Client Report

Business Protection

2019

Business Protection Issues

Succession Planning (SP)

What would happen if:

- One of your business partners is killed or debilitated in an accident.
- One of your business partners wants to retire.
- One of your business partners is not pulling their weight.
- Your business partners have a major and seemingly insurmountable disagreement.

Overwhelmingly, business owners fail to plan for these events, making the transfer of wealth complicated, inefficient and potentially unfair. The succession plan should be planned and clearly documented in a shareholder agreement, including a “buy-sell” component with a business valuation methodology.

Key People

A key person is someone who provides the ideas, drive, initiative and skills that generate the business profits.

What would happen if your key people were unable to work? How would you manage the financial effect and replace the skills of a key person in a timely manner?

The sudden loss of such a person has inevitable costs, not all of them obvious. As well as reduced sales or profits until a suitable replacement is found, there will be recruiting, specialist training and familiarisation expenses. There invariably is a negative impact on capital value, goodwill and credit rating of the business.

Key Person insurance can be a funding mechanism for loss of revenue and recruitment in the event of key person death, disability or critical illness. Who are the key people in your business?

Loan cover

If a loan guarantor or a key person is unable to work, loan repayments will still need to be made, and the bank may call in the loan. Loan cover addresses this risk and means the business and the personal assets of guarantors are protected.

Succession Planning In Detail

Succession Planning can cover death, disablement, Illness, retirement, (under) performance and other issues:

- What is your business succession plan? Who will run the business?
- Do you have a business agreement? What does it say about succession?
- How will exiting partners, or family members receive money from the business?
- How will remaining owners continue to run the business in the event of an owner leaving?

Buy Sell cover for SP

If one of several specified events occurs to a business partner, such as death, disablement or critical illness, then their equity in the business is transferred to one or more remaining partners.

As part of this agreement, funds are payable to the insured or their estate. These funds are provided through insurance where possible, or otherwise funded via staged payments from the business (if there is no insurance or it's an uninsurable event).

When it comes to obtaining cover to fund buy sell agreements, almost half of business owners surveyed (Cameron Research, 2010) suggest they've heard of it – but only 13% actually have cover to fund a transfer of business interests in the event of death/disability or critical illness.

Why is SP important?

1. There is no 'business court'. Unlike family law, there is no equivalent for business. No court cares about the continuation of the business.
2. A partnership or shareholders' agreement is not guaranteed to cover the exit of a business partner. Usually it covers first right of refusal, which works in favour of the non-exiting partner.
3. What happens if the non-exiting partner refuses to buy the share of the business from the exiting partner? You need to find someone else to buy it and have the remaining partner agree.
4. The value of the business will be determined according to a pre-determined methodology to avoid dispute.
5. If there is no agreement, the partnership act only covers the sale of assets i.e. the dissolution of the business, so does not allow for the continuation of the business.
6. If you are negotiating after the death of a business partner who are you negotiating with? The beneficiaries can be a range of people.
7. If there is no will (and 50% of people don't have a will), in Victoria an initial $100,000 goes to the spouse, with the balance split between the spouse and children.

SP Ownership

- Self-ownership.
- Absolute entitlement trusts.
- Cross ownership.
- SMSF – not possible as renders the fund non-compliant.

You want the money going to the people it's supposed to be going to, with tax minimised.

We will discuss the features and benefits of different ownership types with you in terms of tax deductibility, CGT, FBT, transferability and cost.

Who Pays?

Sometimes (often) there is a premium discrepancy between business partners and a sense of unfairness when dealing with partners of different ages and varying health.

Possible solution:

- The premiums come out of the individual's distributions, loans, dividends etc.
- Use a system where everyone pays 50% of their own premium and the remaining 50% is pooled and paid proportionately.
- Use a carrot and stick approach when dealing with someone who smokes or is not very healthy due to lifestyle. Change habits so all benefit from lower premiums.

We will determine with you the most appropriate funding solution for your business.

Valuation & Documentation

An integral part of the SP is the valuation process, and the funding of the SP needs to be transparent, clearly documented and reviewed in line with changes in the market value of the owners' business interests.

This is usually documented via a shareholders' agreement with customised buy-sell clauses. We will help you agree and document your succession, key person or loan cover plan.

Common methods for valuing a key person:

- Salary multiple (6x).
- Replacement cost.
- Net revenue multiple.
- Combination.