

BUSINESS SUCCESSION STRATEGIES

Is the buy-sell agreement enough?

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Have you thought about your business succession strategy? Simply put, what is going to happen if you ‘die at your desk’?

Financial products

The financial services industry has created some sophisticated products and services that can be tailored to people’s individual needs and, which are important to consider in business succession planning.

While most people want to retire from their business on their own terms, their exit from the business may be forced on them through death or disability. Provided business owners take the time to assess and cater for these needs they can avoid a significant amount of anxiety when misfortune strikes.

Prudent business owners will have life insurance, Superannuation and other risk insurances in place to ensure that their families are well cared for in the event of death or permanent disability.

Insurance is a useful mechanism to fund the transfer of a share in an enterprise from the deceased or disabled business owner to the remaining business owners in the enterprise for a proper value.

The financial products are not sufficient without agreements in place to trigger the intended consequences of the business owners when purchasing those financial products.

In other words not only should the business owner have a Will dealing with his or her personal estate, but the business should have a “Will” dealing with its succession too.

The structure of the insurance is, to some extent, governed by how a business owner’s interest in an enterprise is held. For example many people will hold interests in trusts, or, in a spouse’s name, or, in some other entity rather than in their own names. The business structure chosen is usually designed to reduce exposure to liability generally, or, to tax in particular.

Insurances may be taken out as business owned policies, self-owned policies, cross-owned policies or even trust owned policies.

The type and value of each policy that an enterprise takes out will be determined to some extent by the outcomes that the business owners want to achieve.

Achieving Value

The consequences of death and disability give rise to an array of issues that business owners should consider when dealing with their exit strategy from the business.

Often the beneficiaries of an estate are unwelcome as business owners of an enterprise. What if a person becomes disabled and so is unable to provide his or her personal services to the enterprise?

The remaining business owners may want that person's interest to entice a replacement into the enterprise in order to sustain and grow the enterprise.

The exit strategy usually involves the transfer of an interest in an unlisted company or a partnership (the "enterprise") from the estate of the deceased to the remaining business owner.

If a person dies or is disabled, that person's share in the enterprise may be worthless to the person or his or her estate because the share is illiquid.

Determining the proper value of the interest of the departing business owner is a critical part of the process.

The determination of the value of the departing business owner's interest should be made through a process that is transparent and fair to ensure as far as possible that the outcome will be reasonable.

There are various mechanisms to achieve a reasonable outcome. For example: the determination of the value might be made by a valuer at the time of the event triggering the transaction, or, by implementation of a buy-sell mechanism such as an auction. Each mechanism has advantages and disadvantages that must be considered carefully.

Once the value is established and the funding put in place the business owner needs to ensure that the intended consequence is achieved.

The buy-sell agreement

In the context of the enterprise, there is little point in taking out the insurance to fund the exit without putting in place a mechanism to trigger the transfer of the interest from the estate of the departing business owner to the remaining business owners, once the event in respect of which the insurance cover is taken, happens.

This mechanism is called a 'buy sell agreement' and is entered into between the business owners. The typical buy-sell agreement is a short form agreement dealing with the distribution of the proceeds of the insurance policies on the occurrence of a trigger event and the consequent transfer of the business owner's interest in the enterprise.

The short form agreement may be sufficient in the context of a person departing from an enterprise as a result of death or a disability; however, it may not always be the case.

The buy-sell agreement can lose its efficacy, for example, where a party becomes uninsurable and other mechanisms are required to achieve an orderly transfer of interest for value. Similarly, the insurance company may disallow the payment in certain circumstances; for example, where there has been a material non-disclosure by the deceased or disabled person.

The buy-sell agreement should be sophisticated enough to take into account all foreseeable circumstances where succession planning is required.

Is the buy-sell agreement sufficient?

A buy-sell agreement is no more than an agreement between the business owners dealing with ***some but not all*** of the issues that may need to be regulated between them.

Business ownership agreements can, in fact, deal with a comprehensive set of issues that will inevitably affect the operations of the enterprise before, during and after the occurrence of the trigger event for an insurance payout.

In other words, the agreement can govern the relationship between the parties in relation to the enterprise generally, anticipating and dealing with issues that usually bedevil the parties to such an enterprise *including death and disability*.

In determining the range of issues that the business owners may want to cover it is important to identify the vision and goals of the business owners, as well as the needs of the enterprise operationally, in order to enshrine them in the agreement.

Business ownership agreements can include provisions regulating entry and exit of parties **in any circumstances**, it can regulate the need for financial contributions, impose reasonable restraints of trade and confidentiality provisions, regulate the entitlement to board positions and govern decision making, which can be particularly important for minorities, enable budgeting, impose a responsibility to create and adopt business plans, regulate accounting and management reporting requirements, agree policies and procedures, deal with the protection of minority interests and outline dispute resolution provisions in the event of any disagreement between the parties.

In other words a business ownership agreement should cover all aspects of the relationship of the parties to an enterprise and the mechanics by which the enterprise is to be operated.

In summary, it is important to have funding arrangements in place to deal with the vagaries of life, but those funding arrangements should be backed by the appropriate agreement. The appropriate agreement should regulate the complete relationship of the parties to the enterprise in a fair and reasonable way.

A well crafted business ownership agreement can remove the cause of business stress, or, provide a pathway to resolve the cause of business stress thereby enhancing the health of an enterprise and so giving it the best chance to achieve its goals in a competitive world.

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