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WEALTH MANAGEMENT

Protecting and enhancing the value of your business through risk management

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Wealth Planning & Advice

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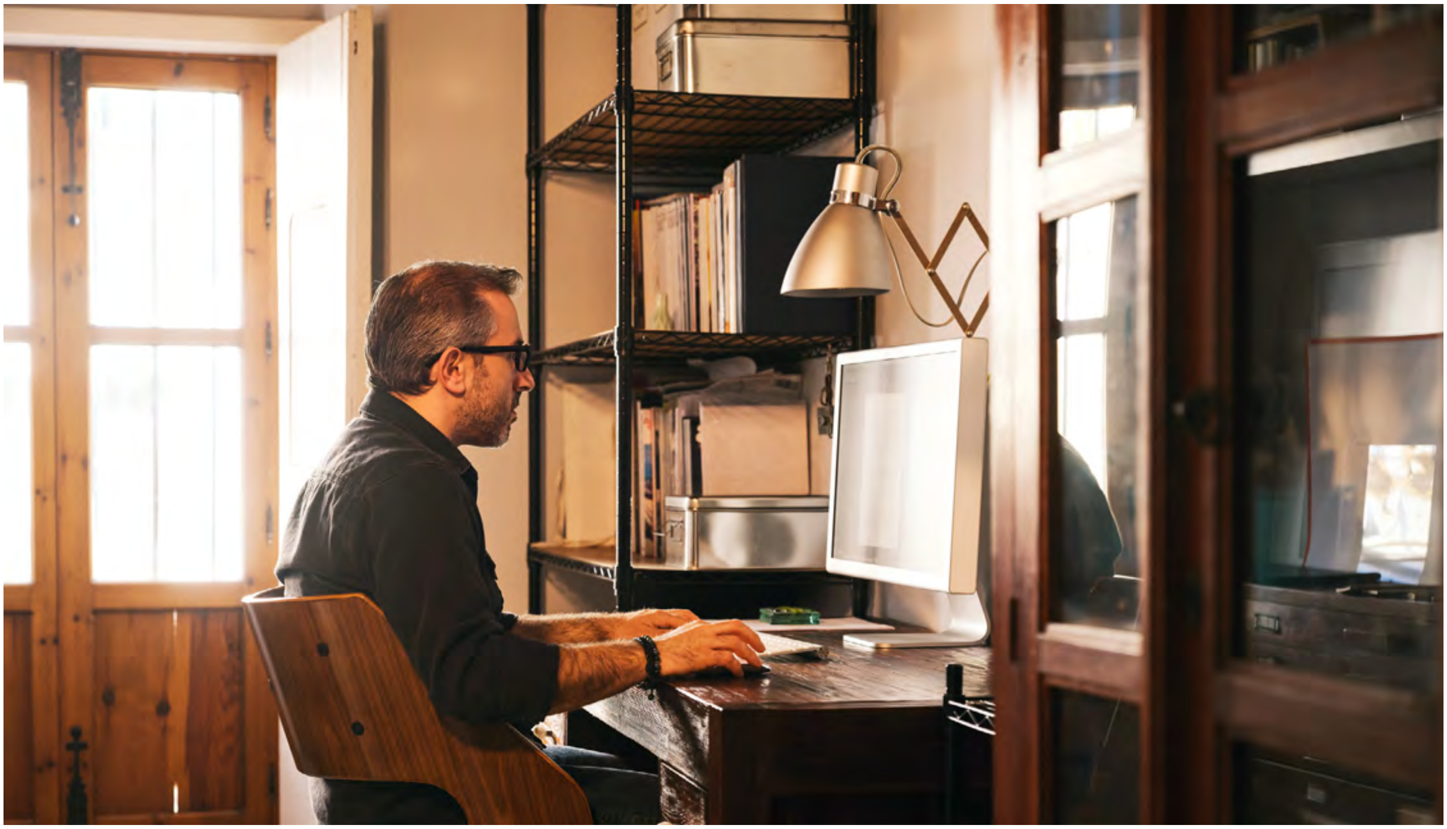


Successful business owners face a wide variety of risks that could severely damage if not completely destroy the value they have spent much of their professional lives creating. While risk management is never as exciting as building and running a successful business enterprise, it is undoubtedly necessary to protect and preserve the value of the business for owners and their families. When surveyed, most business owners indicate their first priority is to protect what they have, especially if they are over fifty years old.[1] And yet, despite such a widespread desire to protect the value in a successful business, many business owners push risk management down on the priority list and fail adequately to address the diverse range of perils each business faces.

