Business insurance strategies

Protect your business ownership

If you are in business with other people, funding a Buy Sell agreement with insurance can ensure an orderly transfer of ownership in the event that you or another owner dies or is disabled.

What are the risks?

If a business owner dies, in the absence of any specific arrangement, their interest is likely to be:

- distributed in accordance with their Will (eg to their surviving spouse), or
- otherwise controlled by their beneficiaries (eg if the interest is owned via a family trust).

As the new part-owner of the business, the spouse (or beneficiaries) would then be entitled to the same management and financial rights as the deceased owner.

But the remaining owners may not be happy admitting the deceased owner's spouse (or beneficiaries) into the business and ownership disputes could arise.

The deceased owner's spouse (or beneficiaries) might not have the necessary skills to assist in running the business, or even want to be involved.

Furthermore, the remaining owners may not be able to raise enough money to buy the departing owner's equity in the business, nor agree on the price.

Buy Sell agreements

To protect the business and ensure an orderly transfer of ownership, a Buy Sell agreement should be considered as part of the broader succession planning process.

A Buy Sell agreement is a legal contract between business owners that usually comprises two components:

- a **transfer agreement**[1] that outlines what will happen to each owner's business interest if certain events occur and how the interests will be valued, and
- a **funding agreement** that outlines how the money will be raised to finance the ownership transfer and who will receive it.

Roll of insurance

There are a number of ways a Buy Sell agreement can be funded. For example, the remaining owners may be able to buy out the departing owner's interest using their own capital or borrowed money.

However, when it comes to death and disability, insurance is usually considered the most cost-effective and efficient way to raise sufficient capital.

Other key considerations

- Because a Buy Sell agreement affects your legal rights, it should always be prepared by a solicitor (preferably one that specialises in this area).
- There are a number of ways to structure the ownership of insurance policies used to fund a Buy Sell agreement. As each ownership method will have different legal, tax and stamp duty implications, the ownership should be reviewed by the advising solicitor and registered tax agent.

[1] The business interest can also be transferred through a partnership agreement, unitholders' agreement or shareholders' agreement.

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Case study

Alex and Bill each owned 50% of the shares in a successful engineering business when Bill died suddenly.

Bill's shares were inherited by his wife Lynn via his Will and, because there was no Buy Sell agreement in place, Lynn is not obliged to sell the shares to Alex and Alex is not obliged to buy the shares from Lynn. Furthermore:

- there was no agreed price or timeframe for the transfer of Bill's shares
- there was no insurance in place to enable Alex to buy the shares, and
- Alex doesn't have enough funds to buy out Lynn and doesn't have the capacity to borrow the money.

To further complicate matters, Lynn is entitled to the same management rights and share of profits as her deceased husband, while Alex is doing 100% of the work and only receiving 50% of the profits.

This outcome could have been avoided if Bill and Alex had sought financial and legal advice and executed a Buy Sell agreement, funded by insurance. By using this strategy, Lynn would have received the insurance proceeds in exchange for handing over her interest in the business to Alex.

As a result, Lynn would have been fully compensated, while Alex would have taken ownership of 100% of the business and received 100% of the profits.

Note: In this example, the insurance proceeds would be paid directly to Lynn. However, different payment arrangements may be preferable for businesses set up under certain ownership structures, or due to the preferred approach recommended by your solicitor and/or accountant.

Other business insurance needs

- Insurance can be used to protect your business revenue if you (or another key person) die, become disabled or suffer a critical illness. To find out more, ask your adviser for a copy of our **'Protect your business revenue'** flyer.
- You may also want to use personal insurances to protect your income if you are unable to work due to illness or injury. To find out more, ask your adviser for a copy of our **'Protect your income'** flyer.

Seek advice

A financial adviser can help you assess all the issues that need to be considered and determine whether funding a Buy Sell agreement with insurance suits your needs and circumstances.

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