Oury Clark Quick Guides:

Business Protection

Financial Services: E23

When you are setting up a business, there are so many things to think about, not least how you are going to support yourself until profits start to flow.

It is a highly stressful, if not enjoyable time, looking forward to the opportunities which your ideas are opening up. The last thing on your mind will be your health, or that of your business partners.

It may be considered rather morbid to think about, however, if you were to lose the contributions of a key partner to ill health, or worse death, the impact on the workings of a small business, could be enormous. Not only would you lose the companionship of a business partner, and friend, but you would also lose their valuable expertise. You could potentially also lose a share of your company to spouses or beneficiaries, who are interested in its value, but have little or no interest in your vision for its future.

Shareholder Protection

The answer therefore, for every entrepreneur, is to set up some level of shareholder or partnership protection. Such an arrangement will safeguard you against these eventualities by enabling the existing company directors to purchase business shares from a fellow director's family, in the event that they die or suffer a critical illness which prevents them working. It is available to individuals in either a limited company or a partnership and, combined with a good shareholder agreement, can help ensure that you and your partners retain control of your firm should the worst happen.

There are a number of ways to go about taking out the insurance. Each principal could take out a policy on each of the others, a popular approach when there are just two partners involved in a business. However, this can get complicated for three or more partners, and can also seem unfair, if the age difference between partners is significant as the cost of insurance for the older age will be much higher. For three or more partners, therefore, the more common approach is for each to write a policy covering their own life and then place it in trust for the benefit of the company itself. The remaining shareholders can then use the funds received by the company to purchase those shares and redistribute them amongst themselves.

The cross option agreement

An appropriate agreement is needed between the shareholders for the disposal of shares on death or critical illness. It must not be a binding agreement for sale otherwise business property relief from inheritance tax will not be available.

The business's legal adviser should draw up the cross option agreement to make sure it does not conflict with the articles of association or an existing partnership or membership agreement.

The agreement works by creating a 'sell' option for each owner in the event of their death and/or critical illness and a 'buy' option for the co-owners in the event of death only. The exercise of the sell option will mean the surviving owners must buy the dead or critically ill owner's share; the buy option will require the deceased owner's personal representatives to sell the deceased's share to the surviving co-owners.

If the arrangement is to include options on critical illness, clients need to consider whether they only want an owner who suffers a critical illness to have a single option allowing them to sell, or if they also want the other owners to have an option to buy. If they choose a single option on critical illness, the owner who suffers a critical illness cannot be forced out of the business against their will. This gives that owner the opportunity to continue in the business if they recover and are able to return to work. But it also means that if they are unable to return, the remaining owners have no right to buy their share of the business. This could mean that the ill person is still entitled to their share of any profit even though they are no longer contributing to the business.

Calculating the Value

Valuing a business is a difficult task. The sensible course of action is to involve the business's other professional advisers, their solicitor and accountant, to find the most appropriate valuation method.

Key person and Loan Protection

Of course, it is not just shareholders who add value to a business and it is not just their shares you need to worry about. Protection could also be extended to cover directors' loan accounts so that money is available to cover the company's liabilities. In addition, key man insurance can help support a business should anything happen to a particularly valuable employee.

Any outstanding business loans will need to be covered (apportioned between the relevant key people as appropriate). As well as the lender usually requiring this cover, many directors may have given personal guarantees and/or used their own residential home as security, so there is the added need to ensure that dependants are protected.

Directors may well have made loans to the company themselves either by making a cash injection or leaving salary, bonus or dividends in the business. These are known as director loan accounts. On death they become repayable to the estate of the deceased key person and therefore need to be included in the sum assured. On critical illness the repayment of such a loan would give the director much needed personal financial security.

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