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Shareholder Protection: Protecting the Business and Family

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Running a successful business comes with a never-ending list of responsibilities. From running day-to-day operations to planning for future growth, there are plenty of things to consider.

One aspect that can often be overlooked is how the business would be affected if a shareholder were to pass away unexpectedly. Beyond the personal tragedy, would their death significantly alter the ownership and control of the business? And would their family be able to access the value in the company, which is, by nature, difficult to value and illiquid?

This article aims to serve as an introduction to Shareholder Protection and the ways in which it can help with business owners' contingency planning for this scenario.

What is Shