dies, they must have the funds available to make the purchase. This is where the life insurance policies come in. Each partner's interest is currently worth about $3 million. When one partner dies, the other two will receive death benefits of $1.5 million, or half the purchase price for the business interest. This allows the other two to buy an equal share of the interest.

The moral of the story

Often, business owners want their families to benefit from their business interest when they pass away, but don't think their heirs should actually be involved in the business. A buy-sell agreement protects both the heirs and the remaining business owners. The heirs are guaranteed a fair price for the business interest and the surviving owners can rest assured that an outsider will not suddenly become a co-owner. By ensuring a smooth transition in ownership, a buy-sell agreement fully funded with life insurance greatly increases the company's ongoing survival.

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