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Worth a read because:

When it comes to recognising the key risks that a business faces, the death of a business partner is not usually the first one that comes to mind; this paper explains why it should be.

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If your business partner died tonight

Business continuity risk in partnerships

Drew Browne

Many people go into business with a business partner. It can be a great way to leverage skills, increase profitability and extend the business's reach into new customer markets. The downside is that if not managed well, it can also increase the risk of losing it all.

Whether it is a family business repairing cars or a group of professional colleagues running an accountancy firm; each business has its own particular risks that need to be managed. But there is one risk that is applicable to all partnerships.

The risk that can put you out of business overnight

When it comes to recognising the key risks that a business faces, the death of a business partner is not usually the first one that comes to mind—but it should be.

Statistically speaking the more people there are in the business structure and the greater their differences in age, the higher the risk of facing the unexpected death or disability of a business partner.

Protecting your personal liability

Unlike a proprietary limited company where liability can usually be

quarantined inside the company structure, liability in partnerships is very different.

Individuals who are in a partnership with another or others, just like sole traders, are personally liable for all the debts of the business.

The average age of a life insurance claim is 53 and the average age of a customer making a claim on a trauma insurance policy is 48. In this age group, most people still have financial commitments such as mortgages, car payments, school fees, and business debts.

What would happen if your business partner died tonight?

If your business partner died tonight, you would be immediately responsible for all the business debts because business partners are said to be jointly and severally liable for the debts of the partnership.

What is the backup plan?

What happens to your share in the business will depend on a number of factors. A strong business will have a documented business partnership agreement in place.

The Australian Taxation Office (ATO) website advises, "A partnership agreement should outline how income or losses will be distributed to the partners and how the business will be controlled".

What happens when a business partner dies with a partnership agreement in place?

If all partners have signed a written partnership agreement when starting the business—or perhaps after reading a paper such as this—there will likely be a clause detailing what the outcome would be if a range of unexpected events occurred, including the death or incapacity of one of the partners.

A partnership agreement can include an agreement ahead of time about matters such as:

- how the business should be valued
- whether the surviving partner will buy out the shares of the deceased at full market value?
- whether the deceased partner's beneficiaries will be automatically required to sell their share of the ownership rights back to the surviving partner, or
- whether the deceased partner's beneficiaries are free to sell their share to anyone, including a competitor.

What happens when a business partner dies without a partnership agreement in place?

If the partners have not created a written partnership agreement, then the Partnership Act in the relevant Australian State or Territory will determine what happens next to the business.

- Generally, upon the death or bankruptcy of a partner, the partnership will immediately be dissolved.
- The surviving partner(s) will become personally liable for staff entitlements if they are laid off.
- The surviving partner(s) will become responsible for GST and other taxation.
- The surviving partner(s) will then owe the deceased business partner's beneficiaries their share of the partnership value.

In most scenarios, this is a disaster for the surviving partner(s) and their families, as well as the family of the recently deceased. Much of this anguish can be avoided if a partnership agreement is in place to deal with these matters.

Without a written backup plan to cover this eventuality, many businesses are likely to fall apart. However, there is a way to prevent the loss of all that you have worked and sacrificed for with some advanced planning and a robust strategy developed in conjunction with a specialist business financial adviser.

Case study: Red Design Agency

Red Design Agency (RDA) is a web development partnership managing websites for local councils in Australia. The business is currently valued at \$1,000,000 and there are two partners, Daniel, in charge of creative, and Raj, responsible for administration and sales.

RDA recently put a partnership agreement in place in case any of the partners died unexpectedly or became permanently incapacitated.

They signed an agreement to the effect that:

- each business partner would take out life insurance to the value of the business's debts and liabilities
- the partners agreed that the proceeds of any life insurance claim would be used to buy out the shares of the deceased business partner, so the surviving family of the deceased partner would receive their share of the business value.

Unfortunately, Daniel died suddenly after his bike clipped a gutter on a corner and a subsequent head injury triggered a fatal stroke.

