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LAGOS WEALTH ADVISORS
BUILDING, PROTECTING AND PERPETUATING FAMILY WEALTH

ADVISOR'S BULLETIN

WHAT'S IN THIS MONTH'S NEWSLETTER

BUSINESS BUY-SELL LITIGATION OVER MISMANAGED FUNDING

A MESSAGE FROM MICHAEL W. LAGOS, CFP®

Dear Strategic Advisor:

Our closely held business owner clients usually rely on their businesses for lots of things:

- To provide income for the owner's family.
- To support the families of employees.
- To leave a family legacy either
  - By allowing family members to take over one day or
  - By turning the business into money at death or retirement

Financial planning professionals work with business owner clients to protect the business and to make sure the owner's goals are met. A properly drafted, implemented, and funded buy-sell agreement can help achieve those goals. If the buy-sell agreement is badly written or the buy-sell funding is mismanaged, the plan won't work.

Furthermore, even if the arrangement is right at the time it's put in place, it needs to be reviewed regularly to make sure the objectives are being met. While the life insurance professional can often defer to the client's attorney regarding buy-sell drafting, the implementation and funding parts of the setup fall in large part on the agent's shoulders.

In this issue, we'll consider three relatively recent court cases that involve buy-sell funding issues. We'll review the court decisions and determine the lessons that can be drawn from the opinions. Read on for examples of how courts were called on to sort things out when the buy-sell arrangement and the funding didn't work together well.

Regards,
Michael W. Lagos, CFP®

This Month's Inserts:
Restricted Property Trust & Buy Sell Planning

Fellow Advisor:

As a supplement to this months Advisor's Bulletin we have included an executive summary for two unique buy sell funding structures that should be considered. The Partnership Administration Succession Strategy (PASS) employs the use of a separate partnership to hold the insurance and accumulate cash for a living buy out. This strategy is also ideal for funding for multiple shareholders or owners with a large disparity in age. The Restricted Property Trust (RPT) is a structure that provides income tax deductions of the premiums paid for the insurance needed to fund a buy sell plan at death. Please do not hesitate to contact us to discuss your clients specific buy sell planning.

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The Advisor's Bulletin is provided by Lagos Wealth Advisors and Lagos Financial & Insurance Services, Inc. It is intended to serve as a resource for the advisors which we are associated with. Recent developments in estate, business, and insurance planning are outlined for your reference. Should you wish to receive additional information related to financial planning, estate planning, insurance planning, or investment management, please do

BUSINESS BUY-SELL LITIGATION OVER MISMANAGED FUNDING

While the cases are taken from different jurisdictions and the decisions depend in part on local law, many of the lessons are universal.

1. Be *clear in the agreement* about what's intended.
2. *Review* the agreement and funding regularly to make sure it's still effective.
3. *Ensure* that the agreement and funding properly reflect all current entities and ownership.
4. *Structure the funding* in a way that makes sense.

BUY-SELL CASES

***Lynn v. Lynn*, 202 N.C. App. 423, 689 S.E.2d 198 (2010 N.C. App.)**

James Lynn & Sons was incorporated in 1988 by James Lynn and his two sons, Gregory and Kenneth. James Lynn owned 51 percent of the issued stock, and each son owned 24.5 percent.

In 1993, the three corporate owners and their spouses entered into a Shareholders' Agreement, which stated in pertinent part:

