Friends Provident International

Partnership and shareholder business protection

Adviser guide

Life changes. Be prepared. Be protected.

A partnership is an effective method of combining skills to build an enterprise.

However, there are accountabilities implicit in any partnership and the possibility of financial problems if one of the partners dies, retires or becomes incapacitated.

For any partner, their share in the business is likely to be their biggest financial asset so they need to take steps to protect it.

Not only for the benefit of their family, but for the benefit of the other partners in order to help ensure the continuation of the business.

The shareholding directors of private limited companies are in a similar position. Business protection plans, based on a suitable legal arrangement, can provide a simple way to protect the interests of partners and shareholders.

This guide shows how the protection of all interested parties can be achieved, as well as detailing other relevant points that should be considered by any key stakeholders looking to protect their business.

While every care has been taken to ensure the accuracy of the information in this guide, Friends Provident International cannot accept liability for actions taken or not taken based on the information provided.

Any reference in this guide to partners and partnerships applies to shareholders and companies, unless stated otherwise.

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Business share protection needs and solutions

Business share protection requirements for partnerships are twofold:

To ensure that if a partner leaves the business for any reason, the business can continue under the control of the remaining partners without undue financial strain.

Ensuring that when a partner leaves the business their family is adequately provided for.

These problems may arise when a partner dies, retires or becomes incapacitated as the following sections demonstrate.

Death

When a partner dies, their share of the business normally forms part of their estate for the benefit of their family. While some companies have restrictions within their memorandum and articles of association limiting share ownership to certain individuals – and determining who has the initial right to acquire shares – it will be assumed that the shares pass in the first instance to the family.

The family then has two alternatives:

1. A member of the family could take over the deceased's position as partner, or they could appoint someone to act on their behalf.
2. Realise the value of the share.

Either of these alternatives can present problems for both the family and those remaining in the business. Under alternative (1) a member of the family may not want to become involved in the business or may not have the right experience or qualifications to do the job. The family could also have a problem finding someone who would be willing and able to act on their behalf.

For those remaining in the business, alternative (1) may not be attractive. They may be reluctant to invite a member of the family to become a partner or a member of the board, especially if that person does not have the relevant experience. This situation is most likely to apply if the family of the deceased had only a minority shareholding in a company, or if their shareholding had been split between a number of beneficiaries on their death.

Alternative (2) is most likely the preferred option of both the family and the remaining partners, if the family could sell the share to the other partners in the business. However, this can only happen if the other partners have the funds available to purchase the shares. They may have to resort to liquidating some assets, borrowing the money or trying to find a replacement partner themselves to buy out the family's share. Depending on the circumstances, it is not certain that any of these options will be open to the remaining partners.

For example, if one of the partners in a computer software development business died and the deceased was the technical expert behind the success of the partnership, there may be few assets, if any, to liquidate. The expert may be extremely difficult, if not impossible, to replace and the bank may not be willing to make a loan to the remaining partners if they do not see the business as being viable without the technical expert.

For the family, the sale of their share may present real difficulties if the remaining partners are unable, or unwilling, to buy out the share within a reasonable period of time. Shares of partnerships and small private companies are not generally readily saleable and even if the family did find a buyer, they may not get the price they thought the share was worth, especially if it is a minority share. Of course, if the family did sell their share to a third party it would likely lead to difficulties for the remaining partners and possibly a takeover or merger, depending on the size of the share held.

Ultimately, if the family and the business cannot resolve the situation satisfactorily, it may lead to the business being forced into liquidation, with both sides losing.

Product solutions

A carefully written share protection plan will help to ensure that on the death of a partner a lump sum will be immediately available to the remaining partners, enabling them to buy back the share from the family, remain in control and ensure the continuation of the business. Such a plan would consist of life insurance plans, combined with a share purchase agreement (see 'arranging the cover' for more details).

Major illness and disability

Not only do partnerships have to plan for a partner's death, they have to consider what would happen if a partner became seriously ill or disabled. The long-term disability or critical illness of a partner could lead to severe financial problems for both the business and the partner concerned. The partner would not be contributing to the daily running of the partnership, but would still be drawing an income in the short term. In the long run, the partner may never be able to return to work so would require another source of income to maintain their standard of living.

