Are you in a BUSINESS 'MARRIAGE'?

Could your business survive if you or a key person in your business were out of action for a while due to illness or injury?

WORDS BY SHARON GIBLETT

Many New Zealand business owners are in partnerships involving two or more people, with each person providing money, skill or knowledge. Nearly half don't have a succession plan.

In a business, as well as sharing the profits, you also share the losses, and one of the greatest losses to a business can be the unexpected departure of a business owner or key shareholder.

Could your business survive if you or a key person in your business were out of action for a while due to illness or injury, or what if they were become permanently disabled or die? Could you afford to buy your business partner's share of the business? If not, you could be forced into business with someone you may not know or like, or even forced to wind up the business. What would the impact be on your expenses, revenue, your clients' expectations, and your relationships (business and personal)?

This is where a Buy/Sell Agreement (BSA) between the partners or shareholders is beneficial. Think of it like a business 'pre-nup'. A BSA details what the trigger events are e.g. illness, injury, death, when the BSA should be activated and how the business is to be appraised to determine the value of the afflicted shareholder's shares. A BSA will often be accompanied by an insurance policy set up to pay out when a triggering event occurs. Ownership structure of these policies is extremely important to ensure the funds at claim time end up in the hands of the correct party.

A BSA differs from, and can operate in parallel with, a Shareholders Agreement which outlines the company's constitution and typically covers more detailed and general provisions surrounding the shareholder's dealings with the company and one another e.g. management and operations of the company, control of shareholders, transfer of shares, pre-emptive rights, restraints of trade etc.

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Case Study

Sally and Samantha run a successful business and rely on a carefully chosen team of advisers, including an Accountant, Lawyer and a Financial Adviser. They meet with their Accountant to discuss their buy/sell agreement planning. She recommends that they meet with their Financial Adviser who can recommend appropriate insurance to sit alongside the BSA.

A few years later Sally is diagnosed with a critical illness and is unable to continue working. Sally dies ten months later. The BSA was triggered when Sally could no longer work in the business and **the insurance policy paid Sally's wages during her illness.**

Upon her death, it paid a lump sum to her husband in exchange for Sally's shares in the company, which then transferred to Samantha.

Samantha then took full ownership of the business and continued to run the company, was in full control of its operations, protecting the future value of the business.

Sally's husband didn't have the worry of the business and has money available to sort out his financial affairs and keep the family afloat.

What could have happened?

As Sally was a 50% shareholder, she could have continued to draw income from the business even though she was unable to work. Both her income and Samantha's income could drop significantly due to the loss of Sally's involvement in the business and therefore cause a further drop in business income. On Sally's death, Samantha realises that she now has a new business partner (Sally's husband) who is contributing nothing to the running of the business, yet still taking 50% of the profits and the level of business debt is increasing to support this.

There are many scenarios that could come into play here; working with a shareholder you may not know or like, inheriting a shareholder that doesn't have relevant skills and experience you need or has no interest in the business, not having enough funds to purchase your business partner's shares, not being able to get funding from the bank, being forced to find a buyer or wind up the business.

And, what if you did have the funds, what is the true and fair value of your business and how should this be determined? Do you want to end up in court with your new business partner, trying to determine the value of the business, or using assets which you may have set aside for other purposes? The capital may be locked into the business until the sale of the shares can be made, potentially leaving the deceased's family without an income?

What can you do?

Understand the potential risks for your business and determine how you are going to manage those risks. Put in place the necessary legal agreements and the funding arrangements to support the BSA. Seek professional advice because this is not a time to DIY.

Unexpected events do happen which can have a severe financial impact on a business, not just in the short term but for the future longevity of the business too. Remember business partnerships are like a marriage and unfortunately, they sometimes don't go to plan.

Some time spent planning, when everything is going well, can avoid nasty or unfair situations later.

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