Risk management is especially critical in the context of business succession planning. While many of the steps business owners could take to maximize value for an eventual exit involve lengthy processes that yield value gradually over time, the process of "de-risking" the business—of looking at risk management for a range of potential negative scenarios—may yield significant value enhancement for relatively little effort compared to other steps in a succession planning process. There are three primary ways to increase enterprise value: increase earnings, position the business as best in class, and reduce risk.[2] Business owners should focus on reducing risk early in the planning process. Protecting value is the first step to building value.[3]

[1] Christopher Snider, "Creating Exit Plans, Module 9" Exit Planning Institute, 2023, p 18.

[2] Sean Hutchinson, "Value Enhancement Process, Module 7" Exit Planning Institute, 2023, p. 21.

[3] Christopher Snider, "Creating Exit Plans, Module 9" Exit Planning Institute, 2023, p 21.

A risky environment for businesses

Even if they aren't aware of it, successful business owners confront a gauntlet of risks that could negatively impact their business, and therefore their livelihood and the financial security of their family, their business partners, their employees and the greater community. These risks can broadly be placed into three categories: personal risks, financial risks, and business risks.[4]

Exhibit 1: Risk Areas

PERSONAL	FINANCIAL	BUSINESS	
Death	Market Risks	Customers	Environmental/Safety
Disability	Concentration	Key People	Technology
Divorce	Personal Loans/Debt	Business Interruption	Owner Dependence
Health	Personal Lawsuits	Economy	Data/Information
Accidents	Loss of Earnings Power	Distress	Compliance/Legal
Family Tragedies	Long-Term Care	Partner Disagreements	Business Debt

Some risks are simply inherent in the business environment and out of the business owner's control, such as market risk, the economy, the environment, and technological developments. Nevertheless, it is important for business owners to acknowledge that there are many risks that are within their control and to take steps to mitigate these risks where possible.

[4] Christopher Snider, "WALKING TO DESTINY, 11 ACTIONS AN OWNER MUST TAKE TO RAPIDLY GROW VALUE AND UNLOCK WEALTH," 2nd edition, page 47.

Steps to address the "Five Ds"

It is estimated that one half of all negative business exits are caused by one of the "five D's": divorce, disability, death, distress, disagreement.[5] These risks are typically understood but not frequently addressed by business owners.[6]

1 Divorce

- » Business owners should consult with legal counsel on the marital property laws of their respective states and seriously consider a signed and detailed pre-nuptial or post-nuptial agreement dictating how marital assets—and especially the business—are to be divided if the owner and spouse split up. Co-owners should consider agreeing among each other that they all should have such agreements in place with their respective spouses.
- » Owners should separate personal and business finances. For example, avoid using equity from the family home to invest in the business (if possible) as this can seriously complicate the question of which property belongs to which spouse in a division of marital assets.
- » Owners whose spouses play key roles in the operations of the business should have plans in place well in advance for what specific steps would need to be taken if the divorcing spouse quits in frustration during the divorce process.

