Case Study
When Insurance Cover Unearths Unexpected 'Value-add'

By **Mark Story**

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An authorised representative of Aon Wealth Management, Rowson has been a business succession specialist since 2002, and holds an MBA from Swinburne University of Technology. A former partner of Lakeside Consultants where he specialised in insurance advice, Rowson established Trumpet Financial as a full service financial planning service covering: Wealth creation, risk insurance, tax planning, family wealth transfer/estate planning, and business succession planning in 2008.

What comes first, the insurance cover or the underlying business succession strategy? As Melbourne-based company directors discovered by default – no business should have one without the other.

With growing concerns that they had inadequate personal life and income insurance, forty-something owner/directors Martin Morey and David Greig of Melbourne-based commercial air conditioning specialists, Fraser & Mountain began a search for adequate protection. Based on a referral from the firm's general insurance broker, Morey approached Todd Rowson, business risk adviser with Trumpet Financial, to provide some specific death, total permanent disability and key-man insurance cover options.

However, Morey and Greig got significantly more than they bargained for when Rowson's initial review of requirements unearthed a Pandora's box of exposures confronting the business. Had these issues not been addressed, Rowson said the company would have been left exposed to significantly greater risks than the directors simply being under-insured.

"Given that Martin and David only had death and total permanent disability (TPD) insurance via previous SGC to personal super, they were both significantly under protected," said Rowson.

BUILDING THE FRAMEWORK

Insurance cover aside, Rowson said the company lacked a legal framework governing myriad business procedures, none the least being what happens when a director leaves the company.

"Results of a recent Monash University study show that less than seven percent of businesses have an agreement governing the unexpected involuntary departure of business partners and directors – whether it's through illness, death, retirement or otherwise," advises Rowson.

Morey never envisaged that the services of a financial planning firm like Trumpet could extend beyond insurance or personal wealthy creation and into the realm of business succession strategy. Nor did he realise that by incorporating insurance cover within the agreement – the business succession strategy would be provided at no additional cost beyond that paid in commission.

"It was a wake-up call to realise that the expertise of a financial planning firm could extend to such matters, and it opened up our eyes to the importance of a buy/sell agreement," said Morey. "We'd never formally discussed how business revenue might be impacted if one of the directors left or died – let alone what it meant for any future ownership structure."

Given that one of the firm's three directors was in his mid 60s, Morey said the business succession agreement – constructed under Rowson's guidance – also needed to address what would happen to his share of the business after his impending retirement.

"During my initial meeting with Martin, who had approached me individually, I become mindful that the security and continuity of the business was an issue," said Rowson.

"While Martin and David wanted to buy out their senior partner, there was nothing in place to prescribe when or how this would be executed. Equally important, there was no business succession structure governing how they'd operate after his retirement."

OVERARCHING AGREEMENT

After going through a number of 'what-if' scenarios with Morey and Greig, Rowson established working guidelines on what would happen within the business if and when any of them were to eventuate. After running the same 'what if' scenarios over their family considerations, Rowson made a series of recommendations that would be incorporated into a formal overarching agreement.

"Given his age, the associate costs, and his plans to exit the business, Morey and Greig were understandably reluctant to insure their more-senior partner. But they did have to address how the sale of his long-standing stake in the business would be executed," recalls Rowson.

Key considerations that Rowson needed Morey and Greig to address before an overarching agreement could be reached included:

a) What would a buy/sell agreement look like? "The buy/sell agreement was a straight forward net-equity payout," said Rowson.

b) What impact would a director's inability to return to work have on revenue?

c) What would happen to the business in the event of director's death?

   "It was established that if one of us died, our family would be paid an amount – based on pre-determined valuations – and the remaining equity in the business would automatically transfer to the surviving partner," said Morey.

d) What impact would a director's need for income following injury have on the company's resources?

e) What responsibilities would directors have should one of them choose to exit the business?

f) What methodology would be used to determine the amount and speed at which payments would be made to a director who wasn't insured?

