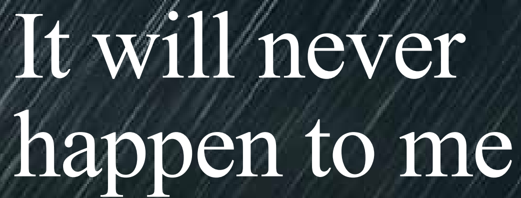
GEORGE DAVIES
SOLICITORS LLP

Business Wills, Cross Option Agreements and Business Protection

How business owners can avoid a possible catastrophe



It will never happen to me

Apparently, business owners never fall seriously ill and never die!

This must surely be the conclusion to draw from the fact that very few business owners actually put in place protective mechanisms to deal with these eventualities. As a business owner you work hard, 24/7 a lot of the time, fully committed to pushing your business forward and creating an organisation which can support your lifestyle and provide long term security for you and your family. But what if...

What if you fell ill or died? What if another major shareholder fell ill or died? *What would happen then?*

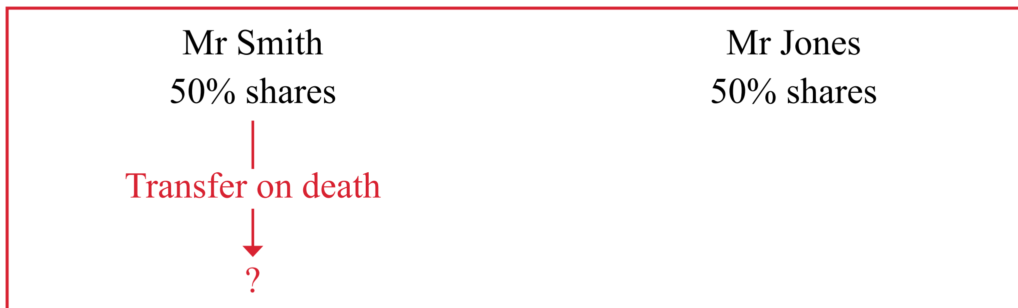
Like most people you will insure your buildings and contents. You will insure yourself when you go on holiday. You might even insure your 'no claims bonus' on your car. But what about your business? Have you thought through the inevitable sequence of events which would follow if the worst were to happen? Maybe not.

And it's probably not because you're too busy – many business owners are, of course, but that's not usually the problem. The main problem is more likely to be that you've never taken time to sit down and think through the consequences.

This Booklet explains what could happen if no protective mechanisms are put in place, and then looks at a range of measures which can substantially improve things. The examples we have given assume two shareholders in a company, each with 50% of the shares. But the solutions we offer can cater for any number of shareholders – the principles are the same.

Surely this couldn’t happen

Consider the straightforward case of two shareholders A and B. Let’s call them Mr Smith and Mr Jones. They spend all their time in their business, manufacturing cowboy boots, and then all of a sudden Mr Smith dies.



So what would happen?

Who will acquire the shares previously owned by Mr Smith? Has he made a Will? Will the shares go to his widow or to his children or to someone else?

Mr Jones could find himself in a very difficult position. Will he be able to carry on running the company as he wants? Who will exercise the voting rights in respect of those shares previously held by Mr Smith.

Even if the person inheriting the shares wants to sell them could Mr Jones afford to buy?

This is potentially a catastrophic situation for Mr Jones.

But all this might be bad news for Mr Smith’s family as well. What if Mr Jones cannot afford to buy the shares or simply doesn’t want to? Where does that leave Mr Smith’s family? Mr Smith’s salary will have stopped, of course, when he died. Will his family continue to receive an income stream by way of dividend payments? Maybe not – the directors will ultimately decide whether any dividends are paid. Mr Smith’s family could be ‘locked in’ to a company with no real prospect of getting any income or other financial support just at a time when they would need it the most.

All these problems (whether for Mr Jones or Mr Smith’s family) are entirely avoidable if Mr Smith and Mr Jones had planned ahead and put in place the necessary structures to deal with these issues. It needn’t be complex and it needn’t be expensive. But having something in place is vital.