2 Disability

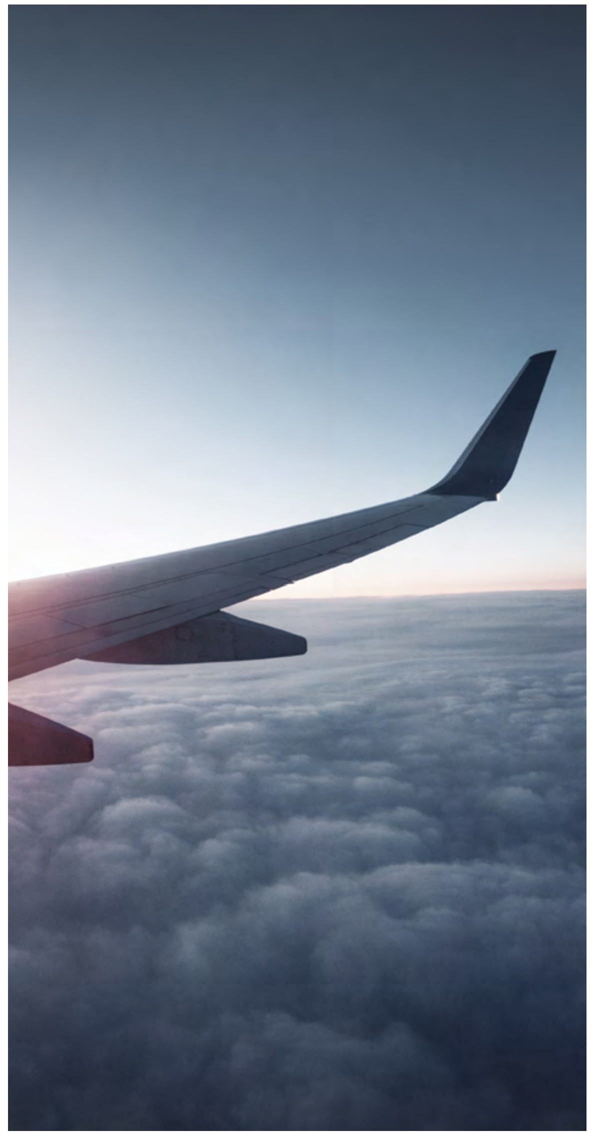
- » Business owners should speak with their attorney to ensure that they have valid and current financial powers of attorney that name agents who could step in and make decisions for the owner in the event of incapacity (either temporary or permanent). A financial power of attorney should name an agent or agents competent to make important decisions about the management of the business and the disabled owner's personal finances—which in many cases will be different people, as the people competent to run the business may not be the same people the owner trusts with his or her personal finances. In the absence of such a document, family or business partners may need to go into court and ask a judge to declare the owner incompetent and appoint a guardian or conservator—a costly and time-consuming process that frequently results in damage to the ongoing operations of a business. If the owner names different parties for different aspects of his or her financial life, it is important to ensure that the power of attorney is very clear about each agent's responsibilities.
- » If an owner's capacity is declining over time, care should be taken to document business processes and operations to reduce the negative impact on business value when the owner ultimately departs.
- » An owner should talk to their attorney about having any buy-sell agreements—which most frequently contemplate the death but not the disability of an owner—include disability insurance or other funding mechanisms designed to offset the negative impact of the incapacity of an owner.

[5] https://www.btcpa.net/insights/prepare-for-the-5-ds-and-exit-your-business-on-your-terms, accessed 24 January 2024.

[6] "The Impact of Unplanned Consequences on Business Value, How to Prepare Your Business for the 5 Ds," Exit Planning Institute, 2023.

3 Death

- As discussed below, a well-drafted, adequately funded and periodically updated buy-sell agreement is essential to mitigate the risk of the death of a co-owner.
- Business owners should consider having insurance policies in place on the lives of key employees in case they, a co-owner or an essential employee dies, as well as funds set aside to hire someone of equivalent skills to fill the empty role (an often overlooked expense in buy-sell agreements).
- Owners should work with an attorney to engage in robust estate planning to address potential estate tax implications and other legal difficulties that may confront family members after the owner's death, such as probate and the need to pay estate taxes a relatively short time after the death of an owner.
- Robust estate planning for all co-owners can be critical in ensuring that the heirs of a deceased owner don't automatically step into the deceased owners shoes, and also ensuring that those heirs have sufficient liquidity to pay any potential taxes due on the death of the deceased owner, thus saving the business from having to sell or borrow to generate enough cash.
- Owners should document critical business processes and other key information about the business to ensure continued operation of the business by employees if the owner dies unexpectedly.



4 Distress

» Owners should engage in extensive planning for a "rainy day", employing a range of contingency plans should the business be impacted by an unforeseen financial decline resulting from a range of causes.

» Contingency plans should include not just consideration of but written, defined steps to be taken in the event of negative events such as hacking or data breaches, legal disputes, supply chain constraints, pandemics or other natural disasters, loss of a key customer or key employee, or governmental or regulatory actions.

