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With over 18 years' experience in the insurance and corporate services industry, James McFarland leads Stanford Brown's Risk Insurance team. He is well known for his friendly and professional manner as well as an advocate for his insurance clients at claim.
James started in the Insurance industry in October 2000. He has extensive experience partnering with high income earners, business owners and partnerships in developing tailored insurance solutions to meet both their individual and business needs.

A GUIDE TO BUSINESS INSURANCE

James McFarland

In over 30 years of business Stanford Brown has gained extensive experience partnering with small to medium sized business owners.

As 'small business' owners ourselves, we understand that the business is your passion, your life, and your retirement plan.

We partner with business owners to help them achieve both their personal and business goals.

We find that business owners are so busy in the day to day demands of running a business, little time is left to plan and protect the business.

Often overlooked by small business owners is the importance of making sure that they have the right structures in place to protect both themselves as shareholders and the business in the event of a shareholder exiting.

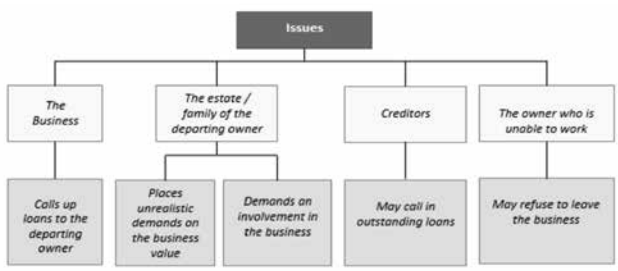
There are three main ways a shareholder may exit the business:
1. voluntary exit – planned retirement or career change
2. forced exit – causes may include a dispute amongst shareholders, a disengaged or absent shareholder, non-performance of a shareholder, bankruptcy or fraud
3. involuntary exit – the death or severe illness/disablement of a shareholder

A well-constructed shareholders agreement will make provisions on how to treat an exit from the business under the above three circumstances.

The purpose of this paper is to explore what can happen after the involuntary exit of a shareholder, and how to minimise the impact this can have on both the business and the remaining shareholders.

Issues that arise in the event of an involuntary exit may include:

Figure 1. Involuntary exit of a shareholder



Also, a business generally depends on a few people to produce the profits, provide the capital or manage the business. Without a well-prepared business protection plan, there may be significant financial hardship for the remaining business owners, as well as for the surviving family members.

The quote

The valuation methodology should reflect the standard practice used if you were to sell the business

Buy sell or exit agreements

Generally known as a succession agreement the buy sell or exit agreement is essentially a pre-nuptial agreement for the business.

The terms are outlined in the company's shareholder agreement or a subsequent addendum and sets out a contingency plan to cater for the interests of all owners in the event of an involuntary exit from the business.

The shareholders generally agree to:

a) have control of the business retained by the remaining principals

b) ensure the outgoing principal/their estate receives fair and equitable value for the release of their equity and control.

A well-structured agreement will address four major issues:

1. The share transfer mechanism (put & call option)
2. The payment terms for the exit
3. The business valuation methodology
4. The funding solutions.

Put and call options

The most commonly used mechanism to transfer the shares in the event of a trigger event is called a put & call option. A put & call option requires:

1. the remaining shareholders to buy the shareholding from the exiting shareholder or their estate and;
2. the exiting shareholder or their estate must transfer the shares

The put and call option creates certainty for both sides of the transaction by providing:

- Certainty for the departing owner or their estate, enabling them to realise the value of their shares within an acceptable timeframe and at a pre-agreed price/valuation.
- The family of a deceased shareholder are not forced to work in or contribute to the running of the business.
- Likewise, the remaining shareholders are not forced to work with the family members of an exited shareholder who may not be qualified or suited to appropriately contribute to the business.
- The estate does not have the discretion to sell shares to a third party, such as a competitor.

Without this agreement in place the business is not compelled to purchase the shares from the exited/deceased shareholders estate, nor is the exited/deceased shareholder required to sell the shares.

Payment terms

The agreement sets out the payment terms for an exiting shareholder.

The easiest and most common option is to provide 100% payment for the value of the shares on exit.

Alternatively, a percentage of the value can be funded upfront, usually 20-30% with the balance funded over an agreed period (usually 3-4 years).