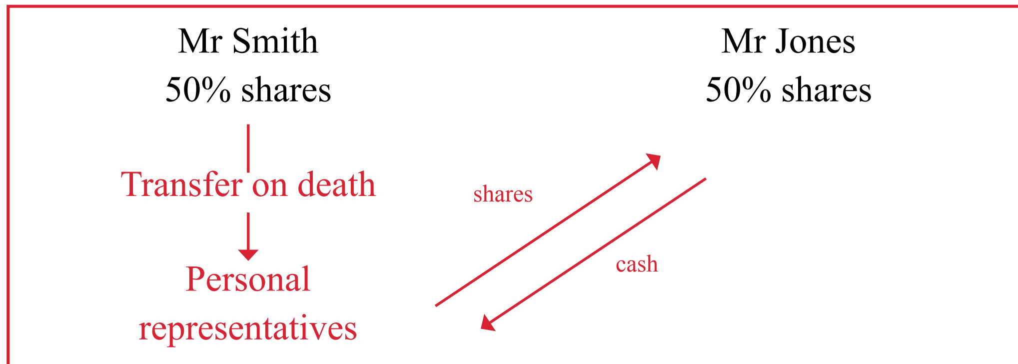
There are different things which can be done. We’ve ‘packaged’ some of these together so that individual business owners can choose what’s best for them.

So let’s take a step back and look at how Mr Smith and Mr Jones can avoid these potential problems.

Solution 1: Cross Option Agreement

Mr Smith and Mr Jones can sign up to a formal agreement now so that immediately following the first death:

- the surviving shareholder will have the *option* to purchase the deceased's shares; and
- the deceased shareholder's personal representatives will have the *option to require* the surviving shareholder to buy the deceased's shares.



In this example, if Mr Jones already has sufficient cash resources to make this purchase then all well and good. However, it would usually be the case that when Mr Smith and Mr Jones sign up to the formal agreement (called a Cross Option Agreement) they will also take out life policies on their individual lives so that the surviving shareholder (Mr Jones in this case) will receive the necessary funds to be able to buy the shares from the deceased shareholder's personal representatives. Usually the Cross Option Agreement will contain details of the agreed sale price or a formula allowing the sale price to be determined at the relevant time.

An alternative approach might be for Mr Smith's shares to be bought back by the company. If this were the preferred route then in the above example the 'purchaser' would be the company rather than Mr Jones. Certain criteria would need to be met before the company could purchase the shares – the company would need to have sufficient available funds and the contract to purchase the shares would need to be approved by the shareholders. It would also be advisable to obtain a tax clearance.

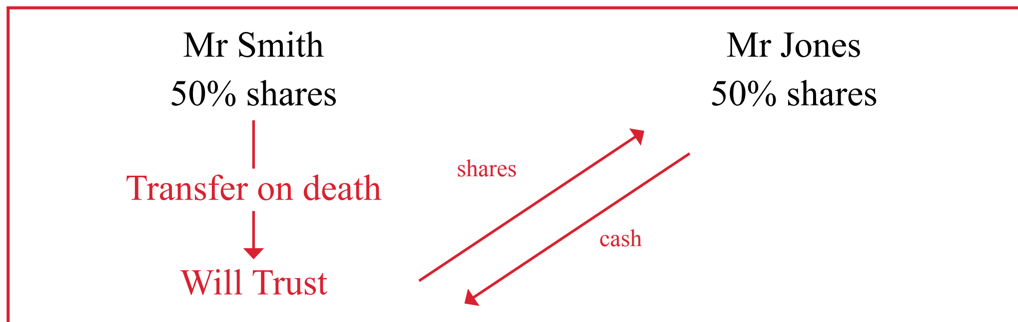
Sometimes it might be appropriate to 'combine' these two alternative strategies – for instance in this example the company may have the initial option to buy the shares, but if the company doesn't meet the relevant criteria the option will then be exercisable by Mr Jones.

Key features and benefits

- Mr Jones (or the company if that is the preferred route) will have the option to buy the shares, thereby allowing him to acquire control of the company.
- Mr Smith's personal representatives can force Mr Jones (or the company as the case may be) to buy the shares (i.e. there is a ready-made market for the sale of those shares).
- The family of Mr Smith will receive cash.
- Life insurance can be put in place if necessary to generate the funds to allow Mr Jones (or the company) to purchase Mr Smith's shares on his death.

Solution 2: Cross Option Agreement and Will Trusts (combined)

At the same time as Mr Smith and Mr Jones sign up to the Cross Option Agreement and take out the life insurance they should also put in place new Wills to provide for the deceased's shares on the first death to pass into a Trust for the benefit of their surviving family members.



So when the shares are sold in accordance with the Cross Option Agreement the money will be paid into the Trust set up by Mr Smith under the terms of his Will – a 'Will Trust'. The money can then be used to benefit Mr Smith's widow (and other family members). Money can be released by way of interest free loans, capital payments etc.