A partnership agreement normally specifies what will happen if a partner becomes incapacitated and unable to fulfil their role in the business. Quite often, they will be treated as 'prematurely retiring'. This means that the partnership will face many of the same difficulties as when a partner retires at the normal age, but without the benefit of knowing the 'retirement date' in advance.

To overcome this problem an agreement could be made to facilitate the sale of the critically ill partner's share to the other partners.

Product solutions

It is possible for a company to effect a policy that combines both life and critical illness cover. This would pay out a lump sum on death, or on earlier diagnosis of a critical illness such as heart attack, stroke and major cancer, thereby providing the remaining partners with the necessary funds for share purchase on disability as well as on death.

Retirement

When a partner retires from their business, they will need a retirement income. If this income is to be provided by selling their share of the business, all the partners will face many of the same problems that would occur on the death of a partner as outlined above.

Of course, having been closely involved in the running of the business, the retiring partner is more likely to have the interests of the business in mind than the family of a deceased partner, but the situation will still be difficult if the retiring partner requires a cash sum, and the remaining partners do not have the financial resources to buy their shares.

Some partners will want to retain some involvement in the business even after they have retired, so may choose to leave some – or all – of their share in the business or withdraw it over a number of years. This scenario is likely in a family-run business or where the retiring partner is making way for another family member. In this situation, the partner will require an independent source of retirement income.

It is not uncommon for a partnership agreement to stipulate that each partner will effect a private pension arrangement, sometimes also stating a required minimum contribution. This 'encourages' each partner to make sensible and adequate provision for their own retirement rather than making the partnership feel obliged to make a payment at a later date.

Product solutions

Where the partners intend to sell their share on retirement, life insurance plans combined with a suitable share purchase agreement will help ensure all goes smoothly and that the business can continue. Any type of life plan that has a savings element, such as a regular savings plan, could be used.

Private individual pension arrangements would normally be the recommended product solution where the partner plans to retire but leave his share to his business partners, or when directed to take out such a plan in the underlying agreement.

Calculating the amount of cover

The amount of cover required under a life plan effected to buy out a partner's share on death or retirement will be the value of that share as follows:

Partnerships

The value of a partner's share will consist of:

- the capital value of the partner's share in the business plus the value of their share in any other assets of the partnership, such as property
- the value of the partner's share of the business goodwill – if this is included in the partnership accounts
- the estimated value of any undistributed profits at the date of death or retirement as appropriate.

'Goodwill' can be described as 'the value of a business' reputation and the likelihood that customers will continue to be attracted, notwithstanding a change in ownership'.

In some partnerships (e.g. accountancy firms) goodwill in the form of the firm's reputation and client list, will be far more valuable than any tangible assets. The valuation of the components of a partner's share would normally be undertaken by the partnership's accountant, or other professional adviser, in conjunction with the partners and with reference to the method of valuation as set out in any partnership agreement.

Private companies

The valuation of the shares of a private company may be relatively straightforward, such as in the case of a recently formed company. However, depending on the type of company and the complexity of its operations, it may be more complicated.

The valuation should be undertaken by a professional adviser, or accountant, with reference to the memorandum and articles of association. If the company has any report and accounts – see 'guidance on financial underwriting' below – this will be a useful guide to its value.

Guidance on financial underwriting

The amount of cover calculated for share protection purposes must be justifiable.

The life insurer's underwriters will need to know who is effecting the cover and its intended purpose in order to be sure that the amount and type of cover is reasonable in relation to the partnership's/company's particular circumstances.

They would also expect to see all the partners effecting similar plans, unless adequate cover is already in place.

For larger amounts of cover, where the risk is greater, the underwriters will require more detailed information about why the cover is being effected, as requested on a financial underwriting questionnaire, and may require further documentary evidence to support the application such as:

- Company report and accounts.
- Business plan for new companies – this is a key document that is produced to support the raising of finance for the new venture and should include the business's trading projections and share prospectus (where appropriate). In addition, the financial underwriting questionnaire may need to be countersigned by the partnership's accountant or solicitor.

Arranging the cover

It has been demonstrated earlier (see 'business protection needs and solutions' section) that all sorts of problems can arise on the death, retirement or disability of a partner. These problems can be largely avoided if a suitable share protection plan is put into place and then regularly reviewed.