> 4. PURCHASE UPON DEATH. Upon the death of any Shareholder, his estate will sell, and the Corporation will purchase, at purchase value (as hereinafter defined), all of the restricted shares owned by the deceased Shareholder at the time of his death; and all the parties hereto will take such action as may be required to effect such purchase, including without limitation any necessary recapitalization of the Corporation. The purchase price shall be paid immediately upon the receipt by the Corporation of the proceeds of any insurance on the life of the deceased Shareholder owned by the Corporation and payable to the Corporation or to the estate or heirs of the deceased Shareholder, to the extent of such proceeds.
>
> PURCHASE VALUE (AGREED PRICE). "Purchase value" means that life insurance proceeds in an amount not less than Seventy-Five Thousand ($75,000.00) Dollars, which will be deemed automatically adjusted equitably and proportionately to reflect any stock dividend, stock split, or similar recapitalization affecting the shares. The aforementioned purchase value has been reviewed by all of the Shareholders and undersigned parties to the Agreement. The purchase value set forth herein shall be reviewed annually by all of the surviving Shareholders and will either be confirmed or revised upon such review on the basis of the then existing business and financial condition and prospects of the Corporation. The good faith decision of a majority of such Shareholders upon each such review shall be conclusive; and each such decision shall be noted in the attached Appendix "A" and endorsed by each such Shareholder. It is the intent of the Shareholders that the receipt of the aforementioned insurance proceeds by the estate, or surviving spouse, or heirs of the deceased Shareholder shall be full and final satisfaction of said deceased Shareholder's interest in the James Lynn & Sons, Inc. Corporation.

Prior to the execution of the Shareholders' Agreement, Kenneth and Gregory Lynn each purchased a $75,000 life insurance policy. Each brother was the record owner and beneficiary of the other brother's policy—classic cross-purchase buy-sell funding. This was apparently done in spite of the fact that the agreement language quoted above was entity purchase.

James Lynn died in 1997 and his estate was administered by his wife, Doris. The corporation did not own insurance on the life of James. The 51 percent interest in the corporation owned by James Lynn at the time of his death passed to his wife intestate.

In March 2001, Gregory and Kenneth Lynn entered into a negotiated settlement with their mother in order to purchase the shares. The parties signed an agreement under which Gregory and Kenneth Lynn paid Doris Lynn $100,000 for the shares and to resolve other disputes among the parties. The release agreement referenced the Shareholders' Agreement.

In May 2001, Kenneth and Gregory Lynn purchased additional life insurance on each other in the amount of $150,000. In October 2001, they increased the life insurance policy amount on each policy from $150,000 to $300,000 and also maintained the original $75,000 policies, for a total coverage amount of $ 375,000.

At some point in 2001, the brothers became owners of their own life insurance policies—*despite the fact that the buy-sell agreement contemplated the company being the owner of the policies*.

Subsequently, during 2005 and 2006, Kenneth Lynn named his wife as the beneficiary of his policy while Gregory Lynn named his children as beneficiaries of his policy. The corporation paid the premiums for every policy on the lives of Kenneth and Gregory Lynn. Despite the fact that the corporation paid for the personally owned policies, the brothers never reimbursed the corporation for those payments, nor were the payments reported as individual income on the brothers' W-2 tax forms.

In 2003, Jan Lynn filed divorce papers against her husband Gregory. She sought an equitable division of their assets.

In 2004, after disagreements arose between Kenneth and Gregory, the two negotiated a stock transfer by which Kenneth became the majority shareholder with a 55 percent ownership interest, and Gregory kept a 45 percent minority shareholder interest. No consideration was given to either party with regard to the stock transfer. Kenneth subsequently terminated Gregory's employment with the corporation, though Gregory maintained his 45 percent ownership interest.

Gregory and Jan Lynn divorced in 2005, but they continued to argue in court over the equitable distribution of their property—including Gregory's ownership interest in the business.

In October 2006, prior to a final equitable distribution order pertaining to the property of Jan Lynn and Gregory Lynn, Kenneth Lynn unexpectedly died without leaving a will.

In December 2007, Jan Lynn filed an amended complaint for equitable distribution, claiming that after Kenneth Lynn's death Gregory Lynn became the sole owner of James Lynn & Sons and that the company shares previously owned by Kenneth Lynn were, therefore, at issue in the equitable distribution dispute.

Gregory Lynn likewise claimed that pursuant to the Shareholders' Agreement, he became the sole owner of the corporation upon his brother's death and the insurance company's subsequent payment of life insurance death benefit to his brother's widow, Penny Lynn. Penny filed a counterclaim asking the court to allow her to keep Kenneth's 55 percent ownership interest in the corporation in addition to keeping the life insurance proceeds.