» Owners should review insurance policies to ensure the business is covered for business interruptions, product liability issues, and property and casualty issues, among other insurable risks—but insurance contracts only apply to contracted risks and likely won't cover every contingency.

5 Disagreement Among Owners

» Business partner conflicts are not uncommon (and in many cases healthy), but effective communication between co-owners can frequently mitigate serious disagreements that could damage the operation of the business.

» Co-owners should keep the focus on the business problem at hand and attempt to keep the conversation from becoming personal.

» Clearly defined roles and responsibilities for co-owners, accountability for results and regular periodic meetings to discuss progress can keep serious disagreements to a minimum. Co-owners should consider outside facilitators to help resolve intractable disputes when the consequences of continuing disagreement are impacting the business operations.

Buy-sell agreements are essential for business continuity and value preservation

Just as a pre- or post-nuptial agreement is helpful for married couples to minimize uncertainty and a range of negative outcomes if a marriage ends, buy-sell agreements are the equivalent for business co-owners. If something unfortunate happened to one of your business co-owners (such as death or disability, as discussed above), imagine whether you would want to be in business with that person's spouse or children, who may be entirely unsuitable as business partners. Without careful advance planning, the death or disability of a business co-owner could force the termination of the business, potentially including the unplanned sale of the business or its assets to third parties at "fire sale" prices, and could jeopardize the financial security of the family of the disabled or deceased owner, not to mention the destruction of business value for the other co-owners.

A buy-sell agreement is a legally binding agreement, among co-owners of a business that specifies what happens to ownership interests in the event of a co-owner's death, disability, retirement, bankruptcy, divorce or other "triggering events." A well-drafted buy-sell agreement which should be prepared by an attorney:

» Creates a market for the acquisition of a co-owner's interest in the business at moments when it is most critical, for example, the retirement, disability or death of a co-owner

» Establishes a method for setting the purchase price for the interest of the departing co-owner

» Protects the remaining co-owners by restricting transfer of ownership interests to unknown third parties—including potentially the heirs or beneficiaries of a deceased co-owner

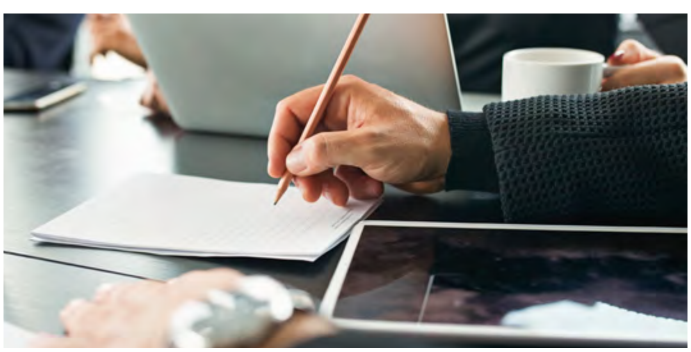
» Provides liquidity for the family of a deceased co-owner to pay off debt or pay estate taxes

» Protects the continuation of the business for the benefit of employees, customers and the greater community

What is the method for valuing the business?

A buy-sell agreement should include a method for valuing the business at the time of a triggering event. Without such a method for valuation pre-agreed in a binding contract, disputes between the remaining co-owners and the departing owner (or his or her estate) are possible, including serious disputes that can unnecessarily escalate into costly lawsuits.

Some common methods of buy-sell valuation include: by formal appraisal; as agreed upon periodically by the owners (typically, annually); book value; a multiple of earnings; or a discounted cash flow method. When the owners agree upon a formal appraisal as the method of valuation, or a pre-agreed upon price (as long as it is periodically updated), there is less likelihood that the valuation can be inappropriately swayed by manipulation of the business' financials as with other methods of valuation like book value or an earnings multiple. While generalizations are impossible and every business is unique, an appraisal or an agreed upon price may better protect a departing owner's interests while still being fair to the remaining owner(s).



How will the purchase be funded?

