# Drafting Buy-Sell Agreements and Ownership Issues of Insurance

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## PART I: BUSINESS SUCCESSION OVERVIEW

### Introduction

Most business people spend most of their time working in their business. If they are very organised, they may even spend some time thinking about how to sustain and grow their business. But how much time do they spend thinking about how to protect the wealth they are building, or how to realise and pass this wealth on? This is what business succession planning is all about.

Business succession planning is part of the answer to the 'why' of business, rather than the 'how':

- Why did you take the risk of buying or starting up your own business?
- Why do you spend every waking hour working in or thinking about your business?
- Why are you building wealth within your business?

Common answers include: "to support a lifestyle", "to ensure a secure retirement", "to pass something on to the next generation", "to build something lasting and of substance", "to leave a mark", "to do my bit for the community". If these are the reasons why someone is in business, then business succession planning is a very important part of what they should be doing.

The best time to think about business succession planning is before you go into business. But there is never a bad time to start. We generally turn our minds to succession planning when an unexpected 'trigger event' occurs – a law suit from a disgruntled customer, an acrimonious divorce, the death of a good friend at a young age, or a falling-out with a long-standing business partner. The difficulty with this timing is that the planning is then reactive, and the outcomes are often compromised.

All business people need to have answers to the following questions:

- What if you want to (or have to) sell your interest in your business – would you get a fair deal from the other owners of your business, or will they get a bargain?
- How would the other owners fund the purchase? Do you need insurance policies to cover this?
- Who are likely alternative buyers, and how would they fund the purchase?
- How do you find out what your business is worth?
- If you sell your business, either to a third party or a family member, how much tax will you pay? Are you appropriately set up to qualify for any tax concessions?

Business succession planning involves detailed consideration of a number of commercial, legal and financial matters. A Buy-Sell Agreement goes a long way towards answering most of the above questions, and is the focus of this paper.

**The objective of business succession planning**

The overall purpose of business succession planning is to maintain and enhance the overall business value for all participants. This is achieved by:

- Agreeing on how to deal with the consequences of 'trigger events' before they happen, so as to **avoid costly disputes**; and
- Having in place a framework of documents that will **ensure business continuity** if a 'trigger event' occurs.

A 'trigger event' is an event that involves a participant in the business that has a real impact on the business. Trigger events may be:

- **Uncontrolled** (involuntary) trigger events (such as death, disability, divorce, etc); or
- **Controlled** (voluntary) trigger events (such as resignation/retirement or a business sale).

**How common are these trigger events?**

Businesses often support a large number of people who all depend on its success for such essentials as housing, food and schooling, as well as for their lifestyle and retirement. The more people involved in a business, the greater the chance of uncontrolled trigger events happening.

Common uncontrolled trigger events that affect a business are:

- Death
- Disability
- Prolonged sickness or trauma
- Divorce
- Bankruptcy
- Fraud

Common controlled trigger events that affect a business are:

- Retirement
- Resignation
- Disagreement
- Deadlock

These risks are real, and are more common than you may think.

*Death and disability rates:*

| Number of partners | Chance of 1 partner dying before aged 65[1] | Chance of 1 partner dying or becoming totally disabled before age 65[1] |
|---|---|---|
| 2 Partners | 35 in 100 | 52 in 100 |
| 3 Partners | 47 in 100 | 67 in 100 |
| 4 Partners | 57 in 100 | 77 in 100 |
| 5 Partners | 66 in 100 | 84 in 100 |
| 6 Partners | 77 in 100 | 89 in 100 |

Source: Zurich Financial Services Australia Ltd - ABN 11 008 423 372 (2012).

*Divorce rates:*

- In Australia, every third marriage ends in divorce;
- Men are more likely to die than to divorce (33.4% chance for a marriage to end in divorce, and 47% chance for a man to die while married); and
- Women are more likely to divorce than to die (33.4% chance for a marriage to end in divorce, and 22% chance for a woman to die while married) - this is due to longer life expectancy for women.

*Bankruptcy rates:*

Provisional annual personal insolvency statistics 2012-13

| State/territory | Bankruptcies (Parts IV and XI) | Debt agreements (Part IX) | Personal insolvency agreements (Part X) | Total personal insolvency activity |
|---|---|---|---|---|
| NSW | 6,799 | 3,235 | 88 | 10,122 |
| ACT | 206 | 173 | 1 | 380 |
| Vic | 4,180 | 1,846 | 79 | 6,105 |
| Qld | 6,052 | 2,706 | 54 | 8,812 |
| SA | 1,493 | 484 | 17 | 1,994 |
| NT | 102 | 102 | 3 | 207 |
| WA | 1,469 | 772 | 47 | 2,288 |
| Tas | 575 | 334 | 5 | 914 |
| **Total** | **20,876** | **9,652** | **294** | **30,822** |

## PART II: BUY-SELL AGREEMENTS

### What is a Buy-Sell Agreement?

A Buy-Sell Agreement is a document that allows business owners to pre-agree on a course of action before a ‘trigger event’ occurs. The outcome recorded in the Buy-Sell Agreement varies depending on the nature of the trigger event, and the identity and circumstances of the affected party or parties.

The Buy-Sell Agreement creates put and call (or sell and buy) options for different trigger events. This is because the nature of the trigger events is that they necessitate a business owner to leave the business. The buy and sell options protect either the exiting owner or the continuing owner(s), or both. For example, on the death of an owner, the Buy-Sell Agreement might grant both buy and sell options: a buy option for the surviving (continuing) owners and a sell option for the deceased (exiting) owner's legal personal representative ("LPP"). In this way, the surviving owners are protected from having to deal with the deceased owner's next of kin as a key stakeholder by succession, and the deceased owner's estate can realise the value of the deceased's interest in the business.

**How can a Buy-Sell Agreement help with some of the main trigger events?**

A Buy-Sell Agreement helps by providing certainty in what is a very turbulent time for a business. It also ensures that any "what ifs" are contemplated and debated by business owners well before the situation arises. And, importantly, it allows the business owners to take other steps to protect themselves and their business, such as obtaining appropriate insurance policies.

So how can Buy-Sell Agreement help for some of the more common trigger events?

*Divorce and separation*

If one of the owners separates from their spouse, the business and the premises (if this is owned by the business owners) will be family assets to be taken into account in the context of a property settlement in the Family Court. In this scenario, the affected owner is often under pressure to realise funds from the business. Alternatively, their former spouse may want to acquire a portion of the business.

For the continuing owners, they may find that the affected owner becomes distracted by the personal and emotional strain of the separation, with a loss of focus on the business. They also usually want to avoid having the affected owner's former spouse as a direct equity holder in the business. And if the affected owner's former spouse was working for the business prior to the separation, they may find that there are a raft of employment and contractual issues that need to be dealt with.

This scenario could be simplified by the owners having in place a Buy-Sell Agreement that:

- Specifies divorce/separation as a trigger event, and grants a buy option to the other owners;
- Agrees a method to value the business at the time of the trigger event;

- Agrees ‘vendor finance’ terms to enable the other owners to fund the acquisition of the affected owner’s interest without being put under financial pressure; and
- Requires the affected owner to compensate the business for any claims made by family members against the business for things like unfair dismissal and redundancy.

*Death*

The death of an owner is a very difficult situation for a business to face, because it tends to brings things grinding to a halt.  Once an owner is dead, any Power of Attorney they have granted is void, and their assets cannot be managed until probate of their Will (if they have one!) has been granted.  This process may take several months – especially as the records of their business interests may not be completely up to date.

In relation to the personal side of things, usually the deceased owner’s family will need money, and will want to realise the deceased owner’s interest in the business and premises (where applicable).  On the other side of the coin, the surviving owners are likely to resent working in the business with the deceased owner’s next of kin continuing to receive a share of the profits for no hands-on input.  It is also very likely that the business will need someone to come in and replace the deceased owner to ensure that the business keeps running.

This scenario could be avoided by having in place a Buy-Sell Agreement that:

- Specifies death as a trigger event, and grants a sell option to the deceased owner’s LPP and a buy option to the surviving owners;
- Insures the lives of the owners so as to provide the funds to enable the buy-out of the deceased owner;
- Requires all the owners who have a company as their ownership entity to execute a Company Power of Attorney in favour of another person so as to enable that person to operate the ownership entity if the owner dies; and
- Requires all the owners who have a trust as their ownership entity to either have multiple directors of the corporate trustee or multiple individual trustees, or to execute an irrevocable deed of appointment to appoint a substitute trustee in the event of the death of the owner.