- The life insurance company paid out the claim value of \$1,000,000 in 24 hours.
- The proceeds were then used by the surviving business partner Raj to buy back the 50% ownership rights from Daniel's family and pay out the business debts.
- The business survived the transition and retained all its staff and key contracts.
- Raj, the surviving partner, continued the business with no further obligations to Daniel's heirs, and went on to win an industry award three years later for design innovation.

Both the partners' families agreed that having the partnership agreement in place made a potentially disastrous business situation a lot more straightforward.

Upon reflection, Raj said, "We could have put the partnership agreement off, but we thought, what is the cost of having protection and not needing it, versus the cost of needing protection and not having it?"

Agree on the backup plan with your partner

Putting a partnership agreement in place requires some tough decisions and some strong conversations. But after that is done, the business will be a healthier, better business and the partners will be free to put all their energy and focus into running the business, unfettered by the nagging question, "What would happen to the business if I or my business partner died tonight?"

Partnership agreements and supply chain risk

Every business is part of a supply chain. Business continuation risk is a factor, not only for your own business, but also for businesses that are important to your supply chain. So how much business continuation risk is in the supply chain of your own business? How would the business be affected if one of your main suppliers lost a key person or a business owner died suddenly? What is your expectation of the ability of those businesses to manage that risk?

Capacity statements

Many larger businesses are hesitant at contracting a smaller business because of supply chain risk and often request a Capacity Statement that outlines the capacity of the business and its plans for business continuation in the face of known business risks.



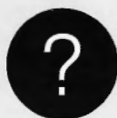
The quote

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Drew Browne,
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Financial

Drew is owner and senior financial adviser at Sapience Financial. An award-winning writer, speaker, financial adviser, and professional mentor, he works with small-business owners and their families to help them better manage life's risks.



CPD Questions

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1. Which of the following risks inherent to partnership structures does the author highlight?

- a) High costs of start up
- b) Joint and several liability for debts
- c) The requirement to share profits
- d) Pressure to employ family members in the business

2. Which of the following most correctly states what will happen when a business partner dies?

- a) The other partner(s) must liquidate the assets of the business
- b) The deceased partner's beneficiaries will automatically be free to sell their shares to anyone
- c) An heir of the partner's estate will take their place
- d) The consequences will depend on whether a documented partnership agreement was in place and the terms of the agreement

3. A life insurance strategy supported by a legal agreement adds protection when a business partner dies by providing funds to:

- a) support the deceased partner's beneficiaries
- b) cover funeral expenses
- c) allow surviving partner(s) to buy out the deceased's share of the business
- d) All of the above

4. Use of capacity statements can provide comfort to a business in relation to its suppliers':

- a) ability to manage known business risks
- b) level of appropriate insurance coverage
- c) business continuity arrangements should a key person die
- d) All of the above

5. The Partnership Act in the relevant state/territory will dictate what becomes of the business when a partner dies with no partnership agreement.

- a) True
- b) False

6. The risks relating to the death of a business partner are often overlooked by businesses as an initial consideration.

- a) True
- b) False

A Capacity Statement document* collects information such as company details, legal structure and ownership, as well as company history, software systems, geographical areas served and financial capabilities. Importantly, it also documents insurance coverage—liability and professional indemnity—and partnership agreements and business continuity arrangements.

The last word

Most larger companies use supplier questionnaires to assess the ethical treatment of staff and other supply chain risks and to ensure they do not fall victim to a supplier mismanaging a risk.

Establishing a partnership agreement and asking your suppliers to complete a Capacity Statement will go a long way to ensuring peace of mind and avoiding the mess the unexpected death of a business partner can bring. **FS**

*A Capacity Statement template is available on Sapience's website at www.sapience.com.au/capacity-statement-template.

Disclaimer: Any information provided is general advice only and we have not considered your personal circumstances. Before making any decision on the basis of this advice you should consider if the advice is appropriate for you based on your particular circumstances.

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