Strategy 3
Protect your business ownership

If you have some equity in a business you own with other people, you should consider establishing a Buy Sell agreement funded by insurance.

What are the benefits?

By using this strategy, you could:

- enable the remaining owners to acquire your interest in the business in an orderly manner if you die or become disabled, and
- ensure you (or your estate/dependants) receive adequate financial compensation.

How does the strategy work?

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.

Potential problems can also occur if a business owner becomes disabled and is unable to work in the business again.

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).

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.

Note: While a Buy Sell agreement will be less important for businesses in which little equity is held, it's still important that the owners of such businesses establish a broader succession plan.

To find out whether you need a Buy Sell agreement and the best way to fund it, you should speak to a financial adviser who specialises in business insurance. A financial adviser can also review your insurance needs over time to make sure you remain suitably covered.

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

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 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[2].

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: This case study highlights the importance of speaking to a financial adviser about establishing a Buy Sell agreement funded by insurance. A financial adviser can also address a range of potential issues and identify other suitable protection strategies – see Tips and traps.

Tips and traps

- 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.
- There may be some advantages in taking out the Life and TPD insurance in a super fund (see Strategy 7).
- It may be more cost-effective over the longer term if you pay level premiums, rather than stepped premiums that increase each year with age (see Strategy 8).
- You should consider using insurance to protect your assets and business revenue (see Strategies 1 and 2).
- You should also make sure you have enough personal insurance to protect yourself and your family if something happens to you. To find out more about using insurance for personal protection purposes, see our 'Smart strategies for protecting you and your family' guide.

2 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 preferences of your solicitor and/or accountant.