

CO-DIRECTOR/CO-PARTNER SHARE PROTECTION COVER – EXPLANATORY NOTES

These notes are designed to help business owners consider steps they could take to protect their families and their businesses if the unforeseen should occur. Whilst these notes assume “the business” is a limited company, they apply equally to partnerships as well.

Most of us take steps to protect our families in the event of our death through life assurance arrangements. However, this thinking often does not extend to embrace the implications for our business assets. A shareholding director (or partner) should therefore ask themselves the following question;

- Have I made a Will?
- What would happen to my shares in the event of my death or early retirement following a critical illness?
- How would the value of those shares be released to my dependants?
- Could the company afford to pay me if I was off work for a prolonged period of time due to accident or illness?

In these notes, we will look at each of those issues separately, but it must be stressed these notes are for information purposes only and are based on our understanding of current rules and regulations which are always subject to change. We can therefore accept no responsibility for any actions taken or not taken as a result of these notes and independent professional advice should always be sought.

Have you made a Will?

Everyone should have a valid Will, but it is even more imperative for shareholding directors or partners whose financial affairs are likely to be more complicated than average.

Shareholders Agreement

A Shareholders Agreement will set out what will happen in the event of a shareholder dying, suffering a critical illness or being unable to work for a prolonged period of time due to accident or illness. It can also cover a range of other issues and it is appropriate to take legal advice in the construction of this document. More often than not, directors take advice on their Wills, the Shareholders Agreement and Cross Option Agreements (which are referred to later) in one package.

Case study

We often find it easiest to explain the concept through a worked example. In this case, we have a limited company with three shareholding directors. Paul owns 42% of the shares, Dennis 15%, Richard 38% and Richard’s wife 5%. They have decided that;

- If Paul dies, his shares go equally to Dennis and Richard;
- If Dennis dies, his shares go equally to Paul and Richard;
- If Richard's wife dies, her shares go to Richard;
- If Richard dies, his and his wife's shares go equally to Paul and Dennis.

Life assurance requirements

Upon death, a director's shares will fall back into their estate to be distributed according to the terms of their Will. We are assuming the spouse is the sole beneficiary. Therefore, if Paul was to die, his wife would become the owner of 42% of the shares in the business but, in truth, she would probably prefer their true value in cash and the surviving directors would like to take ownership of the shares. This can be achieved by Paul taking out a life assurance policy on his own life for a sum assured equivalent to the value of his shares, with the policy written in trust for Richard and Dennis. Upon Paul's death, the sum assured gets paid equally to Richard and Dennis. There exists a Cross Option Agreement which says that either the Executor of Paul's estate, or Richard and Dennis can require the exchange of the sum assured for the shares so that Paul's widow ends up with their cash value, whilst Richard and Dennis take ownership of Paul's shares.

Dennis takes out life assurance cover on his life, written in trust for the benefit of Paul and Richard, but no life assurance is required on Richard's wife because, in the event of her death, her shares transfer to Richard anyway under the terms of her Will. It is slightly more complicated if Richard dies, because not only would his widow want the cash for Richard's shareholding, but she would probably want to sell her 5% as well. Therefore, Richard takes out a policy on his life, written in trust for the benefit of Paul and Dennis, but whereby the sum assured reflects the value both of his shares and his wife's.

It should be pointed out that for life assurance purposes, the Cross Option Agreement mentioned earlier, can be triggered by either the surviving shareholder directors or the Executor of the estate of the deceased. Both parties may decide not to exercise their option when the shares would pass under the terms of the Will and the insurance monies would be retained by the Co-Directors.

Critical Illness

A shareholding director may be diagnosed with one of a specified list of critical illnesses. Our chances of surviving a critical illness continue to improve but the director's ability to participate fully in the business may be impaired and early retirement can often be the best option, but where does the money come from to buy his shares?

Each director can take out a policy providing a sum assured equivalent to the value of their shares which will be paid upon the diagnosis of a critical illness. In the same way as the life assurance policies, the individual takes out a critical illness policy on their own life and written in trust for the benefit of the other two directors. Picking on Paul once again, if he suffers a critical illness, the sum assured is paid equally to Richard and Dennis who, under the terms of the Shareholders Agreement, hold that sum assured under

trust for a period of, say, 6 months whilst Paul, hopefully, recovers and considers his future. If Paul decides to come back to work, Richard and Dennis keep the sum assured (although there may be some private arrangement that will ensure the sum assured is distributed equally). However, if Paul decides, for whatever reason, that he doesn't want to come back to work, then under the terms of a Single Option Agreement, he can require the transfer of the sum assured for his shares. The important point to note here is that under a Single Option Agreement, only Paul can make the decision that he is not coming back to work, the other two directors cannot force him out.

Long term sick leave

If a director is off work for a prolonged period of time due to accident or illness, it will not help their recovery worrying about for how long the company can continue to pay their salary when they are not contributing to the profits of the business. The other directors will be similarly anxious and for the same reason. The Shareholders Agreement is therefore likely to say that in the event of long term absence, the business will pay the director for, say, 12 months at which point their remuneration will cease. The Agreement will therefore also say that the director must personally effect and maintain an income protection policy which will provide them with, typically, 50% of their pre-disability earnings, tax-free, after a deferred period of 12 months so that benefit comes into payment immediately once salary stops. This benefit will continue to be paid to the director until he came back to work or the policy reached its maturity date of, say, 60 or 65.

If all of the above measures are implemented, a business and its owners have done as much as they can to make funds available in the right way, at the right time, to help ensure the survivability of the business and fair treatment for the directors and/or their dependants.

As at 23rd January 2006