A well-drafted buy-sell agreement should include an agreed upon method or combination of methods for paying the departing owner (or his or her estate) for the business interest being surrendered. Some common funding mechanisms include:

- » An installment sale. The parties agree in advance that the remaining owner(s) will pay for the departing owner's interest over time. This method may not be optimal for the departing owner's family.
- » Creating a "sinking fund" of investments to pay for the future purchase. The owners set aside funds on a regular basis over time to pay for a departing owner's interest when necessary.
- » Borrowing the funds to pay the departing owner's estate. However, debt service on the purchase may negatively impact the ongoing operation of the business and in some cases, cripple the business' ability to continue to invest for growth.
- » Life insurance. This is typically viewed as a preferred method for at least partially funding the purchase for reasons which include but are not limited to the preferential tax treatment of life insurance proceeds.[7]

For example, a buy-sell agreement may use life insurance policies as the primary funding mechanism but as the value of the business increases over time, should the life insurance policies in place become inadequate to fund the entire purchase price, the balance could be paid under an installment sale.

[7] To preserve the preferential non-taxable treatment of life insurance in the context of buy-sell agreements, business owners and their advisors should take care to avoid the "transfer-for-value rule" under Internal Revenue Code Section 101(a)(2).

Two Main Types of Buy-Sell Agreements

There are a number of common types of buy-sell agreements, but the two most common are cross-purchase agreements and entity purchase agreements.[8]

Cross-purchase agreement

In a cross-purchase buy-sell agreement, each co-owner enters into an agreement with their co-owners obligating the remaining owners to purchase a departing owner's interest at an agreed upon price if a triggering event occurs.

When life insurance is used as the funding mechanism for a cross-purchase agreement, each co-owner may own, pay premiums on, and be the beneficiary of an insurance policy on each other co-owner. At the time of a triggering event, policy values or death benefits paid to the remaining owners are used to purchase some or all of the interest of the departing owner, and the departing owner's interest in the business is transferred to the remaining owners.

One benefit of a cross-purchase agreement is that the remaining owners receive a tax basis equal to the purchase price paid to the departing owner, which is typically higher than the basis of the owners in their original investment in the business, which can reduce capital gains taxes on a subsequent sale of the business. However, cross-purchase agreements can become quite difficult and cumbersome to implement if three or more co-owners are involved, with multiple policies for each owner required. In such situations, an entity purchase agreement may be a better option.

Entity-purchase agreement

In an entity purchase agreement, each co-owner agrees with the business entity itself to sell their interest back to the business at an agreed upon price when a triggering event occurs. When life insurance is used as the funding mechanism for an entity-purchase agreement, the business will purchase life insurance on each of the participating co-owners. Because such policies are employer-owned, they must comply with tax regulations to ensure that the death benefit will be received tax-free.[9] Tax basis for the remaining owners can be complex with entity-purchase agreements. C corporation shareholders will not see any change to the basis of their shares, while life insurance proceeds received by an S corporation can increase the basis of its remaining shareholders' shares if certain requirements are met. Another caveat with entity purchase agreements is that in most cases the value of a life insurance benefit received by the entity as a result of its ownership of the policy will increase the value of the business dollar for dollar for estate tax purposes if the policy hasn't otherwise been included in the calculation of value.[10]

[8] Other types of buy-sell agreements include: "wait and see" arrangements which are a hybrid of features from both cross-purchase and entity purchase agreements; cross endorsement arrangements where each owner buys insurance on their own life and endorses a portion of the death benefit to the other owners; and trusteed arrangements, where a trust serves as the owner of the life insurance and uses the death benefit to purchase the business interest from the deceased owner's estate and distributes the business interest to the remaining owners.

[9] Internal Revenue Code Section 101(j).

[10] 26 C.F.R. § 20.2031-2(f)(2). Note that the Supreme Court has agreed to hear a case, Connelly v. United States, Docket No. 23-146, that is likely to address this issue.

