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Business Succession

A trauma insurance payout as a trigger event

Introduction

When developing your business succession plan, a question we may ask is whether or not you want to include the payout of Trauma or Critical Illness insurance cover as a trigger event in your Buy Sell Agreement. Before deciding, it is essential to consider the following issues.

What is a trigger event?

A trigger event is a particular event in which a Buy Sell Agreement may come into effect. A Buy Sell Agreement can include up to three types of trigger events related to insurance payouts - death, total and permanent disablement (TPD) and trauma (or critical illness). You may choose to include one or more of these events in your agreement.

For each trigger event you include in your agreement, if a partner is the subject of one of those events, they may be forced to leave the business by the other partner(s), with the departing partner compensated for their equity value in the business by this insurance cover.

So, what is the problem with a trauma cover payout as a trigger event?

Although there may be differences between insurance companies, a trauma or critical illness event is generally associated with conditions such as cancer, heart and blood disorders, strokes and nervous system disorders. If someone suffers a trauma or critical illness event that is covered by insurance, they may recover, unlike a death or TPD event.

There is therefore an element of potential unfairness associated with including trauma or critical illness insurance cover in a Buy Sell Agreement as, if it is included as a trigger event, and a partner suffers a trauma or critical illness but recovers, they can be forced to leave the business. However, it is also possible they won't be able to return at full capacity. In that event, the remaining partners may have a problem.

As such, the uncertainty and ambiguity about the effect of the trauma or critical illness event on someone's ability to work longer term raises questions about whether trauma or critical illness insurance cover should be included as a trigger event in a Buy Sell Agreement.

The possibility of recovery

Let’s say one of your business partners has suffered a trauma event or critical illness. How do you determine whether they will recover and how long it will take them to do so? How do you evaluate their performance fairly?

Or perhaps they think they've recovered but you believe their performance level is no longer adequate. That person may consider they are fit and well enough to work again but you might not agree and want them out of the business.

Alternatively, perhaps they are well enough to continue in the business, but the opportunity for the remaining partners to take over their equity is too good to resist.

The uncertainties around these issues call for a different solution.

If you don't include a trauma insurance payout as a trigger event in the Buy Sell Agreement, what are your options?

Include trauma insurance in an Exit Agreement

Due to the reasons outlined above, we recommend that clients consider managing a trauma or critical illness insurance payout in a separate agreement called an Exit Agreement. This agreement covers voluntary and forced exits, under certain conditions. If a partner suffers a trauma event or critical illness, and receives an insurance payout, the Buy Sell Agreement is not triggered, and they can’t be forced out of the business. However, in the event a partner can no longer work again, the

Special Offers

1. **Free phone call** with a lawyer to discuss how these agreements work. Please call us to organise a time.

2. **Free review of your Partnership Agreement**. If you want to ensure your existing agreement is appropriate, we will review it obligation-free. Please email us a copy.

Business Succession…

Exit Agreement can provide the continuing partners with the ability to force the exit of that partner, if they are unable to work at full capacity, for example, as a result of a critical illness.

If they choose to force them out, they must pay out the departing partner for their equity. However, if there has been a trauma or critical illness insurance payout, that amount may compensate them in full for their equity, or if it is not large enough, can be deducted from the amount owed by the continuing partners.

Why do we say the trauma or critical illness insurance payout can be deducted from the amount owed?

Problems with the payout amount

As with most insurance, where an event is more common, or likely to occur, it is more expensive to insure. As a critical illness or trauma event is relatively common, it attracts more expensive premiums. It can also be difficult to insure for the same amount as death and TPD (when large sums are involved) and as such, may not be enough to cover the value of your equity in the business.

This raises a problem when developing your business succession plan. What would you do if the trauma or critical illness insurance payout was less than the equity value? Would you want the continuing partners to pay out the shortfall in equity value to the departing partner?

Let's consider an example. A business is valued at $1m and has two equal owners with equity value of $500,000 each. Both partners have life and TPD cover of $500,000 to cover their equity, and they also have trauma cover, but only for $200,000. So, there is a shortfall between the trauma insurance payout and their equity value of $300,000 [see Notes 1 & 2 below].

What would happen in the event of a trauma or critical illness insurance payout? In this instance, the departing partner would receive $200,000 from the insurance company. Under the Exit Agreement, if the principal can no longer work at full capacity, the remaining partner can force the equity owned by the departing partner to be transferred to the continuing partner.

However, in this case, the clients can choose to include a clause that ensures the $200,000 of trauma cover is deducted from the equity value owed, if it occurs within a certain timeframe, leaving the continuing partner to pay the additional $300,000, usually over time.

In this scenario, this ensures the continuing partner can only force the exit of the partner if they are unable to perform at full capacity, with a shortfall payable where appropriate. It also ensures the departing partner receives fair compensation for their equity in the business.

Key Person Insurance

With a trauma or critical illness event, a partner could be off ill for quite a few months. To help the business cope with that, Key Person cover could also be taken out to cover the partner for a trauma event or critical illness, with those policies owned by the business. That way, if a partner does suffer a trauma event, the business has enough money to either pay them while they are off work or to fund a replacement over the same time.

Summary

If you are preparing your Business Succession Plan and you would like more information please call us now on **03 8621 9000** or send an email to **info@irongrouplawyers.com**.

Notes

1. You may also choose to insure for an amount to cover capital gains tax (CGT) that might be payable when the equity is transferred.

You also need to ensure the policies are correctly owned to avoid additional CGT that may be payable when the insurance money is received to compensate for your equity share. Your Financial Adviser can assist in this regard.

2. Even though the departing partner has only received $200,000 in the event of a trauma payout, if they were forced to transfer their equity on this basis, they may still be liable for CGT on the full value of their equity i.e., $500,000.

**We have used the term 'partners' throughout this insight but it can equally apply to shareholders, or unitholders.*

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