

Buy-Sell Review

Report Summary

Prepared for
Kramerica, Inc.
Omaha, Nebraska

Thank you for requesting a Principal Buy-Sell Review. We have received the following documents:

- Shareholder Agreement (“Agreement”), dated March 30, 2007, **unsigned**
- Business Planning Fact Finder (“Fact Finder”)
- Unaudited Financial Statements for 2012, 2013 and 2014

Please note this Buy-Sell Review (Review) is based on our review of these documents and is intended to be used as a basis for discussions with your tax and legal advisors. To the extent these documents are invalid or other pertinent documents exist of which we are not aware, the observations, recommendations and analysis contained in this Review may be inaccurate. The Principal Financial Group[®] (The Principal[®]) does not provide tax or legal advice.

The Buy-Sell Review does not provide you with a legal opinion as to the legal or tax implications of your agreement or the appropriateness of any funding strategies. The Principal cannot provide you with any legal document or revise existing legal documents. The valuation will not be a substitute for a formal valuation nor does it establish a value for tax purposes. The Review is intended to help identify your objectives for the buy-sell agreement and any issues that must be addressed to help ensure your objectives are being met.

Background Information

- Kramerica, Inc. (“Company”) is a Nebraska corporation which has elected to be taxed as an S corporation.
- Shareholders (“business owners”) who are parties to the Agreement include Kosmo Kramer, Elaine Benes, George Costanzo, Lloyd Braun, Peter Newman, and the Company.
- The Agreement submitted is unsigned.
- The scope of this Review does not include any buy-sell matters related to Benes Painting, LLC, an additional business entity owned by Elaine Benes and Lloyd Braun.
- Although this entire report should be reviewed with local counsel, ‘Comments’ with bold lettering represent some of the key points for business owners to discuss with local counsel.

Comments:

1. *An S corporation is generally a pass-through entity for income tax purposes.*
2. *At least one individual, Mickey Magellan, may have become a business owner in the Company since the Agreement was executed. Consider adding this person as a party to the written Agreement.*
3. *An unsigned Agreement is without legally binding affect. Before signing the Agreement, ensure that the owners’ are satisfied it contains the needed buy-sell provisions after discussing with local counsel. Once the Agreement is in final form, it will be important for all intended parties to sign the Agreement.*
4. *A buy-sell agreement not signed by a representative of the Company does not necessarily bind the Company to the agreement’s terms. Discuss with local counsel if it would be helpful for the Company to be added as a signatory to the Agreement.*
5. *Benes Painting, LLC may also have a buy-sell agreement which could be reviewed as part of this process. If that business does not have a buy-sell agreement, and if the business has a substantial value, the business owners should discuss creating such a document with local counsel, or submitting the current document for review.*

Executive Summary

- Review the purchase and sale events mentioned in this Report with local counsel to determine if the most appropriate events are included in the Agreement. Discussion with local counsel should also address if each purchase and sale event is to create a mandatory or optional purchase. See the *Mandatory and Optional Purchase and Sale Events* section of this Report.

- Our review of your Agreement indicates that the valuation provisions may be an area in need of additional attention. The business owners may find it helpful to discuss these provisions with local counsel. See the *Purchase Price* section of this Report.
 - i. Explore with local counsel how the Agreement may be used to establish a firm value for estate tax valuation purposes.
- The Agreement's payment terms are not effectively integrated with insurance funding. This should be discussed with local counsel. See the *Terms of Purchase* section of this Report.
- Our review indicates that the provisions applicable to insurance funding are in need of attention. Local counsel may have some suggestions which would be helpful. See the *Funding of Purchase Price* section of this Report.
- Binding business owner spouses to the terms of the Agreement can be important. Discuss our Comments in the *Spousal Consent* section of this Report with local counsel.

General Structure of Agreement

- The Agreement is drafted as an entity purchase buy-sell arrangement upon the death of a business owner. Under an entity purchase buy-sell plan design, the business entity, as opposed to the surviving business owners, is obligated to purchase the interest of a deceased owner.
- The Agreement provides business owners with the option of assigning their purchase rights to the Company.

