

### **Have you protected your business?**

What would happen to your business revenue and any debt, if you as the owner were unable to work in the business for any period of time due to illness or injury?

Similarly, maybe you have people that you employ in your business that are important to its financial security. Perhaps they are great sales people who bring in new business, or they may be specialists in their field and you would find it difficult to replace their skills if they couldn't work due to sickness or injury.

As business owners, have you taken legal advice to ensure you have the right agreements in place, that dictate what happens to your shares if you were to die or be unable to work in the business for any period of time – effectively an exit plan should the unfortunate happen?

Some owners established these agreements at the outset when they set up the business, whilst others have done so later on. Others however, have no agreements in place. Many agreements that are in place don't deliver what the owner's expect and some haven't actually been signed as they're still in 'draft' mode which would probably make them invalid.

It's important that when you're in business with other shareholders, these agreements are established and reviewed every now and then or when changes occur. You may know of these agreements as shareholder agreements and buy/sell agreements. Many shareholder agreements have what is known as a 'pre-emptive rights' clause, saying that if one shareholder wishes to sell their shares, they have to offer them to the other shareholder(s) first at the same price they would offer them to anyone else. However, the other shareholder(s) have no obligation to buy and there is usually no mechanism or funding vehicle to enable the other shareholder(s) to actually purchase the shares. Therefore, it's important that alongside a shareholder agreement, a 'Buy/Sell Deed' is established. This enhances the shareholder agreement and says that in the event that you as a shareholder need to sell your shares, the other shareholder(s) have to buy them, and vice versa. It also helps put in a funding mechanism to pay for the shares.

Let's look at an example:

Joe and Eddy are mates and are 50% shareholders and directors of their engineering business, ABC Engineers Ltd. Joe is mainly responsible for the operations of the business and helping generate new business whereas Eddy is a specialist on the tools and helps supervise and train their engineering staff. They have 6 engineers working for them, one being an expert in his field. They also have an administrator helping Joe run the operations, plus they have a great sales and marketing person working with Joe to build up new clients and look after their existing client relationships.

Joe and Eddy put in place a shareholder agreement and buy/sell deed when they established the business 8 years ago, which covers many areas however, in general, this was to agree on the structure of the business, how it operates and importantly, what would happen should either to them wish or need to exit the business through ill health or injury and what would happen with their shares upon death. They've not really reviewed these agreements since then. They both put in \$50,000 seed capital to help them buy the equipment they needed and they also owe the bank \$150,000 in loans that they've taken out over the years to help them grow the business. Their shareholder agreement has what's known as a 'pre-emptive rights' clause and their lawyer also established a buy/sell deed alongside this.

The buy/sell deed is important, particularly if we say Joe were to die, then his estate, now being passed to his wife Sally, would own Joe's 50% shareholding in ABC Engineering Ltd and Eddy would now be in business with Sally. Sally doesn't know anything about the business and all she really wants is the cash value of Joe's shares. The pre-emptive rights clause means that Eddy has first right of refusal to buy Joe's shares as Eddy doesn't really want Sally to sell them to an external party that Eddy doesn't know, as he's taken 8 years of hard

work to build up this business and doesn't wish to see someone else come in and potentially 'upset the apple cart'. Eddy wants to take on the 100% shareholding so needs to buy Joe's shares from Sally and having asked to buy the shares, Sally is now obliged to sell them to Eddy as per the buy/sell deed. The business is valued at \$800,000 – Eddy therefore now needs to find \$400,000 to pay Sally for Joe's shares.

Eddy can do one of 4 things:

1. **Use his own personal cash in the bank.** This depends upon Eddy having this amount of cash readily available
2. **Sell some personal assets he may have.** This is a difficult option unless Joe has sufficient property or investments that he's built up personally and that wouldn't compromise his own family's lifestyle and financial security. Furthermore, he may be forced to sell these assets when the markets dictate it might not be a good time, like a type of 'firesale'
3. **Go the bank and ask for a loan.** This may be viable, however, the bank may decide to impose restrictions or high interest rates on such a loan which would affect the cashflow of the business, or may even decline to provide Eddy a loan now that Joe is no longer in the business and the business's future may not look so rosy an investment without him
4. **Claim upon an insurance policy.** This is dependent upon whether Joe and Eddy took financial planning advice and established shareholder protection insurance cover. If they did, and the cover was sufficient, the claim would release \$400,000 so that this can be paid to Sally and the shares can be transferred to Eddy, as per the buy/sell deed and 'pre-emptive rights' clause. It is a good idea to consider an independent trustee sit in the middle, so that they facilitate the exchange of shares and cash – all helping to have the correct ownership structures in place

Other things to consider:

As well as ensuring Joe and Eddy have adequate insurance cover for themselves as shareholders, they also need to consider how the business revenue and any debt or contingent liabilities within the business, would be affected if either of them as key people, or their expert engineer and sales person, were to be off work through illness or injury for any length of time. ABC Engineers Ltd revenue is basically driven by Joe and Eddy's individual skills, plus the skills of their expert engineer who would be difficult to replace, and their salesman who knows their trade extremely well and brings in a good deal of their new business and keeps their existing clients relationships strong.

Again, taking out insurance to protect the revenue and repay contingent liabilities or debt upon one of these key individuals not being able to work in the business through ill health or death, is vital to ensure the continued financial viability of the business going forward.

Finally, although I've only touched on the importance of taking care of the shareholders and key staff within a business, the knock-on effect to that individual's personal financial situation and staff morale, from someone of importance being unable to work through illness, injury to death, is another area that also needs to be carefully planned for and considerations including ACC cover should also be looked at.

In conclusion, if you're not sure if you have the right agreements and back-up plans within your business, it's important that you obtain a review of your risk management strategies. An expert financial planner working in this field will work with your lawyer and accountant to ensure that you have the right money going into the right hands at the right time.

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