Insurance Funded Buy Sell Agreements

View Legal

WHAT IS A BUY SELL AGREEMENT?

A buy sell agreement is a contractual arrangement between members of a jointly owned business (for instance, a company). The agreement is structured so that subject to certain events relating to the departure of a principal, the continuing principals are given the option, or in some cases are obliged, to purchase the interest of the departing principal.

NEED FOR AN INSURANCE FUNDED BUY SELL AGREEMENT

While buy sell agreements can be structured without insurance, there is often insufficient capital available for the remaining principals to buy out the exiting principal without suffering financial hardship.

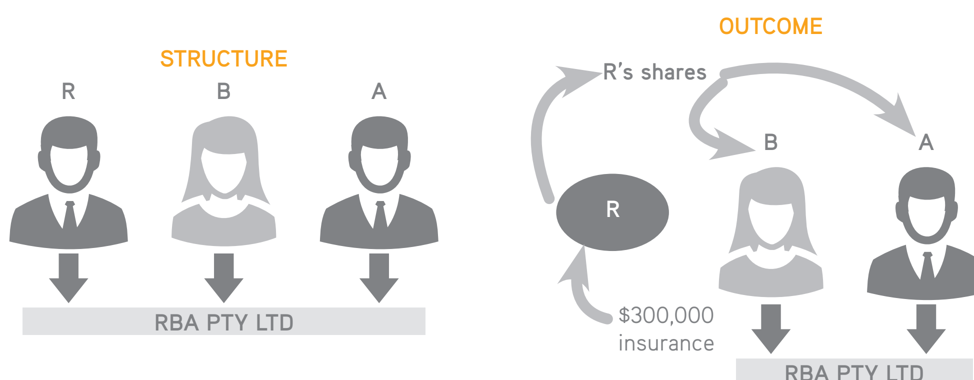
If one of the principals in a business suffers an insurable event, significant commercial difficulties can arise unless there is adequate insurance protection and a legally enforceable agreement.

Insurance funded buy sell agreements deal with the valuation and transfer of the equity in the business from the beginning, avoiding the awkwardness and unpleasantness that often accompanies buying out an exiting principal or their estate where no pre-agreed arrangements are in place.

The insurance funding provides liquidity to ensure the transfer of equity does not create financial difficulties for any of the parties.

ADVANTAGES OF AN INSURANCE FUNDED BUY SELL AGREEMENT

Example:



The buy sell agreement is implemented contemporaneously with each principal (or a trustee) taking out additional insurance. The agreement gives each of the principals the option of forcing a sale of shares to the other principals, should a principal suffer a triggering event. Buy sell agreements are normally designed to ensure that equity in a business remains closely held. As with any contractual arrangement, a buy sell agreement can override the provisions of an individual principal's will. Buy sell agreements reduce the likelihood of members ending up 'in partnership' with unwanted 'partners'.

KEY ISSUES TO BE CONSIDERED IN PREPARING A BUY SELL AGREEMENT

The triggering events under an insurance funded buy sell agreement are typically:

- death
- TPD
- trauma

It is generally also preferable to implement a non-insurance funded buy sell agreement or participation agreement to account for triggering events such as:

- bankruptcy of a partner
- divorce of a partner
- retirement at a compulsory retirement age, or earlier
- dismissal from the business

The above summary is based on the law as at 1 October 2017.
This summary covers legal issues in a general way. It is intended for information purposes only and should not be regarded as legal advice. View Legal does not assume a duty of care in connection with this document and further advice should be obtained before taking action on any issue mentioned.

In both types of agreements it is important to consider issues such as:

- valuation of the exiting partner's interest
- payment terms
- how new partners can be admitted

The manner of owning the policy also needs to be considered. The two main options in this regard are:

- self-ownership - where each principal owns their own policy
- trust ownership - where a trustee holds all policies on behalf of the principals. This is generally only appropriate for 'hybrid' arrangements where the insurance proceeds will be divided multiple ways

HYBRID ARRANGEMENTS

A 'hybrid' self-ownership approach is a variation on standard self-owned arrangements. The hybrid model can significantly simplify the legal documentation required and maximise the commercial and tax outcomes.

Under the hybrid arrangement, either self-owned or trust-owned insurance policies are obtained which are sufficient to ensure that:

a. the principal suffering the insurable event (or the principal's estate), receives insurance proceeds at least equal to the market value of the principal's interest in the business;
b. any excess component of the insurance proceeds is distributed to the continuing principal to apply for any purpose, including the repayment of debt; and
c. any excess component of the insurance proceeds, once the two funding requirements above have been met, may be kept by the principal suffering the insurable event (or the principal's estate) to apply for any purpose.

Under the hybrid approach, the principals and their adviser must review the adequacy of the overall insurance cover on an annual basis, and then adjust (if necessary) how each component of the cover is to be applied should an insurable event take place.

Having said this, the principles underpinning the hybrid approach also provide solutions where, on an insurable event, the principals want to deal only with the debt of the business, as opposed to equity transfers.

SUMMARY

The potential consequences of the unexpected exit of a principal are generally unfavourable, reinforcing the reasons why insurance funded buy sell agreements are so important for the sustainability of a business.

Where two or more unrelated people are carrying on a business, an insurance funded buy sell agreement helps to ensure a fair outcome when a triggering event takes place. It also provides certainty for each principal's personal estate plan. This is because there is a price or valuation mechanism established on a reasonable basis and set out in writing and insurance funding available to avoid creating financial hardship for any of the parties.

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