

BUSINESS ADVISOR REPORT

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A newsletter for closely-held business owners and advisors

Message From The Firm

Our Business Advisor Report contains three articles that we hope you find of interest. As an increasing number of companies seek bankruptcy protection or become insolvent, you may discover that an insolvent buyer owes your business money. Gary's article describing how to reclaim goods from an insolvent buyer will be very helpful if you have recently sold goods or products to such a company.

If you are in a partnership or are a shareholder in a corporation with several owners, take a look at Jeff's article on inheriting an unintended partner, such as the spouse of a deceased partner. One of Jeff's recommendations is keeping the buy sell agreement current with valuation methods that will update the business' value on an on-going basis.

If your goal is to hire, retain and motivate key, valuable employees, read my article on stock appreciation rights, which describes how they can be used creatively to provide employee incentives outside of outright ownership.

Also included with this newsletter is a copy of Don's article describing the use of ESOPs in planning for the succession of ownership in a corporation.

Please don't forget to send us your e-mail address if you'd like to continue receiving this newsletter. In the near future, we will distribute this newsletter by e-mail only.

As always, if you have any questions or comments, please contact me or one of the attorneys who has written an article.

Jon Karp
JonKarp@Reish.com

Motivating Employees in Good and Bad Times



By Jon Karp, Esq., CPA (JonKarp@Reish.com)

Problem: A client who operates retail stores across the country recently asked us how to retain and motivate their employees in the current economic times. According to our client, their employees sought such motivation in the form of ownership in the company. However, our client was reluctant to give employees ownership, fearing that an employee will later leave the company at an “inopportune” time and either try to retain his or her stock or sell it for a high price.

Solution: To solve our client's dilemma, we set up a stock appreciation rights plan, which does not give the employees actual ownership interests in the company (hence, no voting rights or rights to review books and records). These plans are designed to benefit the employees only under certain circumstances, such as death or disability of the employee or the sale of the company.

Benefit: Since our client's goal was to retain the employee, we structured the plan so that payment would not be made if the employee quit or was fired before the company was sold. This requirement protected the company from the employee leaving at a bad time and shackling it with a large payment to a terminated employee. These plans can also be designed to benefit only selected employees. For example, our client designated as participants only certain levels of management and certain staff in the main

office. In order to further encourage employees to remain with the company, we utilized a vesting schedule, which required employees to remain employed for a certain number of years before becoming eligible for the plan and before being entitled to the full benefits under the plan. Other clients have limited these benefits to only one employee and have included the plan as part of that individual's employment agreement.

For another client, who wanted to sell the company and whose employees were key assets, we designed the plan to require the employees to remain employed by the purchaser of the company for a certain period of time before being entitled to receive the payments under the plan. Usually this period is as long as the seller of the company is exposed to claims by the purchaser that the company isn't as successful as the seller stated it was or the period of any earn out, in which the payment to the seller was dependent on the operations of the company after its sale.

In this case, our client hoped to commit employees to the successful operations of the company, both before and after the sale. This client wanted to achieve the best of all worlds, retaining valuable employees and getting the most value when selling the company. And, best of all, it worked!! When the company was sold, the key employees remained with the buyer and the seller (our client) received full payment of the purchase price, including the maximum earn out. ❖

Inheriting Unintended Business Partners



By Jeff Lewis, Esq. (JeffLewis@Reish.com)

Problem: Your business partner unexpectedly dies and much to your surprise, you have just inherited a new business partner...the spouse of your deceased partner. If this sounds familiar, you are not alone. Many business owners face this situation each year.

In a recent matter, a business owner was already enmeshed in a lengthy and bitter dispute with his deceased partner's wife by the time he came to us for advice. The wife, once our client's very good friend, had sued for her husband's salary (cut off when he died) to pay her living expenses. She also sued for an accounting of the income and expenses of each of their co-owned companies. Finally, she sued for the forced sale or liquidation of all of the companies.

These lawsuits, and the subsequent countersuits, badly disrupted the on-going businesses and decimated the previously close personal relationships between the parties. Additionally, each of the parties spent hundreds of thousands of dollars in litigation costs.

Solution: What can you do to protect your partnership, corporation, or limited liability corporation (LLC)?

- 1) Create a valid buy-sell agreement among all owners;
- 2) Make sure any existing buy-sell agreement reflects the current status and value of the business; and
- 3) Conform your will and revocable trust to obligate your executor and trustee to implement the buy-sell agreement.