But when Mr Smith's widow dies later on, any funds still held in the Will Trust will fall outside the widow's estate for inheritance tax purposes. This means that the funds can pass through to the children tax free. The potential tax savings could be substantial.

Although the principal use of a Will Trust in circumstances such as these will be to save inheritance tax it can also play a vital role as an 'asset protection mechanism', so that even if Mr Smith's widow's circumstances change, the money will eventually find its way through to Mr Smith's children. This might be particularly important in second marriage situations or if Mr Smith was concerned that his widow might remarry after his death.

Looking longer term, the flexibility and protection afforded by structures such as these might also be useful for the children in the context of their own financial planning or if they were to experience a divorce.

Key features and benefits

As with Solution 1:

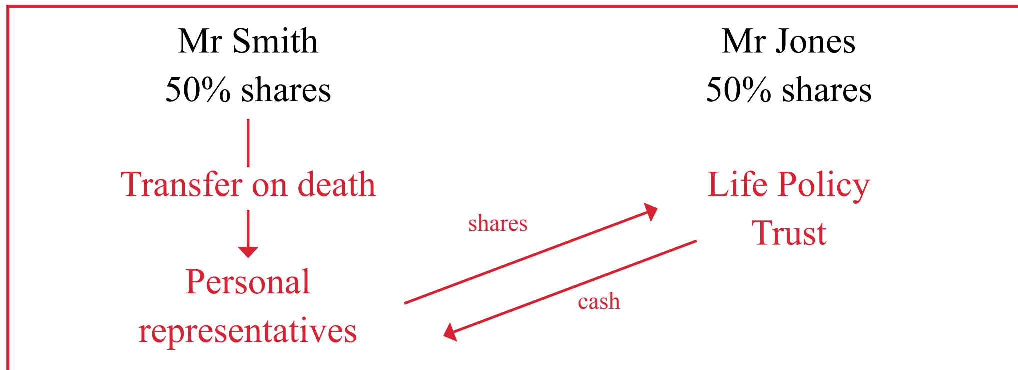
- Mr Jones will have the option to buy the shares and therefore acquire control of the company.
- The trustees of Mr Smith's Will Trust can force Mr Jones to buy the shares (i.e. there is a ready-made market for the sale of those shares).
- Mr Smith's family will receive cash.
- Life insurance can be put in place if necessary to generate the funds to allow Mr Jones to purchase Mr Smith's shares on his death.

But in addition:

- The Will Trust (which will receive the proceeds of sale following the purchase of shares by Mr Jones) can be managed for the benefit of Mr Smith's widow and other family members, providing a range of tax saving opportunities and an extremely useful 'asset protection mechanism'.

Solution 3: Cross Option Agreement and Life Policy Trusts (combined)

When Mr Smith and Mr Jones sign up to the Cross Option Agreement and take out individual life policies they should each consider transferring those life policies into separate Life Policy Trusts.



The focus here is on Mr Jones and what he does with the company shares in the future. What impact would there be on the estate of Mr Jones if he were ever to sell the company? If the life policy money on Mr Smith's death had been paid direct to Mr Jones, and if Mr Jones himself had bought the shares in his own name, the entirety of those sale proceeds would form part of his estate and could give rise to a substantial charge to inheritance tax in the event of his death.

But if, instead, the life policy money on Mr Smith's death was held in a Life Policy Trust, perhaps with Mr Jones and one or more other persons in control as trustees, then Mr Jones would have some very useful planning opportunities going forward.

The shares could either be bought by the trustees and held within the Life Policy Trust or Mr Jones could borrow the money personally from the Life Policy Trust (say by way of an interest free loan) and then buy the shares in his own name.

Either way, if the company were ever sold in the future he would have an opportunity to save substantial amounts of inheritance tax for his family. If the shares had been held within the Life Policy Trust then the money received on the sale of those shares would also be held within the Life Policy Trust. This money could then be made available to Mr Jones during his lifetime but without forming part of his estate for inheritance tax purposes on death. Alternatively, if he had borrowed the money from the Life Policy Trust to buy the shares in his own name then following the sale of shares he could keep hold of the money received on the sale of the company in the knowledge that the loan would operate as a deduction against the value of his estate for inheritance tax purposes on death.