The legal framework

There are a number of possible share protection plans that can be used and the particular one that is recommended will depend upon the individual circumstances of the partnership.

The suitability of a share protection plan should be assessed with reference to the following criteria:

- **Money must be in the right hands** – those who will need the cash must have it available – and at the right time.
- **Equitability** – the cost of providing the capital should be distributed fairly amongst the partners.
- **Flexibility** – the plan must be flexible enough to take into account future changes in the constitution of the partnership.
- **Tax efficiency** – the plan should be designed to mitigate the effects of tax.

A share protection plan consists of:

- A written share purchase agreement
- a series of suitable life assurance plans.

The share purchase agreement provides detail on what will happen to each partner's share on death, retirement, etc and the insurance plans provide the money to carry out the provisions of the agreement. To ensure the share protection plan is effective, it is vital that the insurance plans are underpinned by an agreement.

The share purchase agreement will sometimes form part of the partnership agreement in respect of partnerships and the articles of association in respect of private limited companies.

Details of the types of plan that could be used can be found in the appropriate 'product solutions' sections earlier in this guide.

Common types of share purchase agreement

Clearly, given the number of businesses in existence, one can expect to encounter many types of agreement, formal and informal, often specifically dovetailed to what may be the relatively unusual circumstances of a particular concern.

However, in practice there are three agreements commonly encountered as follows:

- buy and sell
- double option (also referred to as a cross option)
- automatic accrual.

Buy and sell agreements

This method consists of two elements, namely the life assurance plan and an underlying legal agreement. Each partner is party to a buy and sell agreement. Under the agreement, each partner agrees to two things:

- That on death the executor(s) will sell the share of the business to the surviving partners.
- On the death of a partner the surviving partners will buy the deceased's share.

The capital to purchase the share is provided from the proceeds of a life assurance plan. The sum assured should be equivalent to each partner's share of the business. The plans are set up on an 'own life' basis for the benefit of the remaining partners.

Buy and sell agreements provide 'the money in the right hands' and can be equitable (see 'sharing the cost' section) and because they are legally binding, certain in effect.

Double (or cross) option agreements

These are used most commonly in businesses owned or partly owned by UK domiciled individuals.

A double option agreement can be incorporated into the partnership agreement, under which the following is agreed:

- The surviving partners have an option to buy the deceased's share of the business within a specified period of time.
- During that period, the deceased's estate has a duty not to sell the share to any other party. In addition, they have an option to insist on purchase by the surviving partners.

If one party exercises their option, the other party must comply. Only if neither party chooses to exercise their respective option will the share of the business remain with the family. Again, the capital to purchase the share is provided from the proceeds of a life assurance plan. Each partner effects an 'own life' plan usually set up under a business trust for the benefit of the remaining partners which ensures 'the money is in the right hands'. The sum assured should be equivalent to each partner's share of the business. The cost of providing the capital through life assurance plans can be made equitable (see 'sharing the costs' section later).

Cross option arrangements are also flexible enough to cope with new partners (see 'business trusts explained' overleaf). The new partner would complete a supplemental cross option agreement and effect a life plan on their own life under trust for the benefit of the other partners. Also, if the correct trust form has been used, the new partner will automatically become a beneficiary of the plans already effected by the existing partners. The 'optional' nature of the agreement means it is not a binding contract for sale.

Cross option agreements are the most commonly used and accepted method of setting up partnership or shareholder share protection arrangements for UK domiciled individuals.

Many existing cross option agreements are appropriate for covering the death of a partner.

To cater for any critical illness cover, clauses could either be incorporated within the cross option agreement or as a separate standalone single option agreement giving the critically ill partner the option to sell their shareholding with no reciprocal option for the fellow partners to buy.

The type of agreement that is used will be used may be influenced by by tax considerations in your client's country of residence or domicile. You should take professional tax advice before recommending a particular course of action.