*Resignation/retirement*

Invariably, the owners do not want to work forever. They may plan to eventually retire from the business when it is capable of running passively and live off their share of the profits, or to sell the business to a third party and realise the value of what they have built.

It is important that a Buy-Sell Agreement deals with controlled exits (such as retirement or resignation) as well as uncontrolled exits, to give all owners a sense of certainty. Controlled exits can be addressed in a Buy-Sell Agreement by:

- Requiring that all owners must work in the business (and stipulating any expectations around that work, such as the expected number of hours per week);
- Providing that the other owners will have a buy option if an owner ceases working in the business; and
- Alternatively, providing for a suspension or reduction in profit entitlements if an owner ceases working in the business.

*Sale of the business*

The goal of the owners will be to build the business up to a point where it has a marketable value. If they achieve this goal, they may find that they have third parties who are interested in buying the business from them. The process of selling the business (or an owner's interest in the business) can also be addressed in a Buy-Sell Agreement. This is particularly helpful in situations where the owners are divided on the decision of whether to sell or not.
The most common mechanism is to give the owners who do not want to sell an option to buy the other owners' interests on the same terms as the third party offer. This does not require a valuation of the business because the market has already decided the value of the business. If this buy option is not taken up, then all owners are obliged to sell to the third party.

**What entities are covered by the Buy-Sell Agreement?**

So far, this paper has used 'owners' as a generic term for the people who have the beneficial interest in the business. But in order to prepare a Buy-Sell Agreement, you will need to clearly understand what **people** and **legal entities** are involved in order to determine what needs to be included and who should be party to the Agreement.

A business enterprise is made up of 3 levels: business entities, the proprietors and the principals.

The **business entities**:

- Business entities are the **legal entities** through which the enterprise is carried on.
- A business entity can be identified by the fact that it either:
    - Carries on a **business activity** directly; or
    - Holds an **asset** used by another business entity to carry on a business activity.
- A business entity can be an individual, partnership, company or fixed trust (e.g. a unit trust).

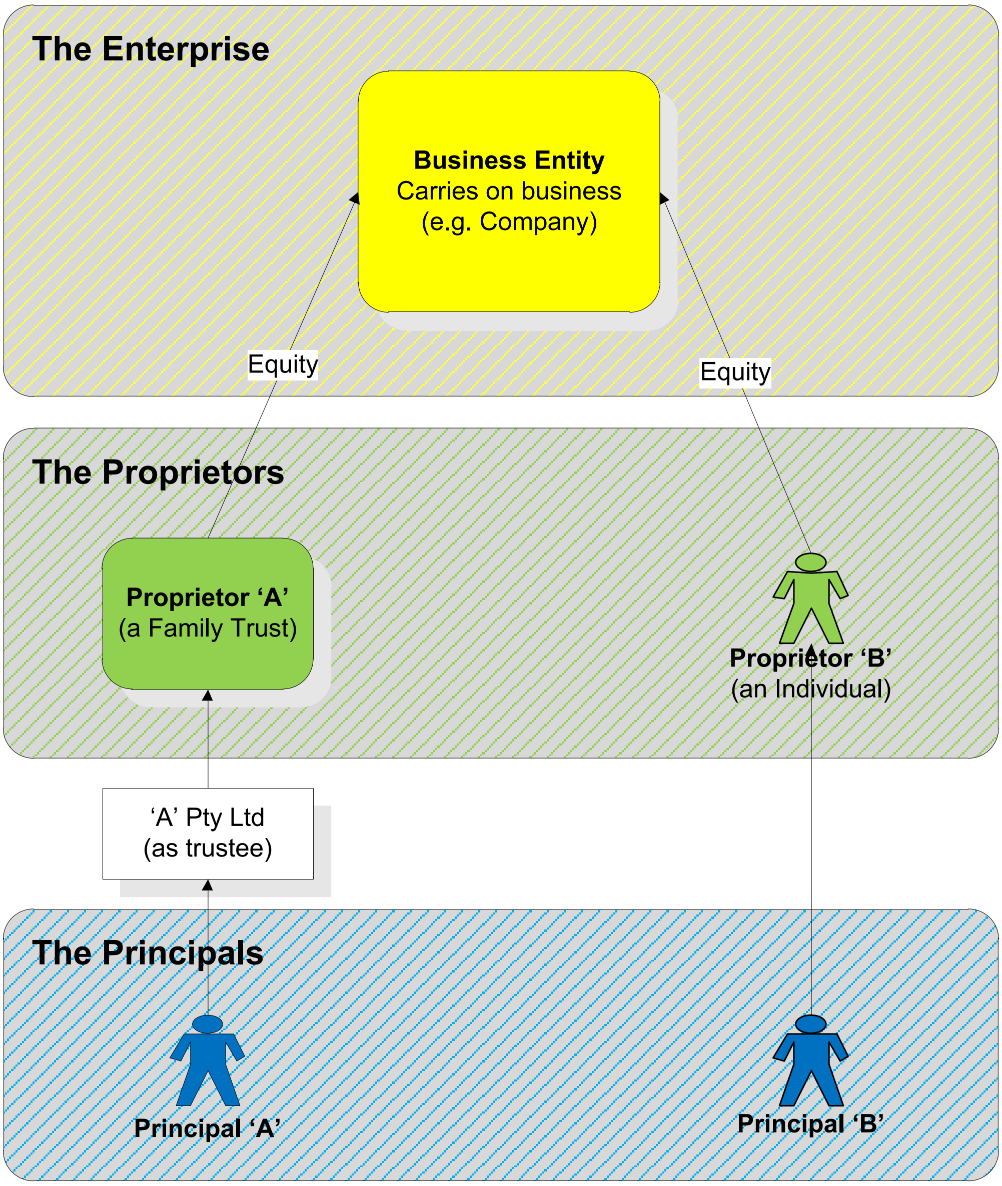
The **proprietors**:

- A proprietor holds '**equity**' in a business entity.
- Equity may be in the form of shares, units or another interest (such as an interest in a partnership).
- A proprietor may be an individual, company or trust.

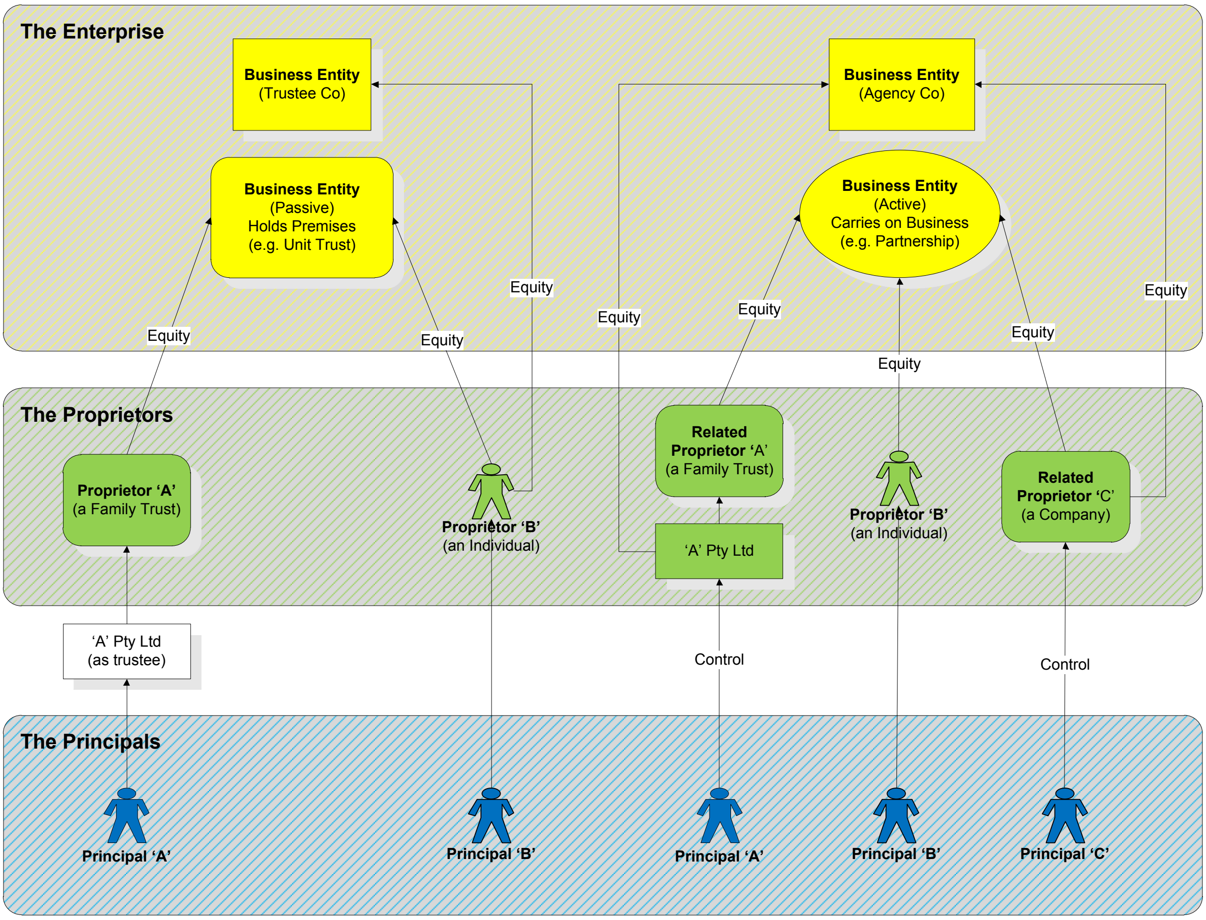
The **principals**:

