



Leimberg's Think About It

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Why a Buy-Sell ? Understanding the Problems Constructing the Solutions

Introduction

The importance of stabilizing and maximizing the value of a closely held business and transferring it under carefully controlled conditions to the parties desired while minimizing the costs of that transfer can not be overestimated. Failure to do so will usually be economically and often emotionally disastrous.

This commentary is designed to help professionals help their clients see the problems inherent in retaining control of a closely held business and assure them that the full value of the business will be available to provide the maximum possible financial security in the event of retirement, death, disability, or other severance of relationship with the business.

This commentary will be an invaluable guide to business owners in keeping their corporations "close" and transferring their lifetime efforts in the most secure manner possible or creating a profitable market for what might otherwise be an unmarketable business.

Keep reading and you'll have a better understanding of the problems inherent in closely held businesses, the inevitable conflicts that occur when no buy-sell arrangement is created, and the advantages in creating a binding arm's length bona fide agreement.

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For a business to survive one or more of the transitional events described above, a systematic planning process must be used. That process should take into consideration not only the business and its survival but also the personal needs, desires, and agendas of each of the firm's owners and the needs, desires, and agendas of those they love and for which they feel responsible. In other words, buy-sell planning must be incorporated into a larger picture of estate planning for each of the business's owners and their families.

The Nature of a Closely Held Corporation

Five Key Characteristics: Certain characteristics are present in almost every closely held corporation. In order to understand the nature and scope of the potential problems and the importance of a buy-sell in solving these problems, it is essential to know the problems inherent in these five key characteristics:

1. The majority shareholders are active in the operation of the business.
2. The majority shareholders receive most of their incomes in the form of salaries or fringe benefits rather than as dividends on their investment.
3. The majority shareholders have limited liability to corporate creditors, except to the extent they have personally guaranteed corporate indebtedness.
4. At the death or disability of a majority shareholder, the legal structure of the business generally remains intact.
5. At the death or long-term disability of a shareholder, the personal structure changes dramatically.

These five key characteristics have a significant impact upon the problems the business, its owners, their families, and their creditors may face when ownership changes hands because of death, disability, retirement, divorce, bankruptcy, loss of professional license; on a sale to an outside purchaser; or termination of a stockholder's employment. Although each of these (and many other) contingencies must be considered in the drafting or review of a buy-sell agreement, this commentary will concentrate on the two most economically troublesome (mainly because the timing and event are unpredictable) problems: death and/or long-term disability of an owner/worker.

Death and Disability – Succession Blockers. Why are death and/or disability such traumatic events? One reason is that while a shareholder is alive, there is great flexibility. The shareholder can sell the business interest, give it away, or keep it. However, the choice and flexibility is gone at death or disability. If there is no buy-sell agreement, the shareholder's stock will be distributed either by will or under state intestacy laws. The decedent's executor, and later his heirs or the party who purchases the stock from those heirs, will have the right to hold and vote the stock.

Bluntly stated, the death or long-term disability of a shareholder in a closely held business may signal the death or financial crippling of the enterprise. The business (or practice) and the business owner (practitioner) often both die (or become permanently disabled) on the same day! At the death or disability of a working owner, no asset tends to deteriorate in value as quickly or as completely as a business. Although the value of a car or home or almost any other asset will remain relatively the same a day, a week, or a month after its owner dies, the same cannot be said for the value of a business, especially a service-oriented business. If a restaurant doesn't reopen for a month or a doctor's practice is closed for a month, or a manufacturing plant produces no goods for a month, what happens to its value? In many cases, the precipitous drop in value is staggering! Typically, the economic power of the business or practice has ended.

The following scenarios have played out many times:

“Across from my dad's jewelry store was Meyer's Shoe Store. Both stores were there since I was a kid. Meyer ran the business with the help of a long-time manager, Peter, and two part-time summer employees. The business provided a good living for Meyer, his wife, Miriam, and their two daughters as well as Peter and his growing family.

Meyer was from the old school; he worked night and day in his business but never took the time to make sure the business would survive him. When Meyer had a heart attack and died within three days, his family immediately felt the emotional trauma of his unexpected death. The death also created economic problems – problems that soon seemed insurmountable.