Buy-sell agreements must be updated periodically

Businesses evolve over time, sometimes rapidly. As businesses evolve, buy-sell agreements need to be reviewed and updated with an attorney on a periodic basis. Some common reasons for updating an existing buy-sell agreement include:

- The buy-sell agreement is not adequately funded, for example, if the existing agreement provides that the departing owner's interest will be purchased with an unfunded installment sale, or if life insurance is part of the funding mechanisms, the life insurance death benefits may have become inadequate given the current value of the business
- The existing agreement includes a method for valuing the departing owner's interest that is no longer appropriate (for example, using book value or a multiple of earnings rather than valuing the business by appraisal or a pre-agreed upon price that is periodically updated)
- If the buy-sell agreement provides that the value of a departing owner's interest shall be determined by a number agreed upon periodically by the owners but the owners have not updated that value in years
- The existing agreement, for whatever reason, does not include all current co-owners, or treats certain co-owners differently for reasons that may have changed
- The existing agreement may have been voluntary (the remaining co-owners have the option but not the obligation to purchase the departing owner's interest) but should now be made mandatory
- The existing agreement was drafted with certain triggering events in mind (death or incapacity, for example), but failed to include other triggering events like bankruptcy, divorce, loss of a professional license, or retirement
- If life insurance is used as a funding mechanism, there may be a discrepancy between the type of buy-sell agreement and the ownership of the underlying policies.

Owners should follow the formalities that are part of their entity agreements

Business owners can have an extremely well-drafted buy-sell agreement, but if they ignore the requirements of that agreement (or other organizational documents) they may cause the agreement to be unenforceable. And if they are too cavalier about following the formalities of their entity, such as by mixing personal and business expenses together, they may subject their personal assets to claims by creditors of their business, among other negative consequences.

For example, if the buy-sell agreement requires the owners to agree on a value and update that agreement periodically, the owners should do that. If they don't, the remaining owners, a departing owner or that owner's heirs, or even the IRS, could challenge the validity of the agreement and the value. The more a business owner doesn't follow the formalities of the governing documents the more likely it is that a crisis or a disagreement can end up in a costly lawsuit or other action.[11] Behavior contrary to written intentions can undercut even the best documents.

[11] See Connelly v. United States, No. 21-3683 (8th Cir. 2023). This portion of the Connelly decision is not at issue in the appeal to the Supreme Court

Take steps to offset the loss of key talent

While many business owners carry insurance coverage to protect the business from loss of property and equipment, not as many protect themselves from the loss of what can be a business' most valuable asset—its key employees—who walk out the doors of the business each evening. Key employees can be co-owners, top executives, or employees with unique skills or talents critical to the business. The loss of such a key employee can create a significant negative financial impact on the value of the business. "Key employee insurance" can offset this financial impact by replacing lost revenues and can fund recruiting and training efforts to replace the employee.

In addition, competition for key talent in successful businesses can be intense. In addition to robust compensation packages, retirement programs and other employee benefits, insurance solutions can play an important role in retaining key talent critical to the ongoing operations and value of the business.
These insurance solutions can include:

- An executive bonus plan, where the business pays a tax-deductible bonus to the key employee to cover premiums on a life insurance policy owned by the employee. (Internal Revenue Code Section 162).
- A split- dollar plan, where the business and key employee agree to share the benefits of a life insurance policy. Typically, the employee will purchase the policy, and the business will pay the premiums to the life insurance company, (characterizing the payments as a "split-dollar loan" that will be repaid if the employee leaves or dies).
- A supplemental executive retirement plan (also known as a "SERP" or 409A Deferred Compensation Plan). SERPs can be extremely attractive to highly-compensated employees for whom traditional tax-deferred retirement plans will not provide adequate retirement income. SERPs can be unfunded (promised benefits paid out of future cash flows), funded informally with equities and/or mutual funds, or funded informally when the business purchases life insurance on a key employee (the employee may receive benefits upon retirement or disability from policy loans or withdrawals).

In conclusion

Business owners confront a risky business environment and a wide range of perils that endanger the value they have spent their professional lives creating. There is no time like the present to address these risks and minimize their impact, from buy-sell agreements to insurance, to personal estate and financial planning. While risk management is not why business owners decided to become entrepreneurs, it is undeniably essential for successful business owners to protect what they have and to increase enterprise value moving forward. Your J.P. Morgan financial advisor can play an essential role working side -by -side with you and your broader team, including your attorney and CPA, to help offset the minimize risks to your business and your personal finances.

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