- Principals are the 'ultimate controllers' of the business enterprise, and are always **individual people**.
- Principals own or control the proprietors.
- It is possible for a principal to also be a proprietor (e.g. where a person is an individual partner in a partnership, or an individual shareholder in a company).

*Example of a relatively simple business enterprise:*



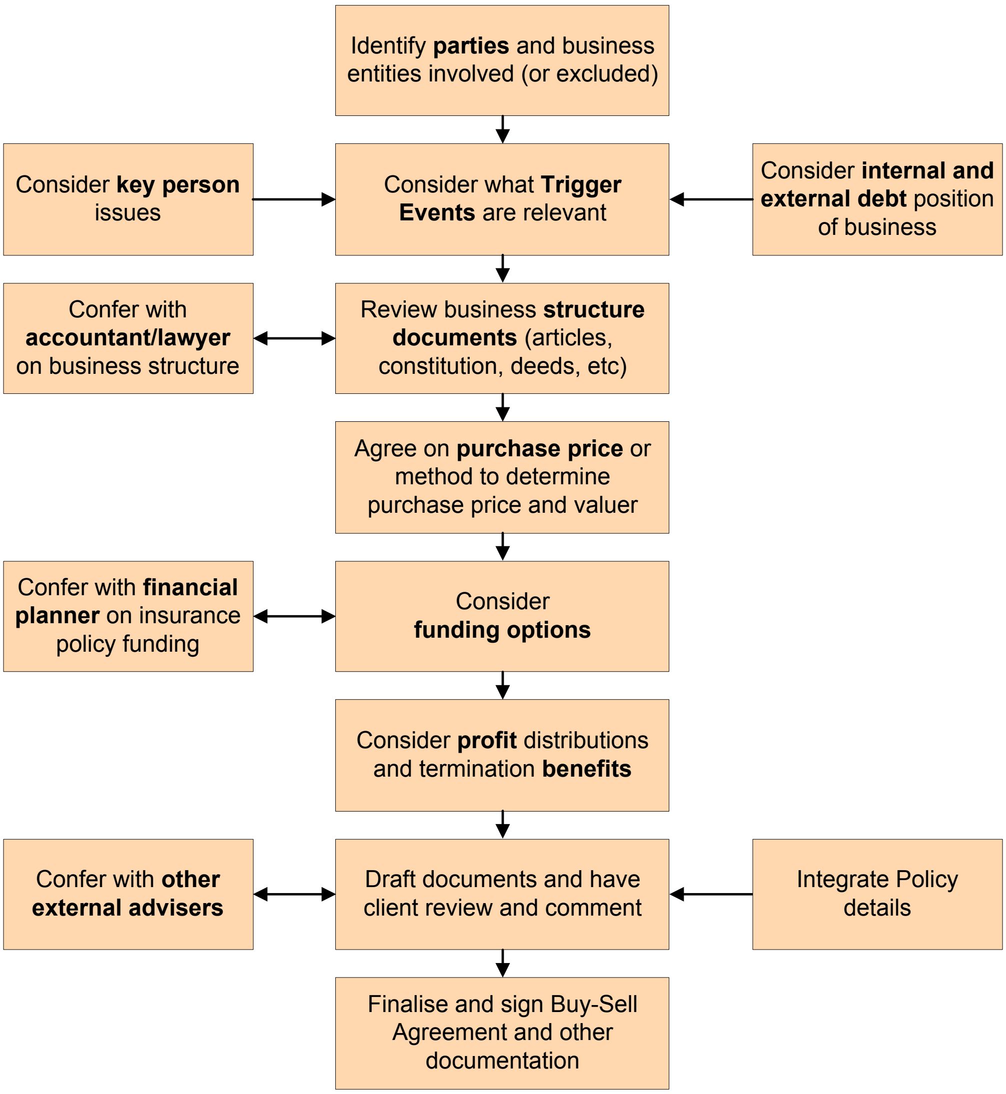
*Example of a more complex business enterprise:*



## PART III: DRAFTING THE BUY-SELL AGREEMENT

Once you have worked out what people and entities comprise the business enterprise, you are ready to start drafting the Buy-Sell Agreement. The process of drafting a Buy-Sell Agreement involves 8 key steps, which can be summarised as per the following flowchart. In this part, this paper will discuss the first 6 steps in the drafting process.

*Flowchart of 8 key steps to preparing a Buy-Sell Agreement:*




### Step 1: Identify the parties to the Buy-Sell Agreement

You may want to exclude certain entities from the operation of the Buy-Sell Agreement, so that the proprietors do not have the option to acquire a specific interest in the excluded business entity when a trigger event occurs.

For example, if the property from which the business operates is also owned by the proprietors, they may prefer to exclude the property-holding entity from the Buy-Sell Agreement and deal with it separately (as the property is a different kind of investment, and potentially a much more saleable one).

You should also consider whether the current spouses or partners of the principals should be party to the Buy-Sell Agreement so that they are bound by its terms. This way, the principals can have some reassurance that they will be able to exercise their rights under the Buy-Sell Agreement in an unfettered manner in the event of the divorce or separation of one of the principals.

**Step 2: Consider what trigger events will be covered by the Buy-Sell Agreement**

There are a number of common trigger events that give rise to issues for business owners. We refer to these as the '7 Dogs':

- **Death**
- **Disability** (including prolonged sickness and trauma)
- **Divorce**
- **Default** (including bankruptcy, criminal conviction, or a failure by a principal to adhere to the agreed terms on which the business enterprise is to operate);
- **Departure** (retirement, resignation, sabbaticals, etc)
- **Disagreement** (resulting in a permanent failure in the relationship between the principals)
- **Deadlock** (meaning that one or more key decisions cannot be made by the principals)

There may be other trigger events particular to a business, for example:

- The loss of a licence to carry on a particular trade or vocation (e.g. AFSL, builder's licence, etc); or
- An inability to get professional indemnity insurance.

The occurrence of some of these trigger events is within the control of a principal ("controlled trigger events"), while others are not ("uncontrolled trigger events"). Furthermore, some are insurable, while others are not.

*Table of common trigger events and whether they are controlled or insurable:*

| Trigger event | Controlled? | Insurable? |
|---|---|---|
| **Death** | No | Yes |
| **Disability (including TPD and Trauma)** | No | Yes |
| **Divorce** | No | No |
| **Default** | Yes | No |
| **Departure** | Yes | No |
| **Disagreement** | Yes | No |
| **Deadlock** | Yes | No |

The principals need to agree on what trigger events they want to give rights under the Buy-Sell Agreement. Our advice? The more comprehensive the list of trigger events, the better.