The trial court determined that there were ambiguities in the Shareholders' Agreement and decided to hear further evidence. The principal ambiguity was whether any life insurance proceeds paid upon the death of one of the shareholders would serve as complete payment to purchase the shares inherited by an heir of the deceased—in this case, Penny Lynn.

Jan and Gregory contended that the Shareholders' Agreement provided that upon the death of a shareholder, the life insurance paid would serve to repurchase the shares inherited by the decedent's heirs. Therefore, according to plaintiffs, upon Kenneth's death, Penny Lynn inherited that stock and received $375,000 in life insurance proceeds, the stock was effectively purchased from her by the corporation, making Gregory Lynn the sole shareholder.

Penny contended that the proceeds of the life insurance policy did not effectively purchase the shares, and Penny Lynn was, therefore, the rightful owner of her late husband's 55 percent interest in the corporation.

Internal documents from the life insurance company showed that the applications for insurance noted that the insurance was to fund a "Partnership Buy/Sell Agreement." The brothers' applications also referenced each other's policies. Glenn Ray, the life insurance agent who sold Gregory and Kenneth Lynn the policies, also testified regarding the intent of the purchase stating that the policy was to fund a buy-sell agreement.

Alan Thompson, a CPA who performed corporate account services for the corporation, testified that he was aware of the Shareholders' Agreement and it was his understanding that the life insurance was meant to fund a buy-sell agreement.

In August 2008, the trial court ruled in favor of Jan and Gregory. It ordered Penny to turn over her inherited shares to the company, finding that by collecting the insurance proceeds she was effectively bought out.

Penny appealed to the North Carolina appeals court. That court affirmed the judgment of the trial court, saying:

> As the trial court acknowledged, the policies were owned by Kenneth Lynn, not the corporation, at the time of his death; however, this does not defeat the clear intent of the Shareholders' Agreement, which was observed by the parties through their actions and course of dealing since its execution. The evidence shows that the brothers intended for the life insurance policies to fund a buy-sell agreement. The Shareholders' Agreement expressed the intent of the shareholders that the proceeds of the life insurance policies would serve as full payment for any interest, which would include all shares, in the corporation inherited by the estate of a deceased shareholder. We must honor the intent of the Agreement, viewed as a whole. . . . In so doing, we hold that the trial court did not err in concluding as a matter of law that "the shareholders of James Lynn & Sons, Inc. complied with the provisions of the Shareholders' Agreement . . . upon the death of Kenneth Lynn. . . .

The court of appeals affirmed the trial court's order.

***Baker v. Ayres & Baker Pole & Post, Inc.*, 2005 WY 97, 117 P.3d 1234 (2005)**

In 1993, Alvin Baker and Larry Ayres, along with their wives, Joan Baker and Karan Ayres, formed a Wyoming corporation to operate a saw mill.

The Bakers and the Ayres executed a "Stock Purchase Agreement" which provided that they each owned half of the corporate stock and, upon the death of Mr. Baker or Mr. Ayres, the surviving shareholder would succeed to full ownership and control of the company. In order to effectuate a buy-out of the deceased stockholder's share, the agreement provided that "the company has, or plans on procuring insurance" on the lives of both men, "which [insurance policies] will be owned by the company." The life insurance policies procured by the company were intended to fund a buyout in the event of the death of one of the shareholders, thus securing the surviving member's succession to sole ownership and control of all stock.

In 1988, five years before the formation of the corporation and execution of the Stock Purchase Agreement, Mr. Ayres bought a life insurance policy and named a prior partnership as beneficiary. In 1990, Mr. Baker likewise procured a life insurance policy; however, he named Mrs. Baker as beneficiary. The company was never named beneficiary of Mr. Baker's life insurance policy, before or after execution of the Stock Purchase Agreement, and Mr. Baker never transferred or assigned his insurance policy to the company. Additionally, the company never procured a separate insurance policy on Mr. Baker's life naming itself as beneficiary.