Buy-Sell Agreements

A buy-sell agreement is an agreement in which one co-owner buys out the other co-owner (or his or her estate) upon the happening of certain specified events, generally some type of voluntary or involuntary withdrawal from the business. There are two types of buy-sell agreements: 1) a cross-purchase agreement and 2) a redemption agreement. In a cross-purchase agreement, each remaining co-owner purchases a prorata share of the withdrawing co-owner's interest in the business. A redemption agreement differs only in that the purchaser is the company rather than the individual co-owners.

A major benefit of a cross-purchase buy-sell is that each of the remaining co-owners receives an increase in his or her basis in the company as a result of the purchase of the withdrawing co-owner's interest. Since this does not occur in the redemption situation, the cross-purchase buy-sell can save significant income tax if the business is sold in the future.

The types of triggering events that should be considered by owners for inclusion in a buy-sell agreement are death of a co-owner; total or partial disability of the co-owner (he or she is no longer able to function in the business as before the disability); and the withdrawal or retirement of the co-owner. Each of these buy-out situations, except for withdrawal or retirement, can be paid through the purchase of life insurance or disability buy-out insurance. This insurance, commonly purchased at the time of the creation of the buy-sell agreement, will provide some or all of the liquidity needed by the remaining co-owners to purchase the withdrawing co-owner's interest in the business. If no insurance

is purchased or if the insurance proceeds are less than the purchase price, the agreement should provide for an installment payment of the balance of the price, with a stated interest rate.

Keep Buy-Sell Agreement Up-To-Date

Too often, even when a buy-sell agreement has been put into place, the co-owners file it in a desk drawer and don't look at it again until a triggering event has occurred. This results in an agreement that does not reflect the current ownership of the business. Some of the original co-owners may have left the company or new co-owners may have joined the enterprise.

The most frequent and most devastating problem in an out-of-date buy-sell agreement is a purchase price which does not reflect the current value of the business. Think of the impact of you or your estate being forced to sell your interest in your business at a value that is 10 or 15 years old. While the remaining co-owners would be ecstatic, the withdrawing co-owner, his or her estate, spouse or children, would be left with a significantly reduced value for the interest in the business. One way to avoid this problem is to build into the agreement a formula which calculates the value of the business based upon objective information, such as gross revenues, profits, book value, or valuation by an independent third party appraiser.

Estate Planning Conformity

Even if you have a buy-sell agreement with all current information, you need to insure that your estate plan is consistent with the terms of the agreement. Don't create a buy-sell agreement and then have an inconsistent provision in your will or living trust, distributing your interest in the business to your children. That will only create problems, disharmony, and potential lawsuits.

In order to avoid probate administration (a lengthy, costly and public process), the business interest should be held by the
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Prelitigation Remedies: Seller Reclaims Goods from Insolvent Buyer



By Gary Wexler, Esq. (GaryWexler@Reish.com)

Problem: A seller of goods sought our advice after learning that one of its customers was insolvent and unable to pay any part of

the seven figure amount due for goods recently purchased from the seller. The seller believed that the only available recourses were to file a lawsuit and/or be an unsecured creditor in bankruptcy.

Solution: At the time we learned of the buyer's insolvency, we were advised that a substantial portion of the seven figure amount due was for goods delivered within the last 10 days and that the goods were readily identifiable. We recommended that the seller immediately exercise its reclamation rights.

The Commercial Code affords a variety of prelitigation remedies for resolving disputes between merchants concerning the sale of goods. Most sellers are aware that if the buyer of goods becomes insolvent, there are procedures that permit the seller to withhold delivery of goods still in the seller's possession or control, stop delivery of goods already in transit, or refuse to deliver future orders except for cash. However, sellers should also be aware that even if the buyer has received the goods before the seller discovers that the buyer is insolvent, there is an "expedited" procedure to reclaim those goods.

According to Commercial Code, the seller of goods may reclaim those goods from the buyer if the following conditions are met:

(1) *The goods must have been received while the buyer was insolvent. An "insolvent" buyer is one that has ceased to pay its debts in the ordi-*

nary course of business, cannot pay its debts as they become due, or is insolvent within the meaning of the federal bankruptcy law.

