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PRIVATE WEALTH

Understanding Continuity Agreements and Business Assurance

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Jeff Middelmann (CFP®)
Director, Consequence

In recent months we have noted the relevance of correctly structured business continuity agreements in estate planning. Many business owners neglect this issue and, on their death or disability, leave behind uncertainty and delay and possibly even legal complications. This brief article attempts to clarify some of the basic concepts involved. Please contact us for more detailed information.

What is a business continuity agreement and why is it important for a business owner?

Some years ago a client of ours passed away within a month or so of our first meeting, before we could apply our usual estate planning process. His business structure was complex to start with, but the lack of a signed agreement to guide matters to the satisfaction of both his estate and his business partner and no insurance to provide cash for the partner to purchase the shares from his estate, resulted in acrimony. Ultimately our client's family did not receive fair value and the business has barely survived.

Not all businesses require these agreements, such as when spouses or children are already involved and would be expected to inherit shares and continue in the business with the support of the remaining owners. There are many scenarios in which specific agreements are not required but in all circumstances, we would urge owners to at least ensure that Shareholder Agreements and Memoranda of Incorporation (MOI) are up to date.

Understanding the structures

The distinction between continuity agreements and insurance policies

It is important to distinguish between the agreements and the insurance policies ("Business Assurance") used to fund potential share transfers or provide liquidity for businesses. In all cases the agreements are crucial, be they Buy and Sell agreements or company resolutions for Key Person cover etc. The insurance itself may not be required, such as where an owner can clearly show sufficient liquid assets to fund a share purchase. It is however our experience that a properly underwritten life and disability insurance policy held with a reputable insurer removes uncertainty around the ability to fully fund purchases at agreed values.

The distinction above is crucial as we have encountered owners who believe all is resolved simply because "buy and sell" insurance has been taken out. Without a correctly worded and signed agreement the arrangement relies only on the honourable intentions of surviving owners. They would be paid the policy proceeds but not legally required to use the proceeds to buy the deceased owner's share.

We define below the main Business Assurance types:

Key Person

This is insurance owned and paid for by the business, to provide funds in the event of a key employee death or disability. That employee may or may not be an owner/director. Those funds are used to replace that individual and provide stability within the business. A signed business resolution to the effect should be kept on record to ensure that the proceeds attract no tax in the hands of the business. Policy contributions are not tax deductible. In many cases it is advisable for an owner to be insured by this policy in addition to a Buy and Sell policy, but they are separate and not to be confused with each other.

Contingent Liability

The business owns and pays for the policy in case of death/disability – but here the proceeds pay to the business to settle debt linked to the life of an owner. It may be that the owner has stood surety in their personal capacity for debt taken on by the business or that a loan account owed to that owner must be settled. Again, contributions are not tax deductible and proceeds should attract no tax.

Buy and Sell

This deals with the transfer of ownership in the event of death or disability. As an example, Jack and Jill each own 50% of a business. Jill owns and pays for a life and disability policy on the life of Jack for a value that corresponds with Jack's agreed share value and vice versa. Jack and Jill also sign a Buy and Sell agreement. Jack passes away, the policy proceeds pay to Jill who is then compelled as per the agreement to use those proceeds to buy Jack's share from Jack's estate. Jack's heirs therefore receive the agreed lump sum value and Jill acquires the shares, becoming the sole owner of the business.

The same structure can apply for multiple owners with varying shareholdings (and Trust ownerships) and proportionate payouts as required. "One-sided" agreements can also be structured for minor shareholders or small business owners who wish to realise value in their estate by, for example, giving a competitor or a manager in the business, an option to purchase.

Business valuations should be professionally prepared and policies should match values accurately and be updated annually. Owners must fund the premiums for each others' policies to avoid estate duty being levied on policy payouts.

It is also possible to structure the transfer of ownership via a **Share Buyback** agreement in which the company buys back shares and proportionally reallocates ownership but tax treatment differs to a Buy and Sell arrangement.

In all cases the important goals are to ensure that fair value is realised from the business for heirs and to ensure smooth continuity for the remaining owners.

Further Information

Please contact us for more detail on the above, we have strong experience in this field and can arrange professionally drafted agreements which tie in with existing shareholder and trust documents and can structure the relevant insurance policies in the most cost effective and durable manner.

Please note that the above is not be construed as financial advice in and of itself. Please consult further with us or your financial advisor before making any financial decisions.

 Consequence Private Wealth (Pty) Ltd (Reg 2009/005302/07) Authorised Financial Services Provider: 39659 Directors: Michael Furter, Jeffrey Middelmann. Address: 1st Floor, Newlands Quarter, Cnr Main & Dean Street, Newlands, Cape Town, 7725 Ph: 021 674 2222 Fax: 086 653 4999 Email: info@consequence.co.za Web: www.consequence.co.za