It is important to consider the impact the payment terms will have on the business.

If the agreement provides funding over an extended period, the payments are likely to occur in a period of reduced or declining cashflow, and funding a share exit during this period may be difficult.

Likewise, if funding 100% of the value upfront, it is important to consider where funding is likely to come from, regardless of the economic timing of the exit.

Each business is different and the payment terms should reflect its needs.

Valuation methodology

One of the most important terms to be outlined in the agreement is how the valuation of the shares is determined in the event of an exiting shareholder.

The valuation methodology should reflect the standard practice used if you were to sell the business under normal circumstances.

There are a number of options available:

- The most common is a multiple of EBIT (earnings before income tax) reflecting the industry norm for your business.
- Some agreements set a pre-agreed valuation amount as a set dollar figure which is agreed to by all shareholders.

It is important to recognise that this may be problematic if the valuation amount is not reviewed on a regular basis. If an exit arises and the valuation does not reflect the current/true value of the business the estate may be underpaid for the true value of the shares or the business is compelled to purchase the shares at a premium.

Some shareholder agreements discount the valuation methodology used for a forced exit. This is usually as a result of the individual shareholders wrongdoing affecting their ability to be a shareholder and/or work within the business. The discount is agreed between the shareholders and could range from 20-50% of the agreed valuation methodology.

The agreement should also outline who will complete the valuation at the time of exit. This is generally completed by an external party.

Funding options for a buy/sell

There are four main strategies for the funding of a buy/sell agreement:

1. Borrow the funds
2. Personally fund
3. Repay the value over a set period
4. Obtain insurance coverage.

Borrow the funds – Borrowing money at the time of an exiting shareholder may be complicated. The more involved the shareholder was in the day to day running of the business, the greater the chance the lender will view the loan as high risk and be less likely to provide funding.

Personally fund – the remaining shareholders may sell business or personal assets to fund the exiting shareholder. Realistically, most self-employed people have the majority of their assets tied up in their businesses and their personal assets such as the home are already used to secure borrowings for the business, meaning this option is often not viable.

Repay over a set period – One option is to repay the exit over a period of time. This would be a drain on future years cashflow, putting undue stress on the business at a time of likely reduced income effected from the loss of business partner.

Obtain Insurance coverage – The most common and simplest method for funding an exiting shareholder is through insurance. While you cannot insure against all possible trigger events, you can obtain life insurance policies to fund an exit in the event of a shareholders death or permanent disablement.

Ownership of shareholder insurance

The shareholders insurance policies are usually personally owned by the individual shareholder. If the cover is owned by the business, receipt of the insurance proceeds on claim would inflate the valuation of shares (due to the cash surplus held by the business).

1. An added benefit of personal ownership is the flexibility and transportability of the cover which allows:
2. The business owner to maintain the cover personally if the cover is no longer required for business purposes.
3. Ease in making changes to cover when there are changes to shareholdings in the business.

Less common is cross ownership of the insurance policies. This is where the insurance on one shareholder life is owned by the other shareholders. This method is not usually favoured as the policies ownership would need to be changed when there is a new or exiting shareholder in the business which may trigger unintended tax consequences in the event of a claim.

Premium funding of shareholder insurance

Most businesses choose to fund the premiums on behalf of the shareholder. This is usually the optimal solution as:

- It creates equality amongst shareholders in that the premiums vary depending on the age and sex of the shareholder, the larger the age gap the higher the discrepancy.
- It enables the business to oversee the renewal of cover to ensure the insurance is not lost due to non-payment of premiums

It is important to note that funding the premiums through the business will result in fringe benefits tax being payable on the premiums paid. The company will normally inflate the shareholders income drawings to reflect their share of insurance premiums plus the tax liability.

Generally speaking, shareholders insurances cannot be funded from superannuation.

Taxation of insurance proceeds and share transfers

The payment of insurance proceeds does not normally trigger a tax liability as it is a personally owned insurance policy which pays the proceeds directly to the life insured, their beneficiary or estate.

While the shares are transferred to the remaining shareholders with no money transaction between the business or the exiting shareholder, the capital gains tax liability of the transferred shares will be calculated on a fair value basis. What this means is that the valuation of the shares will be determined on the date of transfer and tax will be payable based on this value, as though full payment was made for the sale of these shares.