(2) *The seller must make demand for reclamation of the goods within ten days after the buyer received the goods if the sale was on credit. If the sale was for a subsequently dishonored check, the seller has a "reasonable time" to reclaim the goods after it discovers the check is bad. If the buyer misrepresented its solvency in writing to the seller within three months before delivery of goods, then the ten day limit does not apply.*

(3) *The goods must be identifiable in some manner, such as by invoice and/or purchase order number and description. The seller ordinarily cannot reclaim the payments received for goods already sold. Nor can the seller reclaim goods processed into other products, because the goods are no longer identifiable.*

Benefit: Exercising reclamation rights is neither time-consuming nor expensive. However, the conditions must be fully satisfied so as to avoid counterclaims and potential damages. Sellers should act promptly upon discovery of a buyer's insolvency.

An additional caveat is that a seller who successfully reclaims its goods may not invoke any other remedies against the buyer with respect to such goods. Accordingly, the seller most likely foregoes any anticipated profit or "benefit of the bargain." If the buyer refuses to relinquish the goods on demand, the seller may not breach the peace. Instead, the seller must institute a lawsuit based on "claim and delivery." Even if the goods

are not recovered, reclamation may afford the seller a position superior to that of other unsecured creditors in a bankruptcy proceeding.

In our client's case, the buyer cooperated and a substantial portion of the goods that had been delivered within the preceding ten days were released to the seller's designee. ❖

Unintended Partner

(Continued from page 2)

owner's living trust. In the event the business is a professional practice (such as medical, dental, accounting or legal), the trust cannot own the interest unless one of the trustees is a "licensed person." In those situations, the trust must make specific provision for the appointment of a licensed individual as special trustee to implement the sale of the interest in the business upon the death of the owner.

Benefit: Clearly, co-owners can avoid unintended consequences with this simple advance planning. It can leave surviving spouses financially secure and minimize the potential for conflicts. Failure to act may subject you, your business, your partners and your survivors to unnecessary turmoil and financial hardship. ❖

We Need Your E-mail Address!

We will be discontinuing our printed newsletters in 2002 and will only be sending them by e-mail. If you are not already receiving our newsletter by e-mail, then we do not have your current e-mail address.

If you would like to continue receiving our newsletters, please let us know your e-mail address by sending an e-mail from your return address to Traci Mortimer at tracimortimer@reish.com. Please include your name and your organization's name in the e-mail message.

Around the Firm

We are pleased to announce that Brad Cohen and Michael Foster, founding partners of the tax, business and estate planning law firm of Cohen, Primiani & Foster, have joined our firm as of June 1st, along with their associates, paralegals and support staff. Cohen and Foster's strong focus on representing individuals and companies in the entertainment, music and sports industry will enhance our firm's tax, estate planning, and complex corporate transactional expertise, and expand the platform of services for clients.

Jon Karp was a member of the planning committee and a speaker at the California CPA Education Foundation's 2002 Flow Through Entities Conference in San Francisco and Los Angeles in July. Jon also spoke on "Structuring the Agreement" at the Foundation's 2002 Succession Planning for the CPA Firm Conference. In addition, Jon co-presented a seminar with Adam Cohen to the Pasadena Discussion Group of the California Society of CPAs - Los Angeles Chapter on "Pre-Merger Agreements: Planning the Business Breakup or Sale in Advance of Formation." _____ presented "Retirement Plan Distributions" in July to the Personal Financial Planning Committee of the California Society of CPAs - Los Angeles Chapter. In May, Marge Paul gave a presentation on "Cash Balance Plans" at the AICPA National Conference in San Diego.

Lee Reicher was quoted in the June issue of the *Journal of Accountancy* in "Is a Subsidiary in Your Future?" Jeff Lewis authored "Buy-Sell Agreements Offer Hedge Against Unforeseen" in the May 6th issue of the *Los Angeles Business Journal*. Don Mariotto's article entitled "ESOP: Centerpiece of Business Succession and Retirement Planning," a copy which is attached to this newsletter, appeared in the May edition of *CalCPA Online*. Nelson Handy co-wrote "FLP Audit Triggers" for the May issue of *California CPA*.

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Reish Luftman & Reicher
A PROFESSIONAL CORPORATION
ATTORNEYS AT LAW
N E W S L E T T E R
11755 WILSHIRE BOULEVARD
10TH FLOOR
LOS ANGELES, CA 90025-1539

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