At first, Miriam tried to run the business. Unfortunately, she had never been involved in its operation while Meyer was alive. When she realized she needed help, she offered Peter a significant raise in pay to keep the business going. But when she had to take out most of the firm's working capital to pay state death taxes, loans, and medical expenses not covered by Meyer's insurance coverage, essential summertime business inventories dropped and, inevitably, sales plummeted.

Peter, figuring it was only a matter of time until the business went bankrupt and his job was lost, quickly accepted a position with one of the store's competitors. Miriam had to sell the remaining inventory for less than 30 cents on the dollar.”

The problems faced by unrelated co-owners are often compounded when all the owners are family members. Attorney Charles K. Plotnick of Jenkintown, Pennsylvania, a frequently quoted authority on family held businesses, relates the story of two brothers, Joe and Paul, who, during lifetime, could not have been closer.

They had been in business together for almost thirty years. Business responsibilities were divided down the middle: Joe ran the day-to-day operation of the business while Paul, the younger brother, was a super salesman and worked night and day to build up company profits. Even though the business enjoyed several million dollars a year in sales and was highly profitable, Joe's lifestyle was

very conservative. Joe lived in a modest home with his (second) wife Mary and four young children. Paul, a bachelor, lived in a downtown apartment on a much higher scale.

Joe died at age 53 after a six-month battle with cancer. Paul was more than a little shocked when he was invited to the office of Mary's new attorney. The attorney said that since Joe had owned half the business, Mary, his widow, was entitled to the same income Joe had been bringing home before his death. Mary insisted it was urgent that she receive at least that much since the twins had just started college and the other two children were in their freshman and sophomore years of high school.

Paul, of course, felt a deep moral obligation to his late brother's wife and children. He wanted to do "what was right" and do as much as possible. However, he knew very little about how the business was actually run. He did know he would have to hire at least one and probably two people to do the work that Joe had done. He also knew it would put quite a strain on the business to pay, in essence, three salaries.

Paul's accountant cautioned that even Paul's salary might have to be reduced until a competent replacement for Joe was found and properly trained. Mary became distraught. However, Paul's accountant told Mary that if the pressure became too much for Paul and his health suffered the entire value of the business would be jeopardized. He suggested that she should try to find a job to provide for her children's education."

The physical and emotional drain when the surviving partner tries to do "the right thing" drains that person's strength and all too often ruins that person's health. Regardless of intent, an after-the-fact solution usually becomes unsatisfactory to some and perhaps all of the parties.

The Almost Inevitable Conflict of Interest

There is a diametric opposition of interests; what the surviving stockholders need and want and the decedent-shareholder's heirs will need and want almost inevitably conflict.

At best, the beneficiaries of the deceased shareholder often find that "the principal asset of the estate has a value that is substantially less than its intrinsic value because it is subject to the control of other persons whose interests differ significantly from theirs. At worst, these conflicts of interest can threaten the very life of the corporation" and ruin long term business and personal relationships.

The surviving employee owners typically seek to

- maintain (or increase) their salaries, fringe benefits, bonuses, and other advantages as employees;
- reinvest corporate earnings and profits in the business;

- expand the business and take other steps that build up its survival capacity and financial strength;
- reinvest money that might otherwise be paid out in dividends to build up a strong cash reserve for emergencies, opportunities, or for cyclical working capital needs;
- retain their jobs (those jobs may be jeopardized if controlling shareholder heirs sell their business interests to outsiders or decide the active shareholders are no longer productive);
- prevent outsiders from interfering with the management and seizing control of the business and its affairs (Yet, who would purchase an interest in a business that has just lost a key individual if the money that had to be invested, no matter how much it was, wouldn't buy a controlling or at least equal voice in corporate decisions?);
- ensure that the ownership of a corporation does not move outside the agreed-to group of entrepreneurs/investors/workers;
- keep a family owned business within the family (Many business owners are willing to be in business with a business owner's working-in-the-business child but certainly not with his or her never-worked-in-the business spouse (or ex-spouse) or his or her new spouse or lawyer, or the creditor of a child who might obtain stock by attachment;
- prevent the loss of an "S" (subchapter S) election;
- prevent a former shareholder from competing with the business (in the case of a shareholder selling during lifetime); and
- protect against shifts in proportionate ownership and control.