‘Business trusts’ explained

For UK domiciled partners or shareholders a ‘business trust’ is normally used alongside a cross option (or buy and sell) agreement to distribute the proceeds of the life assurance plan to the beneficiaries. Whilst this type of trust may vary slightly within the market place, they generally provide for the following:

The partners in business with the life assured at the time of death are identified as initial beneficiaries. It is these individuals who will have the prime responsibility to buy the shareholding. The trust does not name the eventual beneficiaries or specify the exact shares in which they will benefit. Thus, partnership shares may be altered, partners may leave and new partners may join without the necessity of rewriting or assigning the life assurance plans as the shares of the benefits will be automatically adjusted.

Notwithstanding the above, the trust provides for the trustees to appoint the benefit of the plan in whole or part to designated potential beneficiaries. The ‘list’ of potential beneficiaries will usually include anyone who has been or is in business with the life assured, and the actual life assured.

The life assured is nearly always automatically included as a trustee. At least one additional trustee should be appointed, not least to ensure prompt payment of the policy proceeds. Ideally, this would be one of the senior members of the partnership but it should be borne in mind that the death or retirement of a trustee will probably necessitate a new appointment.

Automatic accrual agreements

This share purchase agreement is typically only used by partnerships and operates in a different way to those described above. Each partner agrees that in the event of their death their interest in the partnership would pass to the surviving partners without payment.

Then, in order to ‘compensate’ the family for this lack of payment, each partner effects a life assurance plan (either at the express direction of the agreement or voluntarily) on their own life for the benefit of their family.

The cost of providing the plans can be made equitable (see ‘sharing the cost’ section later). Each partner should undertake to review the cover provided under the plan regularly. However, since partners may overlook such increases or may be prevented from increasing their cover due to deteriorating health, an additional clause is generally incorporated in the agreement so that if the plan proceeds on death are less than the value of the partnership share, the surviving partners will have to make a payment to the deceased’s estate for any excess.

If new partners join the partnership they simply enter into the agreement with the existing partners and effect a plan for the appropriate cover. If a partner leaves they can simply continue the plan unaltered.

Each partner should undertake to review the cover provided under the plan regularly.

Handling the paperwork

Once the appropriate method of share purchase has been selected, it must be put into place. It is important that any existing partnership deed or the articles of association are examined to see if there are any existing share purchase provisions. Any provisions restricting share purchase should be amended accordingly. In the case of a partnership with no partnership deed, it would be highly advisable to execute one which includes the chosen share purchase provisions. Thus, the relevant share purchase agreement must be completed, preferably by all the partners in the business, in order to help ensure that the arrangement will be seen as a bona fide commercial transaction. All the relevant individuals complete a single agreement which is then retained by the business for safe keeping. Then, the appropriate insurance plans, which form the second half of the share protection plan, should be effected.

Normally, each person will effect an 'own life' plan, written if required, under the appropriate trust from outset (see 'The legal framework' on page 7). Any additional financial evidence required by the Life Office's underwriters should also be submitted with the applications. If a new partner joins the business they would normally complete a supplemental agreement. Alternatively, a completely new agreement could be completed by the then partners. The new partner would also effect a life assurance plan on their own life.

Sharing the costs

Usually, partners pay the premiums due under their own plans, as this is an arrangement entered into by the individuals for their mutual benefit. However, the older partners, because of their age (and possibly their larger business interest), may have to pay higher premiums than their younger colleagues, causing them to object to the inequity of the situation.

There are a number of ways in which these differing costs can be made more equitable. In both partnerships and companies, the younger partners could pay part of the cost of the older partners' premiums – e.g. the total cost might be divided either equally between all the partners or in proportion to each person's expectation of benefit.

Specifically for partnerships

- The share of profits could be altered to allow the older partners to draw a larger share, or
- The older partners could be compensated indirectly, e.g. by an increase in holiday entitlement.

Of course, any such arrangements should be formally documented.

Specifically for companies

When dealing with share purchase by shareholding directors the company itself could pay the premiums. Depending on the tax regime in the individual director's country of residence, such payments could be regarded as remuneration for income tax purposes for the individual, but as an allowable expense against tax for the company. The company could increase the director's salary to cover this additional tax liability, which would effectively result in no personal cost to the director. At the same time, if the premium is an allowable expense, this can also result in an overall saving to the company.

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Friends Provident International has over 35 years of international experience and our heritage dates back over 180 years.

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