There are 3 possible outcomes following a trigger event:

- The **mandatory sale and purchase** of an interest in the business enterprise. This is not particularly common, but may be used when the principals are clear that a change of ownership will occur on a given event.
- The granting of a **buy (call) option** to the continuing proprietors. This is common, as it gives the continuing proprietors the right – *but not the obligation* – to acquire the departing proprietor's interest in the business enterprise. The continuing proprietors can decide whether they are willing to take on the funding obligation to buy out the departing proprietor's interest.
- The granting of a **sell (put) option** to the departing proprietor. This gives the departing proprietor the right – *but not the obligation* – to sell its interest in the business enterprise to the continuing proprietors. As such, it provides a guaranteed exit option to the departing proprietor, because if the departing proprietor exercises the option then the continuing proprietors must fund the exit of the departing proprietor.

Sell options are only generally granted when there is insurance that will fund the purchase price either in whole or in part. Sell options may also be used in the context of employee shares, where the majority owner of the business enterprise has agreed to give employees a guaranteed option to sell their shares if their employment ceased.
*Table of common options granted for particular trigger events:*

| Trigger event | Insurable? | Call Option | Put Option |
|---|---|---|---|
| **Death** | Yes | Yes | Yes – if insured |
| **Disability** | Yes | Yes | Yes – if insured |
| **Trauma** | Yes | Yes | Yes – if insured |
| **Divorce** | - | Yes | - |
| **Default** | - | Yes | - |
| **Departure** | - | Yes | (Maybe, if employee shares) |
| **Disagreement** | - | Yes | - |
| **Deadlock** | - | Yes | - |

**Step 3: Review the constituent documents of each business entity**

Each of the business entities will have their own constituent documents. For example:

- A company will have a **Constitution**
- A partnership will have a **Partnership Agreement** (sometimes called an Articles of Partnership), which may be only oral
- A trust will have a **Trust Deed**

Each of these documents will have some level of 'exit provisions'. The most common provisions being 'pre-emption' rights on proposed transfers, and some will contain mandatory transfer provisions on default. However, very few will comprehensively deal with each of the '7 Dogs'.

We generally recommend that the Buy-Sell Agreement takes precedence over the various constituent documents of the business enterprise. This can occur automatically for pre-existing entities. However, if a new entity is set up for the enterprise after the Buy-Sell Agreement is agreed, then it is important to recognise the primacy of the Buy-Sell Agreement in the constituent document of the new entity.

**Step 4: Agree a price-setting methodology**

A key component of a Buy-Sell Agreement is agreement on a price (or a method to determine a price) at which transfers of business equity may take place following a trigger event. It is very important that a clear and unambiguous price or price setting methodology is selected, and in the case of a fixed price, that the value is reviewed and updated regularly.

One of the main areas of dispute in the context of business succession is around valuations. We generally recommend a two-step approach to price setting:

- The first step is to leave it open to the **parties to agree** on a purchase price at the time of the trigger event; and
- If the parties cannot agree within a limited timeframe, then the second step is to fall back to the **agreed methodology** to set the price.

The benefit of this approach is that quite often the parties are able to agree on a sensible purchase price, which reflects the respective circumstances of the parties. This can save considerable expense in not having to apply the agreed valuation methodology (particularly if the agreed methodology involves an accountant or licensed valuer). That said, it is critical to have in place an agreed valuation methodology for when the parties cannot see eye-to-eye.

There are an almost infinite number of valuation methods. The most common are:

- Fixed agreed amount (not necessarily with reference to an insured amount)
- Insurance payment amount (but this will only apply to events covered by insurance)
- Open market valuation (this will usually need to be determined by a licensed valuer)
- Agreed methodology (e.g. an agreed multiple of the revenue or profit)

*Fixed agreed amount*

Under this method the principals agree on a **set dollar amount** as the purchase price that will be payable if a trigger event occurs. This method usually requires that the set dollar amount is updated on a periodic basis.

The problems we see with this method include:

- People often do not remember to update the set dollar amount, which means when a trigger event occurs at a later date, an unfair result may arise; and
- The requirement to update the set dollar amount usually entails applying a valuation methodology to determine the new amount. So in effect, the parties end

up obliged to perform regular valuations that may never be used. This can be expensive. Furthermore, if the valuation methodology is not clear, disputes can arise as to the appropriate application of the methodology.

*Insurance payment amount*

The insurance payment amount method sets the purchase price with reference to the **proceeds that arise under a policy of risk insurance**. As with the fixed agreed amount method, this method usually includes an obligation to regularly review the extent of insurance cover, and for it to be adjusted in line with changes in the business enterprise's value.

The problems we see with this method include:

- The insured value usually escalates automatically with reference to some CPI or some other indexing percentage, which may not reflect changes in the business value;
- If there is a material change in the value of the business enterprise it may not be possible to vary the insurance cover in line with this change; and
- If no proceeds are received, then the departing principal may miss out completely.

*Open market valuation*

One of the more common price setting methodologies is to set the purchase price with reference to the **open market value** of the interest being transferred. This method is often considered the "fairest" by proprietors, but there are a number of potential traps.

The main difficulty is identifying the assumptions that must be applied by the valuer to determine the open market value of the business. For example, a reference to the open market value of the 'interest being transferred' can be materially different to the proportionate interest in the open market value of the 'entire enterprise'. This is because the market value of an 'interest' in a business is usually considerably lower than the proportionate share of the market value of the whole business. This is often referred to as the 'minority discount'.

Other assumptions that can materially impact on the open market value of the business include:

- Whether the business is to be valued as a 'going concern'; and
- Whether the valuation is to take into account the potential impact of the departure of the departing principal.

Simply referring to 'open market value' or 'market value' leaves many avenues for genuine dispute.

*Agreed valuation methodology*

Our preferred method is to adopt an agreed price setting methodology. Under this method, the various assumptions and processes are clearly set out for the valuer to apply. This method need not result in the 'open market value', if that is what the parties agree.

Sometimes this method is accompanied by a Valuation Report prepared at the time of entering into the Buy-Sell Agreement, which sets out in detail the assumptions made, and the multiples and adjustments applied, to arrive at the purchase price. This then acts as a template to be followed by the valuer following a trigger event. Once again, the more detail about how the purchase price is to be determined, the better.

The parties should also pre-agree on who is to calculate the purchase price, or alternatively how that person is to be selected and appointed. While it is possible to agree on a specific person, it is also advisable to name one or more alternatives, in case the nominated person is not able to perform that role. We prefer to avoid nominating a person or organisation who must select a suitable and qualified valuer based on stated criteria (e.g. the President of the Institute of Chartered Accountants, or the President of the Law Society) because this is cumbersome and can cause delays.

In our view it is not appropriate to appoint the accountant to the business enterprise as the valuer. This will invariably lead to a conflict of interest, and favour the continuing principals (i.e. the continuing clients of that accountant).

As a general rule the Buy-Sell Agreement will state that the determination of the valuer is final and binding on the parties, so that it cannot be disputed later on. However, it is possible to specify that two or more independent valuations must be obtained (which will impose an additional cost), or that a second opinion may be obtained at the election of one or more principals. The thing to remember here is to balance fairness with likely additional cost and time.

The general rule is that the cost of the valuation is met by the business enterprise. This means that, ultimately, each principal will contribute to the cost in proportion to their ownership in the enterprise at the time of valuation (because it effectively comes out of their profit share). Other common alternatives for the valuation cost are:

- Shared equally between the enterprise and the departing principal; or
- Shared equally between all of the principals.

**Step 5: Consider the funding options**

Funding the payment of the purchase price to the departing principal is usually the most difficult issue to solve. In the case of a **sell (put) option**, the continuing principals and the continuing proprietors will have a funding obligation to buy the departing principal's equity in the business enterprise. In the case of a **buy (call) option**, the likelihood of the departing principal actually being able to exit the business enterprise and get paid will depend on the continuing proprietors' and continuing principals' ability to access funding.

It is in everyone's interest to agree and provide upfront, how an exit is going to be funded. The parties also need to be realistic, as it is conceivable that a funding obligation (a sell option) to bankrupt a proprietor/principal.

*Possible sources of funding*

The reality is that there are limited funding sources for people wishing to buy interests in SME and family businesses. These include:

- Business enterprise funding
- Bank finance
- Vendor finance
- Insurance funding

Each funding option requires careful consideration of the taxation implications.