The decedent/shareholder's family has different problems and different goals:

- Dividends are of primary importance to the decedent-shareholder's heirs. If the heirs are not capable of earning a meaningful salary or, for any reason, do not go into the business, dividends often become their major source of income. Heirs may need large amounts of capital to pay estate administration expenses, death taxes, and college and other educational expenses.
- Often, the heirs can't, or don't want to, take an active role in the business; they sometimes lack a technical understanding of the business, have little training and experience, or are unwilling or unable to handle the severe emotional punishment entailed in modern business management. They may just be too young; minors are under a legal disability. Surviving parents may be otherwise occupied in raising children or in their own careers. Survivors may be injured and physically incapacitated in the same accident that killed or permanently disabled the shareholder.
- Although surviving stockholders will seldom want to share corporate control or decision making with individuals who have not worked in the business at length, the decedent-shareholder's heirs will want as much control and voice as possible. If the heirs remain inactive, they place their fate in the hands of the surviving shareholders. This is often undesirable because the dividends that inactive and non-vocal heirs are likely to receive

will almost certainly not provide income that is adequate for their current needs or equal to their often inflated expectations.

- It is usually difficult for the heirs (especially minority shareholder heirs) to sell their stock since the price they will want (and often need) is more than most buyers can afford or will be willing to pay. Buyers who are aware of the heirs' pressing needs for estate liquidity, capital security, or day-to-day income often use this knowledge to their advantage and the heirs' disadvantage.

Many times the heirs are totally unfamiliar with the true value of the business and have no objective means of evaluating it. They often assume (erroneously) that the value of the stock should be a multiple of the shareholder-employee's gross salary. Such misguided and naive expectations often lead to forced sales of stock or other property at depressed prices to raise cash for basic living needs. Finally, finding a buyer (i.e., creating a viable market for the heirs' business interest) is itself a difficult task, especially if the heirs are minority shareholders.

- Heirs will want to minimize the cost, time expenditure, and aggravation involved with the federal and state death tax valuation process.
- Heirs often want, expect, and need to have the business provide them with (high paying) jobs and replace valuable fringe benefits (such as medical coverage) lost when the family member-shareholder died.
- Heirs will have high needs for both income and capital. Income will be needed to replace lost salaries and provide food, clothing, shelter, and to continue the family's other standard of living expenses. Capital will be needed in unexpectedly high levels to pay estate administration costs, death taxes, debts, and for special needs such as college education.

Third Parties to the Business

Every business deals with “third parties.” These are individuals or entities who are not formally part of the business or its legal structure but who are essential to the success and sometimes even the survival of the business. For instance, consider what would happen to a manufacturing company if one of its three partners, the key engineer, is killed in an airplane crash and the bank, which has been making loans to the firm is no longer convinced the survivors can run the business successfully.

Consider also the thoughts and feelings of employees who had confidence and faithfully followed the deceased shareholder who was the founder and driving force of the firm but who distrust their future under new leadership. If they lose morale, they may begin to look to the firm's competition for employment or compete on their own with their former employer at the very time when reduced cash flow threatens the business's ability to function profitably on a timely basis.

The point is that whenever a business has more than one owner and those people are important to the success of the venture, third parties to the business can accelerate the sinking process when triggering events occur - unless there is adequate preparation.

The Inevitable Reorganization

When a working shareholder dies or is disabled for a long period, there is, inevitably, a reorganization of the business personnel. Eventually the remaining shareholders MUST:

- buy out the heirs,
- sell out to the heirs,
- accept the purchasers of their stock as business associates,
- take the heirs into the business and share profits and decisions, or
- do nothing and accept the heirs as “silent partners.”