Mr. Baker died in 2000, and Mrs. Baker received the benefits under his life insurance policy. Mrs. Baker subsequently asserted her right to the value of the Bakers' share of the corporate stock which was valued at $719,000. The Ayres and the company responded that the proceeds from Mr. Baker's personally owned life insurance policy should be applied to the redemption price of the Baker stock pursuant to the Stock Purchase Agreement. They asserted that the life insurance policy procured by Mr. Baker in 1990 was the policy procured on the life of Mr. Baker referred to in the Stock Purchase Agreement, and the Bakers breached the agreement by failing to transfer the policy to the company. They contended the life insurance policy proceeds of $500,000 should offset the $719,000 worth of stock.

Mrs. Baker claimed she was the beneficiary under her deceased husband's life insurance policy, making the insurance company's payment of the $500,000 proceeds to her appropriate. In addition, she claimed the company was obligated to pay her the full value of the Baker corporate stock, $719,000, pursuant to the terms of the Stock Purchase Agreement.

When the company refused to pay the entire $719,000 plus interest, Mrs. Baker filed a complaint alleging that the Ayres and the company breached the Stock Purchase Agreement by failing to redeem the Baker stock at its full value.

The Ayres and the company filed a counterclaim for declaratory judgment, seeking a judgment declaring:

- the Bakers breached the Stock Purchase Agreement by failing to effectuate a change in beneficiary on Mr. Baker's insurance policy;
- the Bakers held the insurance policy in constructive trust for the benefit of the Ayres and the Company;
- upon payment of the $500,000 policy proceeds, Mrs. Baker breached the Stock Purchase Agreement by failing to surrender her 1,000 shares of stock; and
- Mrs. Baker was entitled to payment from the Ayres and the Company of $219,000 plus interest in the amount of $ 7,200.

After a hearing, the district court ruled in favor of the Ayres and the company's summary judgment motion. Based on the arguments and evidence presented, the district court found that Mr. Ayres and Mr. Baker explicitly agreed that the insurance policies they procured in 1988 and 1990 respectively were intended to fund the buy-out provision of the Stock Purchase Agreement executed in 1993. The district court concluded that Mrs. Baker breached the Stock Purchase Agreement. It imposed a constructive trust on the life insurance policy proceeds and applied them against the purchase price of the Baker stock.

Mrs. Baker appealed the decision to the Wyoming court of appeals. The appeals court analyzed testimony by the company's counsel affirming that he believed the life insurance was intended to fund the Stock Purchase Agreement. It also noted that the premiums for Mr. Baker's policy were paid by the company and that the insurance agent believed the policy was intended to fund the buyout of shares at death.

Against this evidence, however, Mrs. Baker had submitted at trial evidence that her husband procured the life insurance policy for two purposes: to cover his family and an SBA loan taken out by the prior partnership.

Mr. Baker was listed on the insurance application as the owner, and Mrs. Baker was listed as beneficiary. Mrs. Baker testified that Mr. Baker told her he did not think the life insurance was intended for the buyout, the company did not need it for the buyout, and the insurance was intended to cover an SBA loan and for the family. Mrs. Baker also testified that although the premiums for Mr. Baker's policy were paid by the business, her husband told her they were treated as part of his wages, and he paid taxes on the amounts. In terms of the Stock Purchase Agreement provisions concerning insurance, Mrs. Baker testified her husband told her the company "would probably get a smaller insurance policy than what he had" to fund the buyout.

The appeals court decided that that the district court erred in granting summary judgment on the Ayres' claim for constructive trust. It sent the case back to the trial court, directing it to sort out the parties' actual intentions:

> If the Ayres and the Company meet their burden of proof on one or the other of these claims, Mrs. Baker will be entitled to payment of the difference between the value of the Baker stock and the life insurance proceeds. Conversely, if the Ayres and the Company fail to meet their burden, Mrs. Baker will be entitled to payment for the full value of the Baker stock.

D3 Interiors, Inc. v. Ohio Nat'l Life Assur. Corp., 2013 U.S. Dist. LEXIS 193499

In 1996, Ohio National Life Assurance Corporation (ONL) issued an insurance policy to the Interior Design Firm (IDF) as owner and Charlotte Dann as the insured. At this time Charlotte Dann (Dann) and Pam Stanek were the two sole shareholders of IDF.