Key features and benefits

As with Solution 1:

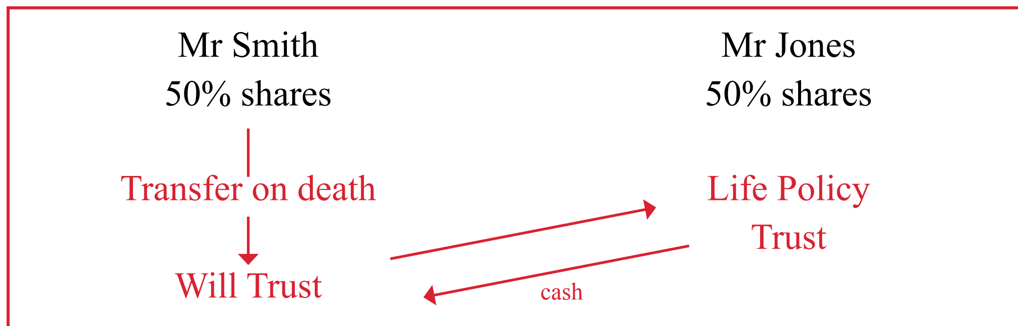
- Mr Jones will have the option to buy the shares and therefore acquire control of the company.
- Mr Smith's personal representatives can force Mr Jones to buy the shares (i.e. there is a ready-made market for the sale of those shares).
- The family of Mr Smith will receive cash.
- Life insurance can be put in place if necessary to generate the funds to allow Mr Jones to purchase Mr Smith's shares on his death.

But in addition:

- The Life Policy Trust can provide the surviving shareholder with long term tax planning opportunities going forward (particularly in the context of saving inheritance tax if he were ever to sell the company).

Solution 4: Cross Option Agreement, Will Trusts and Life Policy Trusts (combined)

This represents the best possible solution for both Mr Smith (and his family) and Mr Jones.



This is a combination of Solutions 1, 2 and 3. As in Solution 2, on Mr Smith's death his shares pass into a Trust set up under his Will (for the benefit of his widow and other family members) – a 'Will Trust'. At the same time, the funds payable on Mr Smith's death pass into a Life Policy Trust for the benefit of Mr Jones and his family.

So when the 'deal is done' in accordance with the Cross Option Agreement the shares pass into the Life Policy Trust and the funds move across into the Will Trust. Alternatively, the life policy proceeds may be lent (interest free) to Mr Jones, to allow him to buy the shares in his own name – but again, the funds would move across into the Will Trust.

The funds in the Will Trust can then be used to benefit Mr Smith's widow (and other family members). There are inheritance tax savings to be made on his widow's death later on and long term planning opportunities for Mr Smith's children. The trust structure can also provide a useful 'asset protection mechanism' for the family going forward – *see Solution 2.*

Holding the shares previously owned by Mr Smith within the Life Policy Trust (or acquiring those shares personally with money borrowed from the Life Policy Trust) will also provide Mr Jones with some very useful planning opportunities in the future, especially if he were ever to sell the company – *see Solution 3.*

Key features and benefits

Combining all of the key features and benefits of Solutions 1, 2 and 3:

- Mr Jones will have the option to buy the shares and therefore acquire control of the company.
- The trustees of Mr Smith's Will Trust can force Mr Jones to buy the shares (i.e. there is a ready-made market for the sale of those shares).
- The family of Mr Smith will receive cash.
- Life insurance can be put in place if necessary to generate the funds to allow Mr Jones to purchase Mr Smith's shares on his death.
- The Will Trust (which will be in receipt of the cash following the sale / purchase of shares) can be managed for the benefit of Mr Smith's widow and other family members, providing a range of tax saving opportunities and an extremely useful 'asset protection mechanism'.
- The Life Policy Trust can provide Mr Jones with long term tax planning opportunities going forward (particularly in the context of saving inheritance tax if he were ever to sell the company).

GEORGE DAVIES
SOLICITORS LLP

If you would like to discuss any of the issues raised in this Booklet or talk through a particular set of circumstances please contact any of the following:

Tony Hall
Partner

t: 0161 234 8820
m: 07740 871 298
e: tonyhall@georgedavies.co.uk

Nicky Collins
Partner

t: 0161 234 8837
m: 07917 763 880
e: nickycollins@georgedavies.co.uk

Zahra Siddiqui
Partner

t: 0161 234 8862
m: 07919 284 616
e: zahrasiddiqui@georgedavies.co.uk

Chris Ross
Partner

t: 0161 234 8852
m: 07973 400 096
e: chrisross@georgedavies.co.uk

The contents of this booklet do not constitute legal advice. You should always consult a suitably qualified lawyer for professional advice about any specific legal matter of concern to you.

George Davies Solicitors LLP, its partners and staff do not assume any responsibility for information contained within this booklet and disclaim all liability relating to such information.