THE IMPLEMENTATION

Firstly, based on Rowson's advice, both Morey and Greig took out death or TPD insurance cover with ABC Insurance – in the event of illness or injury up to age 65 – plus 'key-man' revenue protection.

"Key-man cover meant that in the event that one of us was incapacitated, the funding needed to hire expertise to help run the company (for up to two years) wouldn't financially burden the business," said Morey.

Secondly, sufficiently formalising Morey and Greig's thinking on certain business outcomes meant that they would spend significantly less time on fees once Rowson handed them over to specialists required to prepare the legal agreement.

He said going through this preparatory process in some detail acted as a catalyst to progress things in other areas, especially regarding the exit of the retiring director.

"Putting things on the table allowed the three directors to have necessary discussions around time-frames and roles of those involved," said Rowson.

BUY/SELL

Emanating from these discussions was the all-important buy/sell agreement outlining how and within what time frame the two remaining directors would purchase the older partner's share of the business. Given that the older partner also owned the premises from which the company operated, a corresponding lease agreement was also drafted simultaneously.

Other obligations within this agreement included the buy options in respect to equity, tax implications of funds received under various insurances, and their stated values. Rowson said it was equally important that the agreement include a prescribed mechanism for dispute resolution, a schedule identifying the underlying value of the business, and the values held by each director and under what entities (shares, units, family trusts).

"We also needed to consider directors guarantees and what would happen if one partner was not around," said Rowson.

SIMPLIFYING THE PROCESS

With all the necessary insurance in place, the year's financials all but finalised and the lawyers sufficiently briefed, much of Rowson's initial brief with Morey and Greig was complete. Looking back, Rowson said he wanted to take Morey and Greig to the point where they were sufficiently happy with the process and that the legal aspects would be a mere formality.

"Looking forward, I want to ensure that the agreement and the insurance cover continue to match their professional and personal circumstances," said Rowson.

"Regular reviews also ensure that the agreement continues to act in the best interests of the business following any changes in the regulatory environment."

With Morey and Greig fully committed to an insurance-backed agreement from the 'get go', Rowson did not have to issue terms of agreement for the underlying advice provided. He said as well as having the insurance they were looking for, Morey and Greig also gained a formal road-map for the business, plus much needed clarity around the involuntary departure by a director.

IN RETROSPECT

In hindsight, Morey said the six month 'go to whoa' journey with Rowson was one of self discovery into various dynamics about the business that none of the directors had previously explored in any depth.

"As a contractor, we always had work in front of us, but what we lacked was any formal structure that would provide adequate protection for directors and their families, while ensuring business continuity for employees," said Morey.

He said the biggest education was around implementing the right framework for a buy/sell agreement, which by default meant addressing numerous business issues that would have otherwise been crisis-managed once they surfaced unexpectedly.

Given how long it took to establish, Morey expects the insurance-based buy/sell agreement to remain intact, subject to ongoing modification – for at least 15 years. The best bit of advice Rowson provided, adds Morey, was around planning for a crisis they hoped would never happen.

From the very first meeting, he said Rowson made it perfectly clear he was more interested in establishing a comprehensive business protection package than simply providing advice on insurance cover.

"For David and I it was very much a case of 'we didn't know what we didn't know' until Todd open our eyes," said Morey. "The buy/sell agreement which rotates around insurances – and is tied together with a legal document – gives us as directors and our families, plus staff, the comfort of knowing that adequate provisions are in place to cater for the unexpected."

ADVICE STRUCTURE

Trumpet Financial's fee structure is subject to the type and amount of work undertaken. The firm typically works on a fee-for-service basis, however wherever commissions are received the corresponding fees are dialed back to zero. Rowson typically charges a flat-fee of $3,500 for business succession advice. However, when this advice is supported by an insurance-backed agreement, fees are waivered when commissions apply. ●

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