The policy issued to IDF provided for disability buy-sell benefits to the owner if Dann became disabled. The policy also stated that

> A Buy Sell Agreement must be in effect within one year from the Policy Date and before Total Disability begins. You must certify this to us. If the buy-sell agreement is not in effect within this time, we will treat the Policy as if it had never been issued. We will then refund the premiums.

In order for a payment of benefits, the Policy conditions payment on the following requirements:

1. the Insured suffers a Total Disability which begins during his/her Active Full-Time Work with the Business Entity;
2. Total Disability lasts for the entire Waiting Period; and
3. we receive satisfactory proof that the Buy Sell has taken place. Proof must include:

   (a) a copy of the Buy Sell Agreement in effect when the Insured's Total Disability began;
   (b) the date of transfer of the ownership interest;
   (c) the purchase price;
   (d) the Method of Valuation of the Business Entity; and
   (e) the names of all buyers of the Insured's ownership interest.

On February 16, 1996, Dann signed a receipt acknowledging the original policy. IDF's lawyer faxed ONL an executed copy of the Stockholders' Agreement, dated February 1996.

In October 2005, Charlotte Dann left IDF and reorganized a new business with her two daughters, Lisa McCoid and Julie Odermatt. Dann, McCoid, and Odermatt formed D3 Interiors, Inc. (D3). Each woman was a one-third interest shareholder in the company. Dann was named president of D3. In May 2007, Dann submitted a request to ONL to change ownership of the policy from IDF to herself. ONL rejected D3's initial request for a transfer of ownership because the proposed new owner was an individual and not a business entity. McCoid then put ownership in the name of D3 and resubmitted the request.

On April 3, 2008, ONL advised D3 that it accepted the change of ownership. D3 began to pay ONL annual premium payments for policy coverage when the ownership changed from IDF to D3.

The policy states that "there must be a new Buy Sell Agreement in effect on the new Business Entity within one year of the transfer." The contract did not require certification of a new buy-sell agreement upon the transfer of the policy as it had at the inception with IDF. A buy-sell agreement for D3 was not furnished to ONL upon the change of ownership. A written buy-sell agreement was never executed by the shareholders of D3. Plaintiffs claim they had a mutual understanding that acted as the buy-sell agreement. From the time D3 was created, McCoid states that she and her business partners agreed that McCoid and Odermatt would buy out their mother's shares in D3. After the inception of D3, the business incurred $292,000 in expenses, paid for by loans personally secured by Dann. Later in 2008, D3 Interiors refinanced their debt by a loan from Pinnacle Bank in the amount of $229,278.46. Dann, McCoid, and Odermatt all personally guaranteed this loan.

In late 2009 and early 2010, Dann stopped working at D3 due to serious depression. Shortly after this time, Dann attempted to commit suicide. On or about January 1, 2011, Dann resigned her position as president and board member of D3. At this time Dann also offered to surrender her shares in the business. D3 accepted the offer and repurchased Dann's shares. D3's board executed a corporate resolution stating that Dann's "offer to surrender her shares of stock in the corporation in exchange for no monetary consideration shall be and hereby is accepted." The remaining shareholders, McCoid and Odermatt, obtained a loan through First National Bank for $172,051.65 to pay debt of D3 and to release Dann from her personal liability to the business.

In February 2011, Dann submitted a claim for benefits, claiming that her depression was her disabling condition. On May 11, 2011, ONL sent a letter to D3 Interiors requesting information needed to evaluate the claim, including: (1) a copy of the buy-sell agreement in effect at the time of the ownership change from IDF to D3 Interiors; (2) a copy of the buy-sell agreement in effect at the time Ms. Dann's claimed disability began; (3) proof of the date of transfer of ownership interest; (4) documentation of the purchase price; (5) the Method of Valuation of the Business Entity; (6) the name of all buyers of Ms. Dann's ownership interest; (7) Ms. Dann's percentage of ownership of the Business Entity at the time of claimed disability; (8) the date Ms. Dann stopped working at IDF; (9) the date Ms. Dann began working at D3.

