

Shareholder Protection – Trustees and Closely Held Companies

Although there is an increasing trend for the shares of a private enterprise to be transferred to a Trust, there does not appear to be a correlating trend for Trustees to require legal structures to be implemented to protect the rights of the Shareholders and ultimately, the beneficiaries of the Trust.

There is little dispute amongst professional Advisers that shares in a closely held company are a higher risk investment than the shares in listed stock. These shares are not easily tradable especially if they do not provide the purchaser with a majority control over the business. As we frequently say – there is not much of a secondary market for a non-controlling interest in a closely held company.

It is also well recognised that the solvency and profitability of a closely held company is often directly linked to a few key individuals – the Founder Shareholders. The value of these businesses can therefore decline rapidly following a major event to a key person. It is estimated that at least 20% will be forced to wind-up within three months.

Further aggravating risk is the fact that it is common for these businesses to have borrowings to external parties which have joint and several guarantees provided by the Shareholders and which reach through to the assets of the Trust.

Issues for Trustees to Consider

The case study in the side box highlights a situation that Trustees may be faced with if something serious happens to a key person in a business. Some issues that Trustees should consider when the shares of a closely held company have been transferred to a Trust include:

Will the beneficiaries' interests be best served by selling or holding shares post a major event affecting a key person?

To determine this, Trustees should seek advice on how the loss of that key person will impact on the performance of business and ultimately the value of the business.

Should the Shareholders Agreement be binding or pre-emptive?

A pre-emptive arrangement may enable the remaining Shareholders to decline to purchase the shares leaving the Trust to try to find an external party. Unless the external party can purchase control then a sale may be difficult. The Trustees wishing to sell may find they are a price taker not a price maker with the only interested purchasing parties being the existing Shareholders.

What events will trigger the forced sale of shares?

Death and permanent disablement are common triggers within a buy and sell arrangement. In closely held companies where a Founder Shareholder is key to the financial performance of the business, it may be relevant for Trustees to consider a forced sale if the absence is going to extend beyond six or 12 months.

What valuation methodology should be used and when should the valuation take place?

If there is a delay between an event occurring which triggers the buy and sell and the actual sale taking place, the price of the shares may be heavily discounted as the longer the duration, the worse the financial state of the business. Trustees may therefore be prudent to consider an agreement which sets the price of the shares each year following the completion of the financial accounts.

ZXY Company Limited

Shareholders

- 32% ABC Family Trust and 1% Founder Shareholder and Settlor
- 32% DEF Family Trust and 1% Founder Shareholder and Settlor
- 32% GHI Family Trust and 1% Founder Shareholder and Settlor

The company constitution provides for pre-emptive rights to existing Shareholders for the buy and sell of shares.

All three Founder Shareholders work in the business in key roles. Company value is \$1,500,000 based on three x EBIT of \$500,000

One Founder Shareholder becomes seriously disabled and cannot return to work. The company loses sales revenue of 15% over 12 month period. The company has not made any provision for Key Person Risk. EBIT drops to \$100,000.

The Trustees of the Founder Shareholder's Trust wish to sell the shares and offers the shares to the remaining Shareholders. The Company value when shares are offered for sale = \$300,000.

The Trustees are offered \$100,000 for the shares by the remaining Shareholders.

How will Joint and Several guarantees be revoked following the sale of the shares?

Trustees may want to ensure that the selling Trustees can revoke guarantees provided to the business. Clauses in the Shareholders Agreement will need to address the process for doing this and the obligations on the remaining parties. This may also require some of the debt to be reduced to enable a reduction in securities provided.

How will the Trustees fund the purchase of the shares?

The options most likely to be available to the Trustees are current cash reserves of the Trust, borrowing from a bank or insurance.

Have all other aspects of Estate Planning been completed to ensure timely settlement can occur including Wills, Memorandum of Wishes, Enduring Powers of Attorney and Relationship Property Agreements?



Insurance as a Funding Mechanism

Insurance can be a practical way of creating cash to purchase the shares. It avoids the Trustees having to ensure that the Trust maintains cash reserves for the 'what if' or avoids the Trustees having to increase the debt of the Trust.