Comments:

1. *An entity purchase buy-sell arrangement provides the simplicity of only one life insurance and/or disability buy-out policy on the life of each business owner.*
2. *Under an entity purchase arrangement, life insurance policies are generally owned by the business entity and would be subject to the creditors of the business. However, the policies would not be subject to the personal creditors of the business owners.*
3. *For pass-through taxation entities, life insurance death proceeds, as tax-exempt income received by the business entity, may provide the surviving owners with only some cost basis increase for income tax purposes.*
4. ***Premiums paid by an S corporation for Company-owned policies may be considered a non-deductible item at the Company tax reporting level as an expense not properly chargeable to a capital account. Non-deductible expenses generally reduce the owners' cost basis in their Company ownership interest. Annual increases in policy cash value, if present, may, in effect, be 'netted' against decreases in cost basis.***

5. *Your tax and legal advisors may provide you with a full list of advantages and disadvantages of the different types of buy-sell arrangements.*

Agreement Provisions Limiting the Transfer of Ownership

- No business owner shall sell, assign, transfer, pledge, dispose of or otherwise encumber any of his or her interest in the Company, except as provided in the Agreement.
- Any transfer of shares in violation of the Agreement shall be treated as null and void.
- The Agreement permits transfers under certain circumstances. Transfers to the personal representative of a deceased business owner, a business owner's spouse or children, or to a trust for the primary benefit of the business owner or the business owner's family, are permitted by the Agreement.

Comments:

1. *The provision limiting transfer of ownership interests is common and useful in a well-drafted buy-sell agreement.*
2. *The Agreement effectively addresses the transfer of shares owned by a business owner's trust.*
3. *The Agreement permits certain transfers. This may be a particularly helpful provision for family-owned businesses.*

Right of First Refusal Agreement Provisions

- For proposed sale to an outside party, there is a right of first refusal for the Company (first option) and remaining business owners (second option), as long as the proposed transfer is not transfer that would result in a change in control of the Company. See below for more information on transfers resulting in a change of control.
- The option purchase price is either the offer price or the price under the Agreement, at the election of the purchaser.

Comments:

1. *A right of first refusal provision is typically found in buy-sell agreements and may be helpful to business owners in several ways.*
2. *A right of first refusal purchase price is generally based on (a) the Agreement price; (b) the third party offer price; (c) or the lesser of the Agreement price or the third party offer price.*

Mandatory Purchase and Sale Agreement Provisions

- **Death** of a business owner is a mandatory buy-sell triggering event requiring the estate of the deceased business owner to sell with the Company obligated to purchase the interest of a deceased business owner.
- **Disability** (as defined in the Agreement) of a business owner is a mandatory buy-sell triggering event requiring the disabled business owner to sell, and the Company to purchase, the disabled business owner's interest.
- Disability is first defined according to the definition found in Employee Owner's employment agreement. If no such agreement exists, then disability shall be determined using the definition of disability included in a disability insurance policy acquired for purposes of the Agreement. The Agreement also includes a back-up definition and process for reaching a determination of disability.
- **Termination of employment "for cause"** (as defined in the Agreement), **resignation**, or **termination of employment "without cause or resignation"** require the departing owner to sell, and the Company to purchase, the departing owner's shares.

Comments:

1. *Including death, disability, resignation, and termination of employment as mandatory buy-sell provisions for buyer and seller are fairly common buy-sell agreement provisions.*
2. **Retirement is often a mandatory triggering event under a buy-sell agreement.** *Although the Agreement includes a resignation trigger which might be considered as applicable for a retirement, consider amending the Agreement to include retirement of a business owner as a mandatory purchase event.*
3. *Life insurance and disability buy-out funding is discussed below.*

Agreement Provisions related to Purchase Options

- Before an "**involuntary disposition**" of an owner's interest can take place, the Company is first provided an option to purchase the affected shares. The company may assign this purchase option to the other business owners.
- "Involuntary disposition" may include, but is not limited to, bankruptcy, insolvency, judgment lien or court order.
- If a business owner's **marriage terminates** for any reason other than the business owner's death, and the business owner does not become the legal owner of the spouse's shares, then the affected business owner is provided an option to purchase, which, if elected, shall obligate the spouse or the spouse's successor in interest, to sell.