*Business enterprise funding*

Only in very limited circumstances is it likely that the business enterprise itself will have sufficient surplus assets to self-fund a termination payment to a departing principal. However, in a 'no-goodwill' business enterprise (where the only thing to be funded by the continuing principals is a payout of the working capital of the business enterprise), self-funding may be an option. Self-funding may also be an option where the departing principal elects to take certain discrete assets of the business enterprise in satisfaction of their purchase price. This often arises in professional partnerships, when a departing principal may take a section of the business enterprise's client base (and corresponding 'goodwill').

*Bank finance*

It may be possible for the continuing principals to raise some level of finance from a bank. This will depend on the cash-flow and net asset position of the business enterprise and of the continuing principals/proprietors.

Bank funding will invariably involve the business enterprise granting comprehensive security over the business enterprise's assets, and is also likely to require personal guarantees from the continuing principals. The departing principal (and each of their corresponding proprietors) should ensure that they are released from any funding or security obligations with respect to the business enterprise's ongoing funding lines.

*Vendor finance*

To the extent that self-funding or bank funding is not available or sufficient to fully fund the purchase price, the departing proprietor may be required to provide ‘vendor finance’ to the continuing proprietors. The provision for vendor finance implies that the departing proprietor’s equity in the business enterprise will be transferred to the continuing proprietors prior to full payment being received. This will have the effect of the departing proprietor swapping its ‘equity’ interest in the business enterprise for a ‘debt’ interest (i.e. swapping a variable return for a fixed return).

The two main aspects of vendor finance that the parties will need to negotiate are security for the loan and interest on the loan amount.

It is not unreasonable for the departing proprietor to require the continuing proprietors to provide security over the assets of the business entity/entities to secure the repayment of the vendor finance. Depending on the financial position of the business entity/entities, the continuing principals may also be required to provide personal guarantees (or other forms of additional security).

It may be that the security granted to the departing proprietor for the vendor finance must take second place behind the security to be provided to the bank in respect of existing business enterprise funding, or any additional bank funding raised to pay the purchase price.

In relation to interest, the principals will need to agree on whether interest will be payable on the vendor finance. In our view, a commercial rate of interest should be levied – at least after a period of time. This will provide the continuing proprietors with a real incentive to repay the vendor finance as soon as is practicable. We have also found that charging interest means that all parties view the vendor finance for what it is – a loan – rather than a gift or a favour.

*Insurance funding*

Insurance is a very common source of funding for exits arising from trigger events in respect of which it is possible to take out a policy of risk insurance (i.e. death, disability and trauma). The ability to get insurance funding will depend on a number of factors, including the age and health of the principals to be insured.

Coordinating a consistent level of insurance among more than a couple of similarly aged principals can be difficult and time consuming.  We usually recommend that the parties put in place an unfunded Buy-Sell Agreement if they have not yet secured policies, with provision to link to risk insurance funding once underwriting is obtained. Otherwise, difficulties with obtaining insurance might mean the whole Buy-Sell Agreement gets put in the "too hard" basket.

If insurance is obtained, it is important that the terms of each policy are carefully reviewed to ensure that they are suitable and properly match the events they are intended to fund.  The next part of this paper will focus on the issue of insurance funding for Buy-Sell Agreements.

**Step 6: Determine termination profits and benefits**

*Accumulated profits*

When a trigger event occurs there may be accumulated profits within the business enterprise.  The Buy-Sell Agreement should specify to what extent a departing proprietor is entitled to participate in these profits.  As a general principle, it is necessary to nominate the cut-off time for an entitlement to accumulated profits, and ensure that provisions cover the making of the relevant distribution prior to the departing proprietor ceasing to hold a relevant interest in the equity of the business entity.

It is also necessary to nominate the proportion of accumulated profits that will be distributed and the timing of the payment.  The proportion may not necessarily be 100%.  But as a general rule, the proportion should be in line with the pay-out ratio that has applied to the relevant business enterprise up to that point in time.

*Principal termination benefits*

If the principal is employed in the business, then consideration should be given to whether or not a termination benefit will be paid to the departing principal on the cessation of their employment.  The types of benefits that might apply in this scenario are redundancy pay, long service leave pay and other lump-sum benefits.

The termination benefits may not necessarily accord with the actual level of remuneration being paid to the principal.  For example, if the principal receives less than market rate remuneration, any termination payment would need to be adjusted upwards.

Conversely, a principal may be due termination benefits under employment law that the principals have actually or impliedly agreed between themselves will not apply, or will be satisfied through some other means.  For example, they may have taken this into account when setting the payout ratio of business entity profits.  Accordingly, it could be agreed in the Buy-Sell Agreement that if a principal receives such termination benefits, they are contractually obliged to contribute them back to the business enterprise.

*Related party termination benefits*

Often parties related to the principals are employed in the business enterprise, either in a real role or in a ‘notional role’.  We are not condoning the artificial employment of spouses/partners for tax planning purposes as either effective or a good idea. However, it is a common reality in SME and family businesses.

How effective this is in reality for tax purposes is an open question.  If the business was subject to review by the Tax Office, the salaries to the spouses/partners may be challenged.  However, in the context of business succession planning, there is a risk that the spouses may claim benefits (and be entitled to those benefits), including termination benefits.  Further, the benefits will be calculated by reference to the remuneration they are actually receiving, rather than according to their ‘real’ value (which may be considerably less).

To avoid the issue of related party termination benefits, the principals may wish to agree to indemnify the business enterprise against any claim that a related party may bring for termination and other benefits following the departure of a principal from the business enterprise.

**Other issues to consider when drafting a Buy-Sell Agreement**

*How and when is the equity transferred?*

Following a trigger event, equity in the business entities will need to be transferred from the proprietors associated with the departing principal to the proprietors of the continuing principals. How this is achieved will depend on a number of factors, including:

- The legal nature of the business entity. For example, a partnership may involve either an 'assignment' of partnership interest, or simply a termination of the departing proprietor's interest in the partnership. A company may involve a share transfer or a share cancellation.
- How the exit price is to be funded. For example, if the buy-out consideration is funded by the proprietors, then the exit is likely to be structured as a transfer/assignment between proprietors. However, if the exit is to be funded by the business enterprise itself, then the exit is more likely to be structured as a termination/cancellation of the interest in the business entity (e.g. share cancellation, unit buy-back, etc).
- The tax impact of the departure at that time.

In our view, the Buy-Sell Agreement should provide some flexibility for the parties to adopt the most commercially sensible and tax-effective structure for the exit. In the absence of agreement, then the default method of transfer of equity would be a transfer between proprietors of the relevant interest in the business entities.

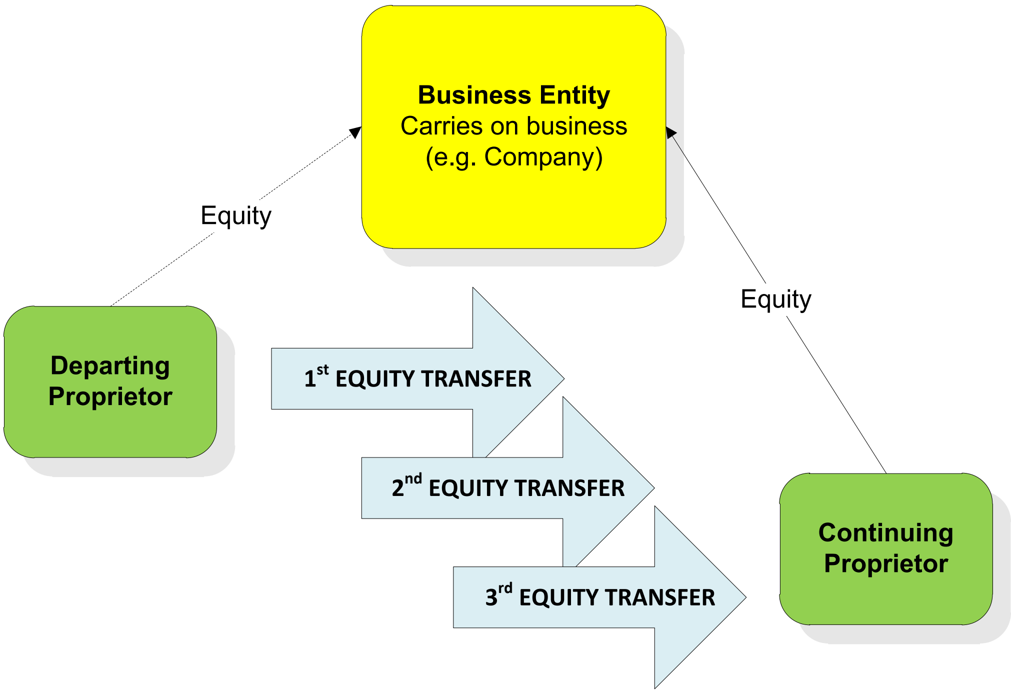
There are two possible time points for the transfer of the equity:

- On the occurrence of the exit trigger event or the option being exercised (depending on whether it is mandatory or an option). This may or may not line up with the time the departing proprietor receives the purchase price.
- On the payment of the purchase price. This may be in one lump sum aligning with a single transfer, or it may take place in tranches.

