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The need for business succession documents – July 2023

With:
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Information provided is general in nature; precise application depends on specific circumstances

Overview

- War stories
- Why a constitution is not enough
- What a shareholders agreement brings
- The benefits of a buy sell deed
- Ways to structure a buy sell deed
- A preferred approach (?)

War stories

- Retirement Village Pty Ltd
- Majority owned by a foreign company
- Prior years made money through property development and sales of retirement units
- Dividends stopped after a period of time
- Minority shareholders no longer seeing activity or growth
- Minority shareholders trapped with an unproductive investment

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War stories

- I Build Townhouses Pty Ltd
- Shareholder approached to invest certain amount for a unit in return
- Mismanagement (at construction and management level) resulted in additional costs being incurred by I Build Townhouses Pty Ltd owed to the builder
- Builder sues I Build Townhouses Pty Ltd
- I Build Townhouses Pty Ltd requesting shareholder (one of many) to contribute additional funds to fight law suit
- Shareholder does not wish to contribute

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War stories

- Mental Health Doctors Pty Ltd have two partners
- Amy Motivated felt that she has undertaken an unfair amount of burden for the business
- Lucy Lousy only works a few days and does not contribute to the administrative work
- No way for Amy to 'boot' Lucy unless a fair price is agreed by Lucy
- Also note the additional costs associated with having Lucy be released from personal guarantees (related to the lease and financier)

War stories

- Property Agents Pty Ltd had two partners
- Cam Contributor introduced the initial contribution to acquire the relevant marketing equipment
- David Dodgy only contributed his effort to sell a property
- Cam managed to sell a few properties initially (smaller sized properties) and split the net profits equally with himself and David
- David managed to sell one property for a large fee and decided to create a new invoice with a different bank account detail to the business (bank account details were for David's personal bank account)

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War stories

- Financial Planners Pty Ltd has over 40 shareholders
- Rachel wants to retire as she has recently turned 75
- She wishes to sell her interest in Financial Planners Pty Ltd totalling roughly $700,000
- A constitution has been tailored to effectively enable the Board to block any transfer to a third party
- Rachel cannot exit the company until there are willing buyers at the Board's consent
- She is not comfortable to retire until she gets her interest liquidated

War stories

- IT Consultants Pty Ltd had 3 partners and was an established business
- Robert Doe decided 1 year into the business that he made enough money on the side through crypto that he wanted to retire to spend time with the children
- Fortunately, IT Consultants Pty Ltd had a shareholders agreement
- They followed the process in the shareholders agreement where:
  - The accountant would value the business
  - John and Jane Smith would decide if they wanted to acquire Robert's shares for the value
  - If they did not wish to acquire Robert's shares, then Robert could sell to a third party (if Robert could find someone)

What's in a constitution?

- All standard constitutions usually say the same thing (unlike discretionary trust deeds which can vary wildly depending on the draftperson)
  - Often states the Replaceable Rules of the Corporations Act do not apply
  - Outlines the various share classes and rights
  - Provides ability to loan to members and potentially includes Division 7A Agreement terms
  - Outlines position on any unpaid shares
  - Acknowledges who is recognised as having title over shares
  - Outlines process of general meetings which are 'stock standard'
    - Simple majority often the way to go unless Corporations Act requires special majority
  - Director appointments outlined and generally appointed by ordinary resolution of members of directors
  - Reconfirm director duties and procedures

What's in a constitution?

- All standard constitutions usually say the same thing (unlike discretionary trust deeds which can vary wildly depending on the draftperson)
  - Execution requirements (see if the constitution now enables electronic signing due to changes in the Corporations Act)
  - Outlining when dividends and reserves are to be paid/made
  - General indemnity requirements (particularly in relation to each 'Officer' of the company)
- All terms are standard and rarely consider the various practical implications of having multiple owners:
  - When can an owner have a right to have a director to represent them
  - How are owners to act to each other
  - What happens when multiple owners disagree
  - How can multiple owners part ways

What does a shareholders agreement bring?

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- In contrast to a constitution, considers the relationship between owners and includes rules governing the relationship
- Whereas the constitution includes generic rules in relation to the appointment of directors (i.e. majority of shareholdings), shareholders agreements can go a step further and enable certain shareholders to have representation at the Board (even without 50% interest in the company)
- Whereas the constitution outlines the general method to transfer shares, the shareholders agreement can go a step further by include additional rules and provisions regarding the transfer of shares including pre-emption right, valuation mechanisms and the ability to grant power of attorney to ensure the transfer goes through

What's common in a shareholders agreement?

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- Specific provisions regarding Board composition:
  - Threshold to enable a shareholder to have a representative director on the Board
  - Tailor what threshold for Board to appoint additional directors
  - Tailor how Board can delegate decisions
- Potential to tailor provisions regarding Board meetings and decisions:
  - How often director meetings are required.
  - How much notice is required to convene a director meeting
  - Minimum threshold of directors
  - How many votes does each director have and does the chairman have a casting vote
  - What percentage of votes make a 'special majority'
  - What are the typical decisions that require a special majority
- Similar tailored provisions for shareholder meetings

What's common in a shareholders agreement?

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- Generic provisions are also included to cover the following (which are not typically included in a constitution):
  - Objectives and commitments clause (which breaching may result in a 'default event' for buy out purposes)
  - Ability to appoint a manager for the business and for 'active shareholders' to be remunerated
  - General requirement to have annual documents approved else the prior year documents (budget/business plan) are reaffirmed
  - When dividends can be declared
  - Requirements relating to internal or external funding rules which can include each owner requiring to put in additional funding in proportion to their interest where agreed appropriately
  - Confidentiality provisions
  - Restraint provisions (which are more likely to hold up where it is intended to protect business goodwill)

What's common in a shareholders agreement?