It is for this reason that the valuation methodology in the agreement should reflect the method which would be used to determine the fair value of the shares on transfer. If the value provided to the exiting shareholder or their estate is at a discounted rate, they will still be liable for the payment of the full tax liability on the sale of shares.

Other areas to consider

Debt protection

In most loan agreements for small businesses, the lender requires the business owners to provide personal guarantees against a loan. This is usually secured against their family home or other personal assets not linked to the business.

In the event of an unexpected exit as a result of the death or illness of a shareholder, the loan provider is likely to 'call in' the loan.

Should this occur, the shareholders (or their estates) are called upon to repay the loan facility immediately. If they are unable to repay the loan the lender may take steps to take ownership of the security assets.

The business should consider taking out loan protection insurance to protect the personal assets of the shareholders. The policy is owned by the business and will provide the cash required to settle the debts in the event of a trigger event.

It is important to ensure that each shareholder is insured for the full value of the loan facility, not the percentage of debt reflecting their ownership of the overall business. In the event of the lender 'calling in' the loan, they may require full payment of the debt to be made, not just the portion of the loan in relation to their shareholding of the business.

Keyperson protection

Keyperson protection needs can be split into two categories:

1. Revenue protection
2. Capital protection.

Revenue protection

In many small businesses medium term income loss can have long term financial consequences for both the business and its shareholders.

The majority of income can usually be attributed to the skills, actions or relationships of a few key persons within the business. The loss of one of these key persons would cause a reduction in revenue and may result in severe financial stress on the business.

It is therefore important to consider insuring these key persons against the business losses should they die, become permanently disabled or suffer a major illness.

The insurance proceeds can be used by the business to supplement the loss of income and provide breathing space until the key person is replaced.

Capital protection

The loss of a key person may incur large capital expenses to the business such as:

1. Recruitment costs
2. Education costs
3. Incentive bonuses (to entice the right person into the role)
4. Loan/debt protection.

In some skilled industries, the cost to provide the above may cause short term financial hardship on the business which can be mitigated with a keyperson insurance policy.

Ownership, taxation and deductibility of keyperson & debt protection insurance

Keyperson insurance policies are owned by the business. In the event of a claim the proceeds are paid directly to the business as the policy owner.

Tax deductibility of premiums and the taxation of the proceeds will depend on the purpose of the insurance policy as per the below table:

Keyperson purpose	Premium tax deductible	Proceeds taxable
Revenue	Yes	Yes-treated as income to the business
Capital (including debt protection)	No	No

It is important to note that key persons in the business may not necessarily be shareholders.

Types of insurance cover

There are three main types of insurances used to support business succession planning:

Death cover - provides a lump sum payment in the event of death or a terminal illness diagnosis of the life insured.

Total & permanent disablement - provides a lump sum payment in the event of the life insured being permanently disabled and unlikely to ever return to work. TPD insurance can have an any or own occupation definition.

Under an any occupation definition, the insurer will consider a claim if the life insured is unable to return to work again in any occupation for which they are suitably qualified.

The own occupation definition allows for a claim to be considered based on the life insured's inability to return to their specific occupation.

When developing a shareholder's insurance plan, own occupation definition should always be used to ensure the greatest likelihood of a successful claim in the event of disablement.

Trauma Insurance - provides a lump sum payment in the event of the diagnosis of a specified major illness such as severe cancer, heart attack or stroke. While not traditionally used for shareholder protection purposes (as the diagnosis of illness does not necessarily result in the exit of the business), it is a valuable form of insurance cover used to mitigate the loss of short-term revenue, in the event of a key person illness, or to reduce company debts.

Business protection in action – case study

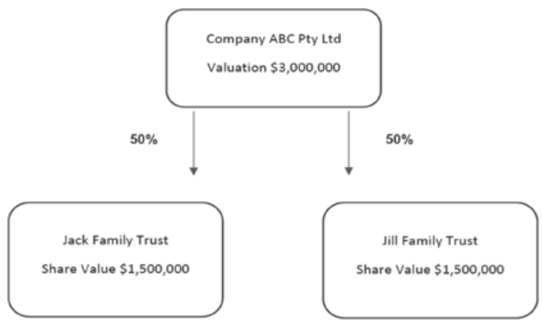
Jack and Jill are equal shareholders in ABC real estate agency and are both actively working in the business. Their respective shareholdings are owned through their family trust which distributes income across their families.