The most common arrangement is for the equity to be transferred on the payment of the purchase price when paid in a lump sum.

An alternative to transferring the equity in the business enterprise at the time of the trigger event or exercise of the option is to defer the payment of the purchase price until a time when the continuing proprietors expect to have more funds available.  For example, equity can be transferred in tranches, as and when the Continuing Proprietors have accumulated funds.

*Example of equity being transferred in three tranches:*




Until such time as the continuing proprietors have taken a transfer of equity and paid for it, the departing proprietor retains an equity interest in the business enterprise, and therefore retains a proportionate interest in the ongoing profits of the business enterprise.  The departing proprietor also remains exposed to the risk of losing capital value, if the business enterprise subsequently fails.

Consideration needs to be given to the price at which the equity will be transferred. This may be set at the time of the trigger event, or may be left to float up or down depending on the ongoing success or failure of the business enterprise.  As a general rule, the parties prefer to fix the price at the time of the trigger event, so that the continuing proprietors get the benefit of the capital value of their continuing hard work, and the departing proprietor is not exposed to the downside of the business enterprise's possible failure.

*Commercial restraints*

If a person pays valuable consideration to acquire business 'goodwill' then the person selling the goodwill should not be able to compete with them and effectively take back what they have sold.  The purpose of a 'commercial restraint' or a 'restraint of trade' is to ensure that the purchaser is free to enjoy the benefit of what they have bought.

Acquiring equity in a business under a Buy-Sell Agreement is no different to acquiring equity in a business under any other scenario.  If the departing proprietor has received valuable consideration for the disposal of their equity in the business enterprise, then they should not be free to compete with the business enterprise and effective take back what they have sold.  There are exceptions to this general principle, for example if a departing proprietor agrees to take a lower than market price for their equity, or agrees to take a portion of the goodwill in whole or part satisfaction of the purchase price otherwise due.

Commercial restraints are less concern in 'funded' exit scenarios, because the principal will be unable to work in the business or any other business (due to death, incapacity or disability).

The courts have a bias against upholding a commercial restraint – because from a social policy perspective, they act as a fetter on free commerce.  However, in the context of a business sale, the courts will enforce a commercial restraint, so long as it is reasonable in the circumstances.

What is reasonable will depend on a combination of:

- The **length** of the restraint.  This can range from a few months, up to several years.  In our view it is reasonable to have reference to the basis on which the purchase price was calculated to see what is proportionately reasonable. For example, if the purchase price is calculated as 3 times profits, then three years may be reasonable.
- The **area** of restraint.  This can range from any market in which the business enterprise operates, to a given geographical area.
- The **nature** of the restrained activities.  Restrained activities can include directly competing, working for a competitor, taking employees, and impacting on suppliers.

*Taxation issues*

Entering a Buy-Sell Agreement ordinarily involves the parties granting 'options' to each other to buy and sell their respective interests in the business enterprise at some future date (i.e. if one or more trigger events occurs). Furthermore, a Buy-Sell Agreement that is funded with risk insurance may involve the departing proprietor effectively transferring their interest in the business enterprise to the continuing proprietors for no consideration, and instead being compensated for their interest in the business enterprise in the form of the proceeds under their own personally held risk insurance policy.

What this means from a tax perspective is that the rights granted under the Buy-Sell Agreement (i.e. to acquire the equity) may have significant value for Capital Gains Tax ("CGT") purposes. Furthermore, this value arises at the time the Buy-Sell Agreement is executed, rather than when the trigger event arises. This would ordinarily give rise to tax liabilities for the parties before any event has occurred and, more importantly, at a time when they have no cash to meet these obligations.

If the Buy-Sell Agreement is entered into on the commencement of a new business enterprise, then these issues are of less concern (because the enterprise has little, if any, established value). But when a Buy-Sell Agreement is proposed for an existing business enterprise that already has significant value, then the issue is more acute.

A Buy-Sell Agreement should be drafted to avoid the issue of CGT. This is usually achieved by having the options to acquire and sell equity in the business enterprise only arise after a trigger event occurs, and not at the earlier time when the Buy-Sell Agreement is signed. This defers any relevant tax liability to the same time proceeds are likely to arise to meet the tax liability.

The occurrence of a trigger event followed by the exercise of an option would ordinarily trigger any CGT liability in respect of the whole of the relevant interest in the business enterprise. This means that the whole of any tax is then payable in the year of the trigger event. This can cause cash-flow difficulties for the selling party if payment of the cash price by the continuing parties is deferred into later years under a 'vendor finance' arrangement. In these circumstances a liability to tax arises on the part of the selling party while there is insufficient cash to pay the liability.

If this is a material issue for the parties, the Buy-Sell Agreement can contain provisions that can be invoked to defer the point in time that the CGT liability arises into later income years to properly match the time when the selling party actually receives the cash consideration from the continuing parties. This way, when the deferred CGT trigger point is reached, the selling party will be in a position to pay the associated tax liability.

Alternatively, if the equity is transferred in tranches, the departing proprietor may only trigger a capital gain (or loss) on the part of the interest disposed of. This limits any CGT to the portion of the vendor proprietor's interest that they have actually received money for.

## PART IV: INSURANCE FUNDING

### What is the purpose of insurance for Buy-Sell Agreements?

There are different types of insurances that may be taken out, as well as a number of different 'purposes' for which any insurance proceeds may be applied. In the context of business succession, the most common purpose is '**Equity Benefits**', where the insurance proceeds are received by the departing principal or departing proprietor in full or part satisfaction of the purchase price for the transfer of their interest in the business enterprise to the continuing proprietors.

However, there is really no restriction on the purpose for which insurance is obtained. The relevant purposes will vary from business to business depending on what the principals perceive as the biggest risks.