Here are some questions clients must be able to answer. The response will help indicate to you (and illustrate to them) the need for a buy-sell agreement:

- How would the business's creditors react if you or another shareholder died or suffered a long-term disability?
- If you died or suffered a long-term disability, would you want your family to retain the business or sell it? To whom? At what price? Under what terms? Could the executor you named in your will sell your business at a profit? What would your strongest competitor offer your executor for the business the week after you die?
- Would you consider selling your business to key employees? Are there any that would want to buy it? Can they afford to buy it?
- Are there outsiders - such as friendly competitors - who might be interested in securing an interest in your business?
- When was the last time your advisors measured the federal estate tax (“going concern”) value of your business? How did they arrive at that figure? Is it realistic today?
- What would be the income producing ability of the business assuming you were not here to run and direct it?
- Who will control your business at your death or disability? Can (will) that same person run the business? If not, what have you done to avoid or reduce conflicts of interest between the two parties? Who are those persons?
- What members of your family are in the business now or are likely to enter it in the near future? How long will it be before they are capable of earning a decent salary and contributing in a meaningful way to the profits of the business? What part of your business is your son or daughter interested in? Are the members of your family who will

be working in the business physically capable and emotionally able not only to work in the business but also to run it?

- Who will operate the business until your child is ready to take over? What have you done to keep that person in the business and happy to build someone else's financial future?
- What have you done to provide security or to even things out for those members of your family that will not be coming into the business?
- How comfortable would you feel being in business with your co-shareholder's widow? How comfortable would your co-shareholder be being in business with your widow?
- If your business partner were disabled for, say four to six months, would you want to continue his full salary during that time? Would you be able to? If that disability became permanent, how long could you afford to pay that salary? What have you done to offset that potential cost and the cost of hiring a replacement? How long could you handle the business alone?
- After your death or long-term disability, what percentage of your salary will the business pay to your family or to you? For how long?
- How important is it to you to guarantee that the parties you desire will control your business after your death or long-term disability?

If a co-shareholder dies and you buy out the heirs:

- Where will you get the cash and how much will it cost?
- What price will you pay and is it fair to both parties?

If a co-shareholder dies and you sell out to the heirs:

- Where will they get the cash and how much will it cost?
- What price will you receive and is it fair to both parties?
- What will you do for work once you have sold yourself out of a job?

If a co-shareholder dies and you accept the purchasers of that owner's stock in the business:

- Will they be capable of doing their share of the work?
- Will they be willing to do their share of the work?
- Will you get along with them - and they with you?
- Will you be willing to share major decisions with them?
- Will the heirs obtain a fair and adequate price for their stock? (Will they know what a fair price is?)

- Will you have a choice if the departed shareholder held a majority interest? (Where does that leave you?)

If a co-shareholder dies and you take the heirs into the business:

- Will they be capable of doing their share of the work? (Do they have the training and experience to carry their load and earn their salaries?)
- Will they be willing to do their share of the work?
- Will you get along with them - and they with you?
- Will you be willing to share major decisions with them?

If a co-shareholder dies and you do nothing and the heirs remain inactive:

- Will they trust you to run the business?
- Will the dividends you pay them be sufficient to meet their needs and their expectations (how realistic are they)?
- Will the heirs panic if you need to invest business profits back into the business rather than declare dividends?
- What will happen to the heirs if you sell your stock to an outsider?
- What will the heirs do at your death or disability?

Particular Problems of a Professional Practice

A professional in practice with other professionals faces almost all of the problems discussed above that business owners face and many more. A Medical Economics article on planning for doctors started by stating:

“If you are in practice with one or more colleagues, the departure, disablement, or death of a stockholder or partner can lead to bitter disputes and unforeseen complications. And if you're the one leaving, you can lose your shirt.”

Here are some problems professionals face in the absence of a properly drafted and fully funded buy-sell:

- How will patients or clients be divided up if one or more practitioners leave the firm?
- Who keeps the office if one or more practitioners depart? What will the departing practitioner receive for his share of the office or office building?
- What happens to office furniture, equipment, and art? What will the departing practitioner receive for his share of those items?
- How will accounts receivable be apportioned among former co-shareholders?
- Should a departing practitioner lose all the money in a non-vested retirement plan?

