

Treatment of Life Insurance Proceeds in Valuation

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 business advisor, business owner, or a valuation expert.

The proceeds of a life insurance policy owned by a company naturally flow to the company. When this occurs:

- Should life insurance proceeds resulting from the death of a shareholder be considered as an asset to be used solely for the purpose of funding the repurchase liability created by a buy-sell agreement?
- Alternatively, should the life insurance proceeds 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 while all parties to the agreement are alive. Absent specific instructions in a buy-sell agreement, business 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. Surprisingly, many buy-sell agreements are silent or ambiguous on this issue

Let's consider the two different treatments 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.

- *Treatment 1 – Proceeds are a Funding Vehicle.* The first treatment recognizes 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, are 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 in the valuation as a non-recurring expense.
- *Treatment 2 – Proceeds Are a Corporate Asset.* This treatment considers the life insurance proceeds as a corporate, non-operating asset for valuation purposes. In valuation, the proceeds are then treated as a non-operating asset of the company. This non-operating asset, together with all other net assets of the business, is available to fund the purchase of shares of a deceased shareholder. Again, under this treatment, the expense of life insurance premiums on a deceased shareholder would logically be added back into income as a non-recurring expense for valuation purposes.

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 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.
- Now assume that Harry is killed in an accident. Assume 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 and finds 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.

Treatment 1 – Proceeds Not a Corporate Asset

Figure 1 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.

Proceeds are a Funding Vehicle	Company	Harry (Estate)	Sam
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre and Post Life Insurance Value (\$m)	\$10,000.0	\$5,000.0	\$5,000.0
4 Life Insurance Proceeds	\$6,000.0		
5 Repurchase Liability	(\$5,000.0)		
6 Post-Life-Insurance Value	\$11,000.0		
7 Repurchase Stock	(\$5,000.0)	\$5,000.0	
8 Retire / Give Up Stock	(50.0)	(50.0)	
9 Remaining Stock	50.0	0.0	50.0
10 New Stock Ownership (%)	100.0%	0.0%	100.0%
11 Post-Life Insurance Value of Co.	\$11,000.0	\$0.0	\$11,000.0
12 Post Life Insurance Proceeds		\$5,000.0	
13 Net Change in Value from Repurchase	\$1,000.0		

Figure 1

On Line 3 of Figure 1, 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).

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. Finally, there is a net change of \$1 million in enterprise value, which has increased to \$11 million as result of the life insurance in excess of the repurchase obligation.

Treatment 2 – Proceeds Are a Corporate Asset

Figure 2 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.

Proceeds are a Corporate Asset	Company	Harry (Estate)	Sam
1 Stock Ownership (Shares)	100.0	50.0	50.0
2 Stock Ownership (%)	100.0%	50.0%	50.0%
3 Pre-Life Insurance Value (\$m)	\$10,000.0	\$5,000.0	\$5,000.0
4 Life Insurance Proceeds (\$m)	\$6,000.0	\$3,000.0	\$3,000.0
5 Post-Life Insurance Value (\$m)	\$16,000.0	\$8,000.0	\$8,000.0
6 Repurchase Liability	(\$8,000.0)		
7 Post-Life-Insurance Value	\$8,000.0		
8 Repurchase Stock	(\$8,000.0)	\$8,000.0	
9 Retire / Give Up Stock	(50.0)	(50.0)	
10 Remaining Stock	50.0	0.0	50.0
11 New Stock Ownership (%)	100.0%	0.0%	100.0%
12 Post-Life Insurance Value of Co.	\$8,000.0	\$0.0	\$8,000.0
13 Post Life Insurance Proceeds		\$8,000.0	
14 Net Change in Value from Repurchase	(\$2,000.0)		

Figure 2

Line 3 of Figure 2 shows the same 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 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. 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 (or otherwise borrow elsewhere) 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.

What's Fair?

The decision of how to treat life insurance for valuation purposes is important for all parties. Which treatment is the most “fair”? 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.

Is it fair 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 this fair? 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.

If you have clients with buy-sell agreements that are funded in whole or in part by life insurance, take the time to review the agreements to see what they state regarding the treatment of proceeds in the event of the death of a partner/shareholder. If the agreement 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 on valuation.

Valuation advisers should be called in 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*, while everyone is in the here and now, what will happen to the incremental asset created by life insurance proceeds when one party dies and is in the hereafter.

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