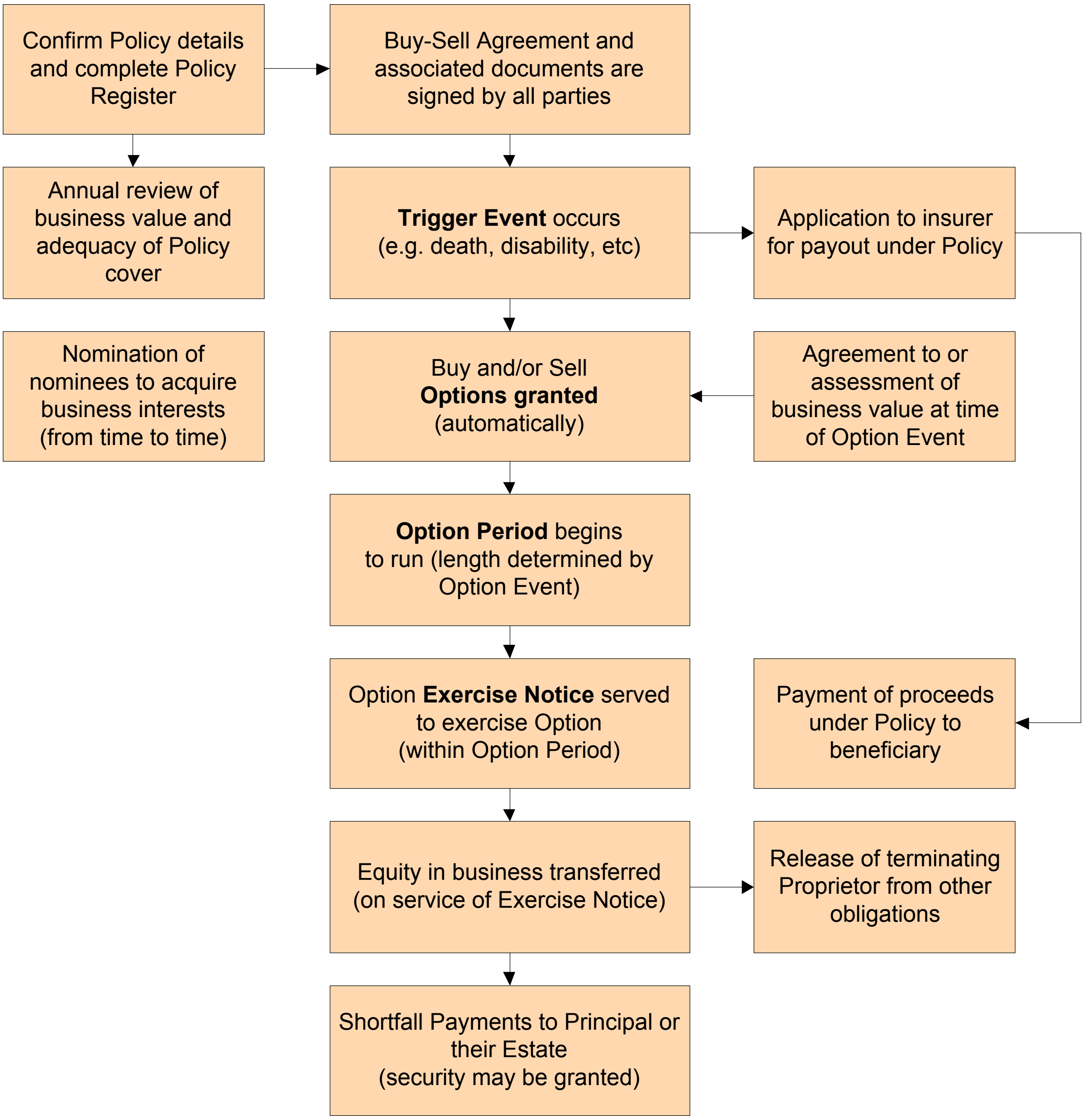
Other purposes for risk insurance proceeds include:

| | |
|---|---|
| **Internal Debt** | The proceeds are utilised to repay debt owed to or from the business enterprise to parties involved in the business enterprise |
| **External Debt** | The proceeds are used to repay debt to third parties (such as banks) |
| **Key Person** | The proceeds are utilised to compensate the business enterprise for the loss of a key person, including the cost of replacing them or for loss of income associated with their departure |
| **Guarantee payments** | The proceeds are used to secure the release of parties from guarantee obligations |
| **Personal** | The proceeds are used for one or more personal purposes of a party |
| **Business Expenses** | The proceeds are used to fund an increase in business expenses or reduced revenue associated with the departure of the principal |

**How much insurance is the right amount?**

The short answer to this question is usually as much as you can reasonably afford, up to the value of the equity interest or other purpose being insured. However, not being able to get insurance for the full purchase price should not prevent the principals from obtaining a lesser amount of insurance. Any amount of insurance is going to relieve the financial pressure associated with a departure.

How does the insurance interact with the Buy-Sell Agreement?

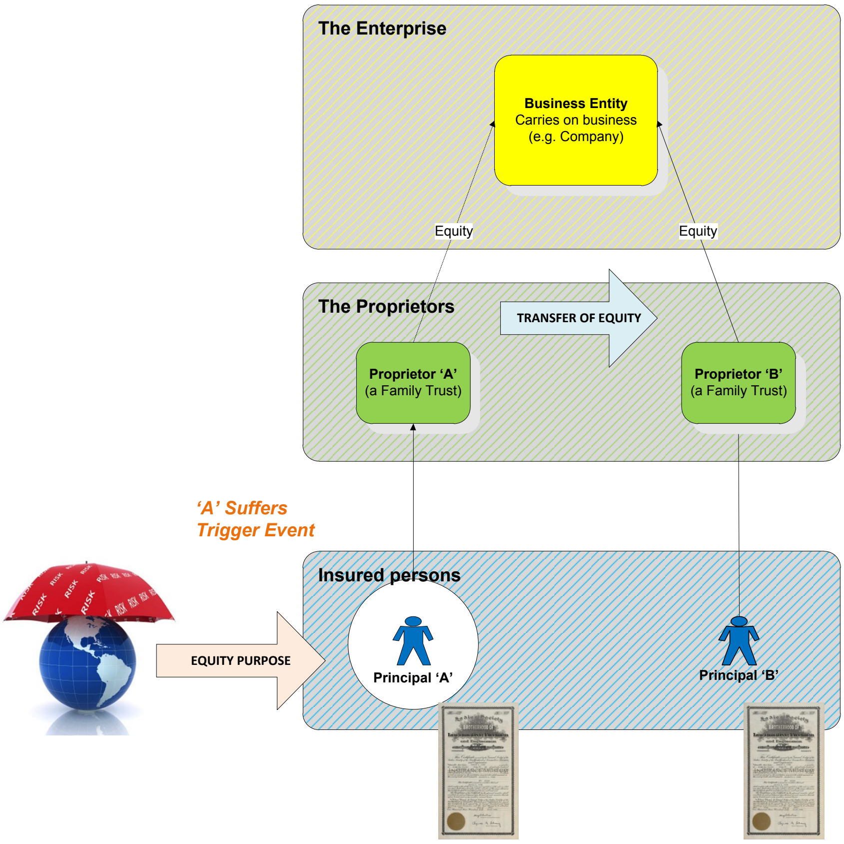



**Who should hold the insurance?**

*Self-funded ownership*

Self-ownership is the most common structure for the holding of risk insurance for business succession purposes. Under self-ownership, each principal takes out an insurance policy covering their own life/disability. If an insured trigger event occurs, the principal (or their estate) receives the insurance proceeds. The corresponding proprietor must then transfer its equity in the business enterprise to the continuing proprietors, and the insurance proceeds received are credited towards the purchase price due from the continuing proprietors.

*Example of the structure of self-funded 'Equity Purpose' insurance policies:*




Depending on how the purchase price is calculated, the insurance proceeds may satisfy all or only a part of the purchase price due. The balance may then be satisfied by another funding alternative.

The benefits of self-ownership include:

- When principals come and go they bring or take with them their insurance. Because the insurance is not cross-owned by the other principals, there is no need to assign interests in policies; and
- No tax will apply to the receipt of the proceeds by the principal or their estate. If the policy was owned by the business enterprise, then tax may apply either on receipt, or later when the economic benefit of the proceeds is distributed to the proprietors.

*Insurance proceeds trust (ownership by a trustee)*

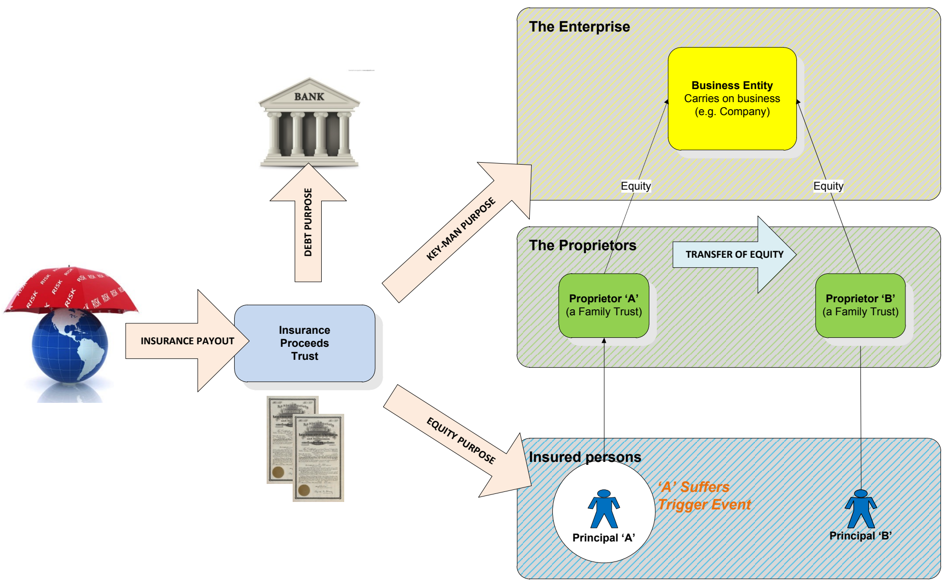
Some banks and insurance companies recommend the use of an 'insurance proceeds trust'. Under this arrangement, the policies are held by a trustee on behalf of the business enterprise and the principals. When a trigger event occurs, the trustee must then apply the proceeds received in accordance with the terms of the trust deed.