- Who pays the malpractice tail coverage (The practice, the remaining professional(s), or the departing professional)?
- What happens if a professional loses his or her license or board certification or can no longer practice at a local hospital?
- Should there be a restrictive covenant (agreement not to compete)?
- Will the firm or the other professionals pay a practitioner if he or she is disabled and unable to work for a long period? What about permanent disability? What if the practitioner wants to come back to work full time but because of mental, emotional, alcohol, or drug problems can't perform at the same level as before? At what point would the other practitioners want a buyout?
- At what age should a practitioner have to retire? How will the firm figure what is due to that person? How will that amount be paid? Can the professional take over of any practice-owned insurance (such as life or disability insurance) on his life?

What Is a Buy-sell Agreement ?

By this point, it should be obvious that when a corporate business owner dies or becomes permanently disabled, his business may die or be permanently disabled the same day - not because something wrong was done but because nothing was done!

As a solution to these problems, most financial service professional advisers recommend a buy-sell agreement (also called a business continuation or shareholders' agreement). This legally binding contract places certain restrictions on the transfer of stock and requires certain actions on given events.

Typically, at the death of a shareholder (or at one of the other specified triggering events such as retirement or long term disability) a buy-sell agreement will require the surviving shareholders (or the corporation or a combination of both) to buy and the owner of the stock (such as the estate of the deceased shareholder or a retiring or permanently disabled shareholder) to sell the ownership interest represented by the stock.

The three major types of buy-sell agreements:

1. **Cross Purchase Agreement:** If the remaining shareholders are to be the purchasers, the agreement is a cross purchase (or criss-cross) plan. Upon the occurrence of the specified event, each remaining shareholder buys the agreed upon portion of the stock of the departing or deceased shareholder. The seller receives cash and/or notes and the buyer(s) receives the seller's stock in exchange. For example, on the death of a shareholder, the other shareholders would be required to purchase the deceased shareholder's stock and the estate would be required to sell it at the price (or according to the formula) specified in the agreement.

2. **Stock Redemption Agreement:** If the corporation is to be the purchaser, the agreement is a stock redemption (or entity purchase) plan. Upon the occurrence of the specified event, the corporation itself buys the agreed upon number of shares of the departing shareholder. The seller receives cash and/or notes and the corporation receives the stock in exchange. For example, on the death of a shareholder, the corporation would be required to purchase the deceased shareholder's stock and the estate would be required to sell it to the corporation at the price (or according to the formula) provided in the agreement
3. **Wait-and-See Buy-Sell Agreement:** Besides the cross purchase and stock redemption agreements, there is a hybrid type of buy-sell agreement called the wait-and-see agreement. This unique and highly flexible tool allows the parties to wait until the triggering event occurs to see which buyer - or combination of buyers - would serve the objectives of the parties best.

No matter which of the three types of buy-sell agreement is used, the purchase is typically triggered on the occurrence of specified events such as a shareholder's retirement, death, long-term disability, divorce, bankruptcy, loss of license, or the receipt of an outside offer to buy.

The agreement, which should (and in some states must) be in writing, can also be incorporated into the corporate charter, the by-laws of the corporation, or both. It is extremely important that the restrictions placed on the transfer of stock be documented on the stock certificates themselves.

The agreement, regardless of whether it takes the form of a cross purchase, stock redemption, or wait-and-see buy-sell, should specify a purchase price for the shares. That price should be established by (1) a stated fixed-dollar amount, (2) a formula, or (3) a required appraisal. The preferred tax method is by formula.

Why Does the Buy-Sell Agreement Make Sense?

The buy-sell agreement makes a good deal of financial sense for many reasons. It answers many of the concerns of the surviving shareholders and heirs presented earlier.

From the viewpoint of the active surviving shareholders:

- The corporation is protected against inactive, uninformed, and potentially dissident shareholders who often cause conflict over management policies such as the size of dividends relative to the level of salaries, the level or fringe benefits or other "perks" provided to working shareholder, or risks the corporation should take for growth.
- Active shareholders can be assured that the profits produced by their efforts benefit them rather than inactive shareholders (or the purchasers of their stock) and they can receive a salary commensurate with increased workload and responsibilities.