McCoid responded on behalf of D3, stating that D3 did not have a formal, written buy-sell agreement. McCoid further responded that Dann was not paid when she surrendered her shares because the valuation of the business was in the negative. ONL then denied the claim in January 2012, citing the fact that "there was no Buy Sell Agreement in effect at the time of Ms. Dann's disability and that Ms. Dann received no compensation for her share of the Business Entity as required by the Policy."

D3 Interiors Inc. then instituted this claim against ONL for benefits they allege are warranted under the policy. D3 claimed that the business did have a buy-sell agreement in place and that Dann was compensated for her shares by the release of her liability on personal loans to D3. D3 further claims that even if there was no valid buy-sell agreement, ONL waived this requirement by continuing to accept premium payments from D3.

ONL moved for judgment in its favor. The district court granted the motion and dismissed the case, saying:

> In this case, there was no decisive act on the part of ONL to waive the policy conditions. There is also no evidence or allegations that ONL had knowledge that D3 had failed to execute a proper buy-sell agreement, nor had knowledge that D3 failed to execute a proper buy-sell until the claim was tendered to the company. Therefore, the elements of waiver of condition have not been met and ONL may declare the policy void for failure of condition.

OBSERVATIONS ABOUT THE CASES

The *Lynn* and *Baker* cases had surprisingly similar facts with regard to the life insurance connected with buy-sell funding. In each the insurance that some of the business owners felt to be connected to the buyout obligation was actually owned by the insured. The insured's personal beneficiary wanted to keep both the insurance proceeds and the business ownership interest of the decedent. Also in both cases the surviving owners asked the court to connect the life insurance death benefit—somewhat artificially, in our opinion—to the buyout obligation. The *Lynn* court decided to make the connection. The *Baker* trial court also linked the insurance death benefit to the buy-sell, but the appeals court thought more evidence was needed to connect the two. So, what are the lessons of the *Lynn* and *Baker* cases?

1. **Keep in touch with your business owner clients.** In both cases the buy-sell insurance ownership and beneficiary designation eventually failed to match the language of the buy-sell agreement. A professional agent experienced in working on business-continuation plans might have helped fix the mismatch and perhaps kept the parties from litigating after the insured's death.
2. **Work together as a team to coordinate the buy-sell agreement and any life insurance funding.** Attorney, accountant, business owners, family, and professional agent should all communicate and make sure they are on the same business-continuation page.
3. **If existing insurance needs to be transferred to properly fund a buy-sell obligation, do it as soon as the need is recognized.** In the *Baker* case, some of the business owners believed Mr. Baker was going to transfer his personal policy to the business to fund the company's buy-sell obligation at Baker's death. He never did, and his partners apparently never reminded him that they expected the transfer of his policy.

In the *D3 Interiors* case, the insurance company refused to pay a disability buyout benefit because the business owners and their advisors failed to implement a written buy-sell agreement as required by the insurance contract. The lack of attention meant that D3's significant premium investment was for nothing.

CONCLUSION

Our business owner clients expect their financial and insurance professionals to give expert business and insurance advice when we work with them with regard to business-continuation issues. For clients who have been through the buy-sell planning process with someone else, performing a thorough checkup can be one of the most important services we can provide. The selected buy-sell court cases described in this newsletter reinforced some important lessons for financial professionals and clients. Perhaps the questions we should ask ourselves are these:

- If we had acted as advisors to the business owners and their families in these court cases, would we have done better than their actual advisory teams?

- How many of our current clients are in situations where the potential for litigation over mismanaged buy-sell funding is only a heartbeat away?

New buy-sell court cases are being filed and decided every day. The possibility of litigation—and the real examples of *Lynn*, *Baker*, and *D3 Interiors*—serve as both a warning to stay vigilant and an opportunity to serve those who need our help.

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IN THIS ISSUE OF ADVISOR'S BULLETIN

Building Protecting and Perpetuating Family Wealth

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