

FUNDED BUSINESS SUCCESSION AGREEMENTS

What is a funded business succession agreement and why would I need one?

A danger period for many established, wholly or substantially owner operated businesses, is the time when a principal of a business departs, whether because of retirement, new horizons, disagreement, illness or death. The value and even viability of a business can be reduced or eliminated if the business fails to make a successful transition to a new ownership structure. The likelihood of a successful transition increases dramatically if a properly funded agreement as to this transition can be put in place ahead of time.

WHAT IS A FUNDED BUSINESS SUCCESSION AGREEMENT?

A Funded Business Succession Agreement is a document that deals with the immediate or future succession of business ownership. An Agreement can be between:

- Two or more business principals
- One or more business principals and key staff, family members or other prospective successors.

Funded agreements usually take two forms:

1. Funded *agreements dealing with an involuntary departure* of a business principal from the business - funded events can include death, total and permanent disability and critical illness. The agreements are most commonly (but not necessarily) wholly or largely funded by life insurance products and are entered into once the life insurance cover is in place. It is critical that the ownership of the insurance policies be completely in line with the terms of the funded agreement and with the estate planning objectives of each principal.

It is often helpful, prior to finalising policy ownership for the risk advisor and the principals to have met with:

- The business accountant – particularly to identify business valuation and tax issues and to get an understanding of the business structure and which people or entities (ie “the proprietors”) hold the equity in the business and any associated entities.
- The lawyer who is to draft the agreement.

2. *Voluntary departure agreement*, dealing with the eventual departure of a business principal, eg. on retirement.

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VALUATION METHODOLOGY

To ascertain the necessary level of funding required, it is critical that a mechanism for valuing the business be determined and set out in the agreement. This requires the business principals to agree on a formula for valuing the business and various methods are used, eg. a multiple of gross fees, new or trailing commissions or the buy-back figure of a franchisor. The role of the business accountant is often critical here in determining the appropriate figure and in identifying any taxation issues that need to be considered or funded, eg. capital gains tax.

TYPES OF FUNDED SUCCESSION AGREEMENTS

There are three main types of Funded Succession Agreements used, ie. mandatory but contingent, contingent option, and forfeiture.

- **Mandatory but Contingent** – where the transfer of business equity under the Agreement is mandatory, but contingent upon a “condition precedent” event (eg. a death, defined health crisis or other defined funded event) but is automatically triggered should the funded event occur.
- **Contingent Option** – where both the continuing and exiting principals (and their associated proprietors, eg. family companies and trustees of family trusts) have the power to exercise options to transfer equity in the business should defined events occur. These arrangements can be made more flexible by providing that a nominee can be put forward when an option is exercised.
- **Forfeiture** (limited application) – where an exiting principal forfeits their interest in the business. This type of agreement is usually only applicable to businesses with high personal goodwill, and no or very low business goodwill, and negligible other net assets, eg. where the depreciable assets used by the business are leased.

Critical illness insurance (as well as income continuance insurance) is often taken out in addition to death and total and permanent disability cover to ensure that a business has adequate revenue to cover the shortfall that is likely to occur if a business principal is incapacitated or has died.

CONSIDER THIS REAL LIFE EXAMPLE

John, Michael and Adrian are the principals of an established and successful construction business. John, who has a wife and three young children, is tragically killed in a motor vehicle accident. Contrary to the advice given by their advisors at the time the business commenced, the principals do not have a Funded Business Succession Agreement with supporting life insurance policies in place. At the time, they didn't think the cost was warranted.

For the years prior to John's death, the construction business has been applying most of its profits towards funding the expansion of its operations and while the business is very successful, neither the business nor the principals have large reserves of cash.

John's interest in the business has been valued at \$1,000,000 and his widow Jill (who is a full time mother) desperately needs this money to support herself and her three young children. John's death could not have come at a worse time as neither the business nor Michael and Adrian can raise the \$1,000,000 required to pay Jill the value of John's interest in the business. Accordingly, Jill has no alternative but for John's estate to sue the business in order to force the business to arrange for John's estate to be paid the value of John's interest.

The ensuing court case cost Jill all of her accumulated savings and although she won the case and the business was ordered to pay John's estate \$1,000,000 plus costs, it resulted in the business becoming insolvent.

What was the outcome?

The outcome was that the business had to be sold. After paying the insolvency costs and repaying loans due to the secured creditors from whom the business had borrowed money to fund its expansion, there was nothing left to pay the \$1,000,000 owed to John's estate or to pay a return to Michael and Adrian for all their years of work in the business.

In order to survive, Jill had to sell her home, move herself and her three young children in with her parents and get a full time job.

Could this situation have been avoided?

This terrible outcome could have easily been avoided if John, Michael and Adrian had taken the prudent advice of their advisors at the time they formed the business and put in place a Funded Business Succession Agreement. If this advice had been taken, when John died the following events would have occurred:

- *Insurance proceeds would have enabled John's estate to have been paid the value of his interest in the business within a few weeks of his death and Michael and Adrian would have acquired John's interest in the business*
- *Jill would have been able to keep her home and continue to be a full time mother to her children*
- *The business would have continued to prosper and been able to achieve the long term goals of its principals notwithstanding the death of one of the principals*
- *The untimely death of John would not have resulted in the collapse of the business and the impoverishment of John's family.*

FURTHER INFORMATION

For further information about Funded Business Succession Agreements, or about Business and Estate Succession Planning strategies please call us or visit our website to find an office near you.