- Surviving shareholders are assured of all or the bulk of the cash needed to purchase the heirs' interests.
- The surviving shareholders know they will not have to pay more than a fair price for the stock.
- Only a buy-sell agreement can guarantee the surviving or remaining shareholders that the transition of management will be smooth and complete and that corporate control will be consolidated in the hands of the agreed-to group.
- The buy-sell agreement can be used to effect changes in ownership percentages that may be appropriate at a stockholder's death.
- A properly drawn buy-sell agreement can protect an S corporation election.
- The buy-sell agreement gives the surviving shareholders a convenient means of fulfilling the natural sense of obligation that they have toward a deceased comrade's family.
- Minority shareholders are protected against a “lockout” of their salaries. A buyout arranged during lifetime prevents a new majority shareholder from firing the minority shareholder, cutting his pay or fringe benefits, or making work so aggravating that it becomes intolerable.
- Perhaps one of the least appreciated benefits of a buy-sell agreement is its ability to prevent involuntary co-shareholdership with unexpected outsiders, such as a shareholder’s creditors who obtain stock through a legal judgment in satisfaction of debt (for example, if stock was pledged as collateral for a loan and the lender foreclosed and took the shares of stock). From time to time, shareholders are forced into personal bankruptcy. The trustee in bankruptcy automatically becomes the successor to any stock held by the bankrupt party. Finally, a divorce court may award stock to an ex-spouse. A buy-sell agreement can prevent involuntary co-shareholdership with an ex-spouse (and her husband/and or lawyer) who obtains stock through divorce proceedings.

From the viewpoint of the deceased shareholder’s heirs:

- A binding and properly funded buy-sell agreement not only helps provide a market for what might otherwise be an unmarketable asset, it helps assure that the decedent's heirs will receive a reasonable price for the stock – especially if the decedent held only a minority interest.
- After the agreement is executed, their economic futures will no longer be tied to the fate of the business and they will be free from worry about the financial success of the business.
- The payout of buy-sell proceeds will reduce the pressure to liquidate other estate assets and provide the cash to pay estate taxes and other settlement costs.
- A properly drafted buy-sell agreement will help establish the value of the stock for death-tax purposes and therefore avoid costly and aggravating IRS litigation as well as the legal and emotional costs of a valuation dispute with the surviving shareholders.

- A buy-sell agreement provides a means to withdraw funds from a family corporation income tax free at death and with capital gains treatment (which may include lower tax rates and a tax-free return of the stockholder's tax basis) during lifetime.
- A buy-sell agreement may increase the cash flow of the heirs as well as reduce their financial risk. Cash flow may be increased since even if the business can afford to pay out a dividend - and in fact does so - the decedent's survivors will have only the after tax income to use for living expenses. Worse yet, all their income will be from the one source - the business - and will be lost if the business goes bankrupt. The buy-sell agreement replaces stock with cash that, if reinvested, can produce income.
- If the deceased shareholder held a controlling interest, a buy-sell agreement can avoid the problem that arises when a key employee (including a minority shareholder employee) ends up operating the business. Without a buy-sell agreement, the family may be at that person's mercy (on the other hand that person may be hamstrung by a family who knows little about how the business must actually be operated). With a buy-sell agreement funded with life insurance, the family has cash and the operator(s) of the business run it without interference.
- The “50 percent stalemate” is broken through a buy-sell agreement. A fifty percent shareholder's interest is more like a minority than a majority shareholder's stock in some ways. There is a loss of salary at his or her death, his heirs have no right or ability to force the corporation to pay dividends, and, at least temporarily, as a practical matter, the surviving shareholder controls the board of directors until the next annual meeting.
- A buy-sell agreement prevents the “lock out” of income flow of minority shareholders. Without a buy-sell agreement, the minority shareholder may find himself without a means of being sure he or his family will ever recover his investment in the business.

CONCLUSION:

A business owned by two or more parties with no funded buy-sell agreement is a source of income in peril. Without a properly drafted document that provides an orderly, organized, and assured transition under predetermined conditions, the result is often chaos, confusion, and bitter disappointment.

This risk can quickly, simply, and relatively inexpensively be alleviated or eliminated through a fully and properly funded buy-sell agreement.

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