EMPLOYEE OWNERSHIP ASSOCIATION

BETTER BUSINESS TOGETHER

PROTECTING YOUR EOT BUSINESS

FAB ASSURANCE

"As the sector grows and evolves, we continuously learn more about the needs of founders, employee-owned businesses, and employee owners. In turn, the products and services to support a thriving employee ownership sector also continue to develop.

"During very uncertain times, we need to create certainty where we can. In an employee-owned business, especially in the early days where the business is paying off the sale of the business from the owners to the employees via an EOT. This is a time of great care to learn as much as possible from the exiting founder. Everyone needs to pull together behind a common purpose to make the business as successful as possible, putting it in the best position to pay back its obligations to the owner/founders.

"Protection and de-risking an employee ownership transition using an EOT is something that has been raised in multiple conversations the EOA has had with members."

James de le Vingne
Chief Executive of the EOA

"If a founder dies during an EOT transition, that should be the only bad thing that happens".

"When we were speaking to one of the corporate and legal advisers who were supporting their clients to transition to an EOT, they raise the issue, 'what if a founder died before they were paid out, what would happen to their family, the business, and the employee owners?'.

"From this challenge we developed Deferred Consideration Insurance (DCI) to offer control for the continuing owners, the hard cash to deliver on intent, and the certainty of life insurance at guaranteed rates making sure the family of the founder were taken care of

"The EOT is one of the fastest growing business models in the UK, DCI is now quickly growing alongside it as a loan insurance/life insurance arrangement that ensures the futures of all interested parties."

Andrew Campbell
Founder and Director, FAB Assurance

PROTECTING YOUR FUTURE WHEN SELLING TO AN EOT

In life, when making huge decisions and transactions, we often look at ways to de-risk and protect our interests.

No one likes to talk about, the 'what if' when it comes to the possibility of someone dying.

However, when making a transaction such as selling your business to an EOT, it is important to protect all those who could be impacted, should the founder or other significant shareholders die in the process of transitioning to an employee-owned business.

For a founder who is acting as the vendor (financing the deal), in many cases they will be paid the agreed value of the business via deferred consideration - i.e., over an agreed period, sometimes several years. Often, the founder will also stay with the business to steady the transition during this period to ensure its future success.

While many businesses have insurance on key people to protect the business financially, and many individuals have life insurance, neither of those give clarity for if a founder died before they were paid out - what could happen to their family and the business and the employee owners in this case?

WHAT'S THE RISK?

If the vendor dies the consequences could be significant:

- The business has a highly geared balance sheet
- The ability to generate cashflow and repay debt could be impaired
- The vendor's family may have Inheritance Tax liability on the consideration
- The 'shares' in the business might not carry any real value

WHAT THE SOLUTION VIA DCI INSURANCE CAN DELIVER:

Deferred considerations insurance (DCI) has at its core loan insurance so that if the vendor dies the EOT is provided with the cash to redeem their outstanding deferred consideration which means:

- The vendor's heirs received cash free and clear of Inheritance Tax
- This takes some of the pressure of the business' balance sheet
- The trust enjoys an uplift in the value of the shares

This therefore benefits all parties during a time of upset and disruption.

DCI is arranged on a declining balance and is designed to mirror the redemption schedule. Also, where there is more than one vendor, there can be a shared DCI, which covers them both in the event of either of their deaths.

ALTERNATIVES TO DCI AND THE DIFFERENCES

Some businesses use something called Key Persons Insurance, which is intrinsically for trading purposes to compensate for the loss of profits resulting from the death of a key person.

By contrast, the DCI is typically on the life of the vendor who is the main shareholder and is now the main creditor. It is possible that a company could take out some form of traditional Key Person Insurance to compensate for loss of profits rather than to pay the capital obligation.

However, the tax and accounting treatment of the premiums differ.

For true Key Person Insurance, the premiums are a tax-deductible expense, and the policy payment is added to the trading revenue. This could result in a Corporation Tax charge.

By contrast the DCI is for a capital purpose to repay the deferred consideration in the event of a death and is not for a trading purpose.

Therefore, the insurance premiums are not a tax-deductible expense, and the policy proceeds are not liable to corporation Tax as they are not a trading revenue.

DCI A CASE STUDY

Sums Assured: £10m

Lives Assured: 2

EOT/DCI Term: 5 years

The business - A Software Engineering company commanding a global reach with Military and Pharmaceutical contracts.

The shareholders: Whilst one director has held majority shareholding, the other had a semi-retired approach to his involvement. The majority shareholder found the semi-retired life of his fellow director increasingly attractive. This has fueled the decision that an EOT is the ideal route to semi-retirement while staying very much involved.

Issues: Both directors were concerned that if the majority shareholder was to die before completion of the deferred payments, then the financial stability of the company would be at risk, with the remaining director being relatively aged and out of touch with the running of the business. The majority shareholder also has a high-risk pastime – ocean sailing/racing.

DCI provided: The insurance covered both directors' consideration for the EOT so that in the event of any one director's death all considerations would be paid. This would relieve the company's balance sheet to provide financial stability while providing the deceased family with the remaining consideration. The premium was taken out on a declining basis over the course of the 5 years.

For more examples:

How much does DCI Cost? – an example
[link to PDF Page 4/8 of original document]

Tax and technical overview of DCI
[Link to PDF of pages 5 and 6/8 of original document]

Case Studies
https://www.fab-assurance.com/eot/

EMPLOYEE BENEFITS - EXTENDING PROTECTION TO YOUR EMPLOYEE OWNERS

The questions we are often asked by our members at the EOA is what employee benefits other members have. Increasingly, employees seek opportunities to work for businesses that show they care about people and society.

One of the key benefits a business can give to employees aside from pension and holidays is life insurance. By having this as part of the business' benefits, it is a saving to employees and gives them some certainty for the future during very uncertain times.

With the cost-of-living squeeze people paying for this themselves is something that could be edged out by other essential costs such as energy bills, leaving food for thought about what employee benefits are achievable and which will have the most impact in the current circumstances.

By having a death in service option for employees, over and above a payout of the person's pension, means employees know that the business is looking after them and should they die while working for the business, their family will be supported. Benefits such as these, during times of economic uncertainty, and at a time where the recruitment and retention are increasingly difficult, differentiates a business from others.

For more information on the products and issues discussed in this publication **info@fab-assurance.com**

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