- The Agreement includes a **‘bring-along’** provision. Under this feature, if a majority owner sells his or her interest, the majority owner is provided a ‘call’ option to force minority owners to also sell their interests, generally upon the same terms afforded to the majority owner.
- Also included in the Agreement is a **‘come-along’** feature. Under this provision, if a majority owner sells his or her interest, the minority owners are granted a ‘put’ option which they may exercise to require the purchaser to also purchase their interest, generally upon the same terms afforded to the majority owner.

Comment:

1. *It appears that the Agreement covers many of the typical optional purchase and sale events.*

Agreement Provisions related to Purchase Price

- The purchase price is based on an independent appraisal of the Company’s fair market value, with modifications as specified in the Agreement. However, an appraisal need not be obtained if the parties are able to reach their own agreement on a purchase price.
- The Agreement includes “sellout” protection for a seller in the event that the Company is sold during the enumerated time frame at a higher price, and allowing the seller rights to accelerate an installment note.

Comments:

1. ***The valuation process incorporated in the Agreement effectively addresses valuation discounts and life insurance death proceeds. Other potential valuation adjustments, such as the proper valuation standard for assets, may be added to Agreement after discussion with local counsel.***
2. ***Under the Agreement’s terms, it may be possible that the value of the business could be locked-in for estate tax valuation purposes. Because the value of the Company appears to be substantial, it may be important to visit with local counsel about making sure that the value of the Company under the Agreement’s terms represents a reasonable fair market value of the Company which may be locked-in for estate tax purposes.***
3. *Key employee life and disability coverage may be helpful to the business owners in protecting the value of the business from the unexpected loss of a key employee’s services. Typically, the business is the owner, premium payer, and beneficiary of key employee policies. Policy proceeds may be income tax free, while premium payments are generally non-deductible.*

4. **Consider amending the valuation provisions of the Agreement in a manner which could effectively exclude the value of Company-owned life insurance from the value of the Company.**
5. **We completed an informal business valuation of the Company based on Company financials. Using several formulas (but excluding book value), the business value ranged from \$10,500,000 to \$15,000,000.**

Agreement Provisions related to Terms of Purchase

- The Agreement includes two sets of terms: Standard and Extended. The purchase price upon death and permanent disability shall be payable in cash.
 - i. 'Standard' terms are either (a) 20% of the purchase price or (b) the higher of 20% or the amount of life insurance death proceeds as a down-payment, with the balance payable in sixty equal consecutive monthly installments, with interest (using the prime rate).
 - ii. 'Extended' terms are 10% payable in cash at closing, with the balance payable in 120 equal consecutive monthly installments, with interest (using the applicable federal rate).
- **Standard terms** are required for (1) death, (2) disability, (3) termination of employment, without cause or resignation, or (4) termination of employment for cause or by resignation on or after the tenth anniversary of the Agreement.
- **Extended terms** apply for (1) termination of employment for cause or by resignation prior to the tenth anniversary of the Agreement and (2) right of first refusal purchase, if elected by the purchaser.
- **No terms** were specified for the termination of marriage triggering event.
- Upon the death of a business owner, available life insurance death proceeds must be applied to the purchase price, with the balance of the purchase price payable under an installment purchase agreement.
- In general, if the Company is prohibited by state law from completing a stock redemption under the Agreement due to issues with Company surplus, the Agreement requires the Company to take whatever corporate action is necessary to increase its surplus in order to complete the redemption. Alternatively, the Company may assign its purchase obligation to the remaining business owners.

Comments:

1. **Generally, business owners try to match-up reasonable and fair payment terms based on the buy-sell triggering event. The parties may wish to compare the likely cash needs of the Company to cash flow upon the occurrence of a buy-sell trigger. If the cash needs are substantial and cash flow limited, the parties may wish to consider**

provisions for payments over a longer period of time or explore supplemental funding.