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- 'Parting way' provisions:
  - Mechanisms where there is a voluntary exit of a shareholder including pre-emption rights
  - Mechanisms for forced exits such as:
    - 'tag along' rights – where minority shareholders can 'tag' along with a sale
    - 'drag along' rights – where minority shareholders are 'dragged' to force a sale of their shares
    - takeover provisions
  - Mechanisms for involuntary exits including a person's absence from the business, retirement, loss of capacity (including death) and breach of the terms of the agreement
  - Noting that certain exits should provide a discount for the buyer where the exiting party was removed due to 'bad faith' (i.e. breaching terms of the agreement)
  - Security provisions in the event payments are not made
  - Dispute resolution provisions

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Is there more?

- Part of shareholders agreement is to include mechanisms to buy out shareholders who are affected as the result of the death or loss of capacity of the key individual
- Rationale – don't want to be in business with deceased's family/don't want continuing business owner to set up a competing business and transfer clients across
- Hard to fund this buy out at market value as it can be unexpected
  - Contrast with retirement (which you can see coming)
  - Absence/breach of agreement (which you want to buy out the exiting party – and the agreement often enables the buy out to be at a discount (10-30% discount applying depending on the seriousness of the offence))
- Needing to get financing last minute may not be possible
- Buy sell deed seeks to solve problem

Buy sell deeds 101

- A way to fund an exit of a key person in a business using insurance
- Think broadly:
  - Insurance is taken over Person A in the event of death/loss of capacity/trauma
  - Person A dies
  - Person B is able to receive Person A's shares
  - Person A is able to receive insurance equal to Person A's shares
- Generally 5 ways to insure with different tax implications
  - Self-insurance – key person obtains insurance over themselves
  - Cross-insurance – key person obtains insurance over each other key person
  - Business entity – where business entity acquires the insurance over key person
  - Special purpose trusts – where a bespoke trust is established to acquire insurance over each key person
  - Superannuation – where insurance acquired through key person's super

Superannuation insured

- Advantages
  - Premiums *may* be deductible
  - Part of 'TPD' insurance proceeds *could* be received tax free
- Disadvantage
  - Unable to obtain 'own' occupation TPD policies
  - TPD insurance proceeds received tax free to the extent they relate to 'any' occupation TPD policies
  - Need to comply with superannuation law issues

Business entity

- Advantage
  - Premiums can be paid through business entity
- Disadvantage
  - TPD insurance proceeds cannot be received tax free
  - When business entity buys interest back from affected key person, continuing key person retains original cost base
  - Premiums may not be deductible on revenue account and may be required to be paid by key persons
  - Additional tax issues to consider when paying out TPD proceeds to exiting key person

Cross insurance

- Advantage
  - Proceeds paid to continuing key person who then uses the money to pay the exiting key person
- Disadvantage
  - Unable to receive TPD insurance proceeds tax free unless key persons are related
  - Premiums are not deductible on revenue account and must be paid by key person
  - Commercially requires buy sell deed to be drafted to ensure TPD proceeds are paid to the exiting key person's entity
  - Requires multiple insurance policies if more than two key persons

Special purpose trust

- Note trust acts as a sought to look through entity
- Advantage
  - Able to receive TPD insurance proceeds tax free provided proceeds are distributed in a particular manner (which requires a tailored trust deed)
  - Insurance premiums may be cheaper if acquired through one entity
- Disadvantage
  - Additional structure required which requires specific tailoring to ensure TPD insurance proceed scan be received tax free
  - Premiums are not deductible on revenue account and must be paid by key person

Self-insurance

- Advantage
  - TPD insurance proceeds received tax free
- Disadvantage
  - Premiums are not deductible on revenue account and must be paid by key person

The preferred approach

- Self-insured or special purpose trust
- Buy sell deed will also need to consider the following:
  - What happens if the value exceeds the insurance?
    - How should any excess be paid?
  - What happens if the value does not exceed the insurance?
  - What happens if the insurance is not paid out?
    - How should any purchase price be paid?
  - What happens if there is debt that is required to be reduced?
  - What happens if one party does not wish to execute documents at the relevant time
- We assist with self-insured buy sell deeds that also consider the above

How would the war stories have differed?

- Retirement Village Pty Ltd
  - Minority shareholders could force a dispute resolution clause into effect that may ultimately require the majority shareholders to buy out the minority shareholders or the other way around
  - Queries surrounding breach of shareholders agreement
- I Build Townhouses Pty Ltd
  - Provided the relevant threshold agreed, all minority shareholders could be required to contribute their portion into a 'fighting fund'
- Mental Health Doctors Pty Ltd
  - Queries surrounding breach of shareholders agreement to force a sale
  - Certainty as to how the business can be valued

How would the war stories have differed?

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- Property Agents Pty Ltd
  - Queries surrounding breach of shareholders agreement to force a sale
  - Default Event could have been defined to include any 'criminal offence that affects or compromises the operation' or breaches of obligations under the shareholders agreement
  - Such Default Events often result in the exiting key person to sell at 70% of the Market Value, noting the exiting key person is still required to pay tax on the capital gains on the full Market Value
- Financial Planners Pty Ltd
  - Retirement can be triggered and the shares can be bought out enabling financial planner to leave
  - In the alternative, thought would have been had as to issues that may arise through a 'private share place' given that most of the planners were reaching retirement age

Contact details

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