Reasons for this structure include:

- If insurance is required for a number of different purposes (e.g. equity, debt, expenses, etc), a single policy can be taken out, with the proceeds then applied by the trustee as required for each purpose. The idea is that the larger policy will qualify for discounted premiums; and
- The trustee will ensure the proceeds are in fact applied for the intended purpose. If the policy is owned directly by a principal, the other principals have no practical control over how the proceeds are applied. Control over the application of the insurance proceeds is particularly important when the purpose of the insurance is to cover debts of the business enterprise. In fact, banks often require such a trust (with a bank-appointed trustee) when the purpose of the policy is to cover business-related bank debts.

Despite these potential benefits, it is our view that an insurance proceeds trust should only be used when there is a real commercial justification.

*Example of the structure of an insurance proceeds trust:*



**Who pays the premiums?**

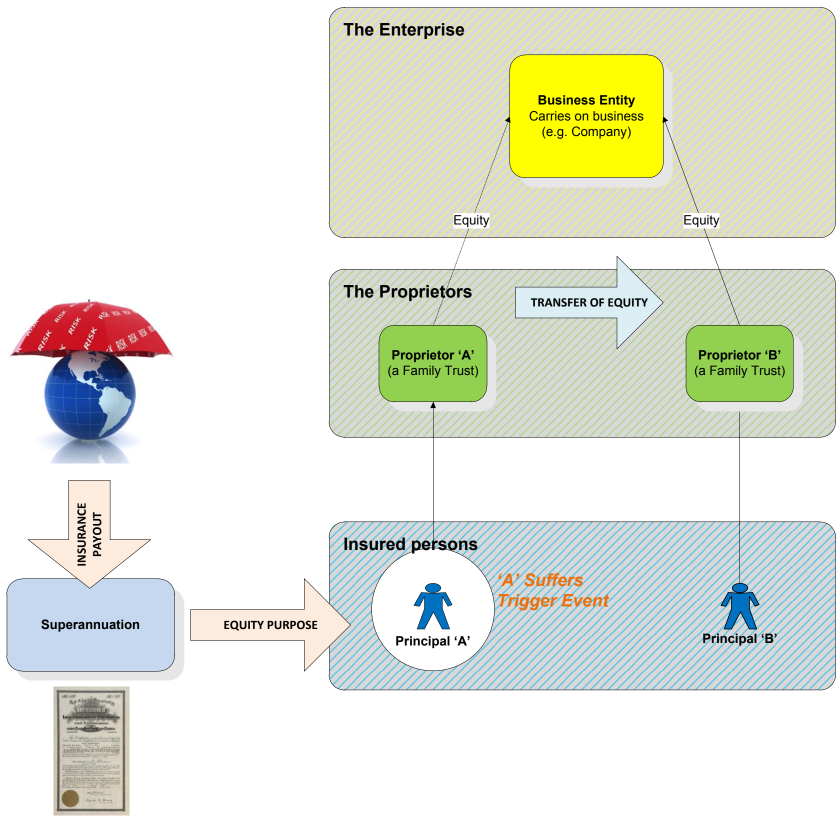
Either the business enterprise or the principals can pay the premiums for the insurance. As a general rule, if the premiums are paid by the principals then no deduction is available for the premiums. If the business enterprise pays the premiums then a deduction may be available, but any proceeds received will then be assessable to the business enterprise. However, specific tax advice should be sought in relation to the tax treatment of the premiums on a case-by-case basis.

Depending on the circumstances, we usually recommend that the principals fund the premiums, and if necessary, the business enterprise may make additional distributions (or provide fringe benefits) to the principals to fund this expense.

**Insurance within super**

Sometimes people choose to hold insurance within superannuation. As a general rule, we recommend against this, as it raises a number of superannuation law and taxation issues.

*Example of the structure of holding insurance within superannuation:*



*Trauma insurance within super*

With respect to **trauma insurance**, the Commissioner has expressed a definitive view that holding this type of insurance within super is not appropriate.[1]

*Life and TPD insurance within super*

With respect to **life** and **permanent disablement** insurance, the position is less clear. In order to remain compliant, a super fund must satisfy the 'sole purpose test'. This test requires that the fund be maintained for the sole purpose of funding retirement or death benefits to members and specified relatives.[2]

Ultimately, the question comes down to whether holding risk insurance in super that is tied to the purpose of satisfying the purchase price under a Buy-Sell Agreement breaches the sole purpose test. Although the sole purpose test is a very strict one, the Tax Office accepts that an 'incidental, remote or insignificant' purpose will not of itself breach the sole purpose test.[3] It is not disputed that the proceeds of the super policy will be paid to the member (or their family) if an insured trigger event occurs. The issue is whether the provision of these benefits is the 'sole purpose' of the investment in the policy by the super fund.

In our view, the question of whether or not the sole purpose test is breached depends on how broadly one interprets the arrangement. Looked at narrowly, it is the member (or their estate) who receives the benefit of the policy. The purpose of the policy is to ensure that the member (or their estate) has cash immediately upon the relevant event occurring. The fact that the other principals may also receive a benefit in the form of a transfer of equity in the business enterprise for less than full value does not necessarily negate the proximate purpose of the policy in super. Further, the transfer of equity is a benefit from the member to the other principals, not from the super fund to the other principals.

The alternative argument is that a broad view of the arrangement implies that the policy in super is being maintained for the purpose of conferring a benefit on the other principals. The benefit is received by the other principals indirectly through the benefit

[1] See the discussion around the sole purpose test in SMSFR 2008/2.
[2] Section 62(1) of the *Superannuation Industry (Supervision) Act*.
[3] Paragraph 8, SMSFR 2008/2.

to the member. Taking the arrangement as a whole, one of the purposes of the policy must be to relieve the other principals of the purchase price obligation – otherwise the agreement to transfer the equity at undervalue does not make sense. We believe this argument is strongest when:

- The business enterprise is specifically paying for the policy in super; and
- The obligation to transfer the equity under the Buy-Sell Agreement is directly linked to the super policy.

Given this uncertainty, as well as the reduction in contribution limits, we generally advise against holding risk insurance within super for the purposes of funding events under a Buy-Sell Agreement.

**What happens if a policy is voided?**

If a policy of insurance is voided, then the departing principal will not receive proceeds on the trigger event. The question arises as to who is to bear the economic cost of the loss of benefits.

A payment under an insurance policy is effectively a windfall to the continuing proprietors. To the extent that the purchase price is satisfied by insurance proceeds, they will receive an additional interest in the business enterprise without having to pay for it. The departing proprietor receives the purchase price, but this is no more than they were entitled to before the insurance payout.

Our view is that it would represent a ‘penalty’ to the departing principal if they were required to transfer their equity in the business enterprise and receive no purchase price as a result of a voided policy. The business enterprise may have assisted in the funding of the premiums, but this is likely to be a small cost to the enterprise relative to the penalty to the departing principal.

Our preferred view is that if the policy is voided:

- The sell option ordinarily available to the departing principal lapses. This ensures that the continuing proprietors are not put under a funding obligation that they are not prepared for;
- The purchase price due to the departing proprietor is reduced by the extent of any premiums funded by the business enterprise; and

- The buy option remains available to the continuing principals, with the availability of generous vendor finance terms to replace the insurance funding.

Some advisers take the view that if the departing principal has caused the voiding of the policy (by an act or omission) then the departing proprietor must still transfer their equity in the business enterprise, with the purchase price being reduced by the amount of proceeds that would otherwise have been received (but for the voiding). It is our view that this represents an inequitable result. This type of approach is also more likely to end in dispute (and possibly in litigation), which is what the Buy-Sell Agreement is trying to avoid in the first place.

**Louise Craven, Andreyev Lawyers**
**14 March 2014**