2. ***Life insurance and disability buy-out coverage may be very helpful in providing cash to meet purchase obligations.***
3. ***Since the Company is taxed as an S Corporation, and it has adopted an entity purchase buy-sell plan design, consider acquiring Company-owned, cash value-oriented life insurance policies. This approach could help to reduce the negative impact on owner cost basis due to the payment of term life insurance premiums as a non-deductible expense. The cash value of Company-owned policies may be used as a partial sinking fund for lifetime buy-outs.***
4. *Since periodic disability buy-out benefit payments may end with the death of the insured, it may be advisable for the Company to retain ownership of any life insurance policies on the life of a disabled owner until the installment purchase is completed.*
5. *Consider amending the Agreement to include provisions regarding disposition of life insurance death proceeds in excess of the purchase price under the Agreement.*

Agreement Provisions and other Information

Related to Funding of the Purchase Price

- The Agreement does not require funding of death-time or disability buy-out obligations with benefit proceeds from life and/or disability insurance products.
- The Agreement appears to permit life and disability insurance on the business owners.

Comments:

1. ***As a general rule, the ownership and beneficiary structure of life and disability insurance acquired for purposes of a buy-sell agreement should be aligned with the agreement's purchase obligations.***
2. *The parties may wish to review life insurance and disability buy-out coverage. The amount of insurance available to purchase depends upon the value of the business. Underwriting standards for life insurance and disability coverage are different.*
3. ***Disability buy-out policies are often structured by insurers as expense reimbursement policies. Therefore, a disability buy-out claim may not be payable until the buy-out of a disabled owner's interest has occurred. Please review with local counsel whether the buy-out procedures in the Agreement are consistent with the claims payment procedures in the disability buy-out policy.***

4. **Life insurance death proceeds are only income tax free to an employer if the insurance is properly structured and the employer complies with IRC Section 101(j).** Section 101(j) applies to employer-owned life insurance issued or materially changed after August 17, 2006. To preserve the favorable income tax treatment of life insurance death proceeds, Section 101(j) compliance requires written notice and signed consent by the insured employee to the placement of life insurance coverage owned by the employer. In addition, annual information reporting (Form 8925) on employer-owned policies is required by IRC Section 6039I.
5. **Consider adding provisions to the Agreement which address future ownership of life insurance policies acquired for purposes of the buy-sell arrangement as circumstances change.** Many buy-sell agreements include dispositive provisions for the following circumstances: (1) termination of the buy-sell agreement; (2) occurrence of a triggering event; (3) sale of the company; or, (4) termination of the business owner's relationship with the company. If any of the preceding events occur, the business owner may be given the option to purchase his or her policy. In addition, if the departing business owner holds a policy on the remaining business owners, the remaining owners should also be provided with the right to purchase their policies from the departing owner. A means of determining the purchase price of the policy should also be provided in the Agreement.
6. Revenue Procedure 2005-25 generally provides valuation safe harbors for the transfer of life insurance policies from a business to an employee (including an owner-employee). The general standard of valuation is a policy's "fair market value". Generally speaking, fair market value is measured differently for different types of life insurance products and may not be represented by a policy's cash surrender value. The insurance company providing the product is in the best position to provide the measure of fair market value for its products. Transactions between or among business owners are generally not bound by the valuation guidelines of Revenue Procedure 2005-25.
7. A business owner exiting the business under a lifetime triggering event through an installment sale of his or her interest generally should not be afforded an option to purchase the life insurance policy on his or her life until the installment sale is completed.
8. **Many business owners have found it advantageous to list all life and disability insurance policies acquired for purposes of the buy-sell agreement on a separate schedule attached to the agreement. Where life insurance policies are concerned, this practice has the advantage of not confusing whether death proceeds are to be used for key person needs of the business or to complete the purchase of a deceased owner's business interest.**

9. *We were not provided with any information regarding the ownership and beneficiary structure of existing insurance, if any. To avoid inadvertent tax consequences and misdirected insurance proceeds, it may be quite helpful to review ownership and beneficiary information with local counsel.*
10. *Consider with local counsel the advantages and disadvantages of providing a business owner with an unqualified purchase option with respect to a life insurance policy where the business owner is the insured prior to the policy being disposed of by the Company or other business owners.*
- 11. *Most states have laws which address the conditions under which a corporate redemption may occur. Often, these statutes relate to the level of corporate surplus present at the time a stock redemption is to occur. Since the timing of a stock redemption may be unpredictable, life and disability insurance contracts may be helpful to the business owners in facilitating a stock redemption.***
12. *A new owner purchasing the Company on an installment sale basis may find it helpful to acquire Business Loan Protection disability coverage to ensure a source of future payments if the purchaser should become disabled.*

Agreement Provisions related to Spousal Consent

- The Agreement includes spousal consent provisions but it does not contain the signatures of any spouses.