Trustees should seek professional advice however to ensure that the structure of the insurance will enable the objectives to be met. This advice should cover the following issues:

- What types of insurance policies match the triggers that have been agreed to in the Shareholders Agreement?
- How should the policies be owned to ensure the Trustees will have access to the funds when they are required?
- Who is responsible for the payment of the premiums and what bank accounts should the premiums be paid from?

- What exclusions are on any policies that would mean the Trustees do not have funds following an event?

Summary

When the shares of a closely held company are transferred to a Trust, Trustees should consider their fiduciary obligations and duty of care to beneficiaries by ensuring that there is a well-structured legal arrangement in place to manage the transfer of shares under a planned or forced retirement of the associated person.

Trustees may find that the most effective way to fund the purchase of the shares is with insurance. It is common to find that there are no legal or funding arrangements in place in closely held companies even where Trusts are involved or that where such arrangements are in place they have been poorly structured.

Source: Triplejump Limited

Introducing ACC CoverPlus Extra

ACC CoverPlus Extra is an alternative to the standard ACC CoverPlus personal injury cover for the self-employed or ACC WorkPlace cover for non-PAYE Shareholder-employees. It provides a guaranteed level of weekly compensation, agreed in advance with ACC, should they be unable to work as a result of an injury.

The standard ACC CoverPlus cover that your clients may have in place will provide weekly compensation based on up to 80% of their previous years earnings, including PAYE income; the weekly compensation will be abated if they return to work part time; with the maximum level of cover being \$102,992 pa (maximum compensation = \$85,178); and the minimum level of cover being \$24,960 pa (maximum compensation = \$19,968).

An alternative for your client to consider is ACC CoverPlus Extra, they must be self-employed and not receive any PAYE; to be eligible they must earn above \$19,968 pa; be self-employed or a non-PAYE Shareholder-employee; the level of lost earnings cover is negotiated; the minimum benefit cannot be less than 40% of their net taxable income (unless there is a business reason negotiated with ACC's underwriting team); they receive 100% of the agreed amount of lost earnings cover (less any tax payable); they do not have

to prove loss of earnings when making a claim; their weekly payments are not reduced if their business continues to generate income; full benefit is paid until they return to substantially their pre-accident level of employment; level one underwriting will result in automatic acceptance (falls within parameters of between 40-120% of the average of the last three years earnings and within minimum and maximum rates of \$19,968 - \$85,178); after three years cover must be reassessed.

Applicable to both types of cover is 24/7 cover for all injuries due to an accident; with access to a full range of medical and rehabilitation benefits; a seven day wait; cover to age 65 (other costs will continue to be met until death); and cover for pre existing conditions.

The circumstances particularly suited to ACC CoverPlus Extra are where earnings fluctuate from year to year (e.g. farmers, real estate agents, contractors); earnings status has changed (e.g. from part-time to full-time); self-employed and new to business; non-PAYE Shareholder-employees and new to business; personal income is not an accurate indication of their earnings capacity because of split income or have taken advantage of options to reduce tax; the business may still generate income if the claimant is injured.

How Triplejump can help

We are able to provide expert advice in this area for your clients. We will take your clients through a comprehensive Needs Analysis stage that will include information obtained from their personal and business taxation statements; analysis of what they are currently paying in ACC; confirmation that their classification unit is correct for the business activity; details of PAYE, Trusts and income splitting.

This Needs Analysis stage will address and recommend how your clients' Income Protection can work best with ACC CoverPlus Extra and will highlight the following issues: cover for personal injury and illness; wait period variations; exclusions on Income Protection; smoking rates and premiums; calculations of maximum reductions; required review every two years; occupation classes for Income Protection being different to ACC codes; definition of agreed value; each client's circumstances must be evaluated thoroughly.

Underwriting criteria applies on a case by case basis and cover is subject to acceptance. As each case should be fully evaluated, we encourage you to discuss the applicability for each of your clients with your trusted Triplejump Adviser.

Talk to your Triplejump Adviser if you would like an in house workshop presented, or alternatively if you would like to provide a client workshop in conjunction with Triplejump.

Source: Triplejump Limited. ACC New Zealand

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