- They estimate the value of the business to be $3M which was determined as 2 times EBIT.
- The agency has $1M in debt used to fund the purchase of a neighbouring real estate business and their rent role.
- Both Jack and Jill provided guarantees against their homes to obtain the business loan.
- Jack is the primary property sales person in the business generating approximately $500,000 in sales commissions annually.
- Jill manages the rent roll which generates an additional $500,000 in revenue to the business.
- They employ three other sales people who generate $500,000 annually in revenue.
- Jack and Jill wish to implement a shareholder protection plan to protect the shareholders and the business in the event of the unexpected departure of one of the shareholders.

Company Overview

Business Details			
Business Name		Company ABC Pty Ltd	
Name of director	Trust name	Occupation	Smoker status
Jack	Jack family trust	Director/property Sales	Non-smoker
Jill	Jill family trust	Director/rental roll	Non-smoker

Figure 2. Business valuation



Company ABC Insurance:

Shareholder/director	% Equity	Sum insured
Jack	50%	$1,500,000
Jill	50%	$1,500,000

Shareholder insurance requirements:

Share transfer funding - As equal shareholders in the business both Jack and Jill would require $1,500,000 death and permanent disablement cover to fund their exit should they suffer a trigger event.

Loan protection - The agency has a $1,000,000 loan facility which they have each secured through their family homes. To provide maximum protection we would recommend the need for $1,000,000 each in loan protection cover.

Keyperson protection - The revenue from Jack is primarily as a result of the relationships and contacts he has in the community. While the loss of Jill to the business would create a gap, they feel that her role managing the rental roll would be easier to fill.

As a result, we would consider $500,000 keyperson insurance cover for Jack to protect the business against loss of income.

They could also consider an additional $50,000-$100,000 to assist with recruitment costs and onboarding bonuses, to help attract the right person into the role.

Cover purpose	Policy owner	Life insured	Type of cover	Level of cover
Share transfer funding	Jack	Jack	Death Permanent Disability	$1,500,000 $1,500,000
	Jill	Jill	Death Permanent Disability	$1,500,000 $1,500,000
Loan protection	ABC Pty Ltd	Jack	Death Permanent Disability	$1,000,000 $1,000,000
	ABC Pty Ltd	Jill	Death Permanent Disability	$1,000,000 $1,000,000
Keyperson protection (revenue purposes)	ABC Pty Ltd	Jack	Death Permanent Disability Trauma	$500,000 $500,000 $500,000

Other considerations for business owners

Income protection

The Shareholders agreement will normally specify that a shareholder needs to be absent from work for 1-3 months after which time the business will cease income and/or share distributions to that shareholder. This protects the business from having to fund income to a non-working shareholder when the business is likely to hire a temporary or permanent replacement to fulfil the duties of that shareholder.

Individual shareholders should consider the personal financial impact of income ceasing.

Income Protection insurance can be obtained by the individual shareholder to provide certainty over their long-term ability to provide an income to meet their personal financial commitments.

A personal income protection policy has a waiting period before monthly income payments start, and the longer the waiting period the lower cost of the insurance. It is therefore worth considering a longer period in the agreement before terminating income payments (3 months) to reduce the cost of accompanying personal insurances.

Business expenses

Shareholders should consider the ongoing financial obligation of an absent shareholder in funding their share of the ongoing expenses of the business.

Rent, employee wages and other regular expenses such as phone and electricity bills would continue regardless of the shareholders health and ability to generate income within the business.

Business expenses insurance provides the business with an ongoing monthly income to help fund the absent shareholders expenses, ensuring the business can continue to operate until they return to health.

Personal insurance requirements

It is important that shareholders consider the impact of the shareholders insurances arrangements may have on their personal insurance portfolios.

As the shareholder insurance cover will be paid to their family/estate, this amount can be offset against their personal insurance requirements (making sure to allow for CGT implications on share transfers).

It can also be quite beneficial to review all business and personal insurances policies under the one review, insurers offer large sum and packaging discounting which would reduce the premiums to both the shareholder and the business. FS