Comments:

- 1. *Parties to the Agreement should discuss with local counsel the impact of not having spousal signatures on the consent forms. The parties should be diligent about obtaining spousal signatures under the spousal consent form.***
- 2. *The inclusion of spousal consent provisions and obtaining the signatures of spouses may be helpful in establishing the value of a divorcing owner's interest in the business. This could also help prevent a divorce court from using its own valuation of the business for marital property settlement purposes.***
3. *Often, a surviving spouse may be named as executor of the estate of a business owner. A smooth transfer of shares at death may be facilitated by prior notice of the Agreement and consent by the surviving spouse.*

Other Agreement Provisions

- The Agreement does not include either mediation or arbitration provisions.

Comments:

- 1. Mediation and arbitration provisions are helpful dispute resolution tools.*
- 2. Consider adding mediation and arbitration provisions to the Agreement.*

Final Comments and Recommendations

- Please discuss this report with your tax and legal advisors.
- If business owners appear likely to have an estate tax liability at death, then best practice suggests that the buy-sell agreement be utilized to “lock-in” the value of the business for estate tax valuation purposes. The requirements to do so for a buy-sell agreement entered into or substantially modified after October 8, 1990, include the following factors:
 - i. the price must be fixed or determinable pursuant to a formula under the agreement;
 - ii. the estate must be obligated to sell at death at the agreement price;
 - iii. the agreement must prohibit the owner from disposing of his or her interest during life without first offering it to the other party or parties at no more than the agreement price; and
 - iv. the agreement must be a bona fide business arrangement and not a device to pass the interest to the natural objects of the deceased owner’s bounty without full and adequate consideration in money or money’s worth;
 - v. any agreement to acquire property at less than fair market value will be disregarded **for federal transfer tax purposes** unless, under IRC Section 2703(b), the agreement (1) is a bona fide business arrangement; (2) not a device to transfer property to members of the decedent’s family for less than full and adequate consideration; and (3) has terms comparable to similar arrangements entered into by persons in an arms-length transaction.
- **If the value of the business is locked-in for estate tax purposes as noted above, and that valuation process also makes it clear that Company-owned life insurance death proceeds exist for redemption purposes, then some or all of the life insurance death proceeds received by the Company may be excluded from the value of the business and the insured’s taxable estate. Given the financial size of this Company, and the unknown value of Benes Painting, LLC, it may be beneficial to discuss this topic with local counsel.**
- Purchase rights or options arising from the occurrence of buy-sell event triggers (including “right of first refusal” agreement provisions) are typically subject to time limits. If a potential buy-sell triggering event occurs, the

parties should pay close attention to the time limit provided to exercise a purchase right or option.

- Included in the Agreement are prohibitions against competition with the Company and a requirement not to disclose confidential information. This review does not address any tax or other impacts of these provisions.
- Whether a non-compete provision is legally enforceable will be determined by state law. As a general rule, terms of the non-compete must be reasonable to be enforceable. Factors to consider regarding enforceability include the geographic scope and duration of the non-compete.

Submitted by: Joe Doaks, CLU

Completed by: Pete Leo, J.D.*, CLU, ChFC, LLIF

Reviewed by: Lance Hennesay, J.D.*, MBA, CLU



WE'LL GIVE YOU AN EDGE[®]

*JD is an educational degree and holder does not provide legal services on behalf of the companies of the Principal Financial Group.

While this communication may be used to promote or market a transaction or an idea that is discussed in the publication, it is intended to provide general information about the subject matter covered and is provided with the understanding that none of the member companies of The Principal are rendering legal, accounting, or tax advice. It is not a marketed opinion and may not be used to avoid penalties under the Internal Revenue Code. You should consult with appropriate counsel or other advisors on all matters pertaining to legal, tax, or accounting obligations and requirements.

Principal National Life Insurance Company and Principal Life Insurance Company, Des Moines, Iowa 50392-0002. Principal National (except in New York) and Principal Life are issuing insurance companies of the Principal Financial Group[®].

www.principal.com

BB9868SPRES-08 | 12/2014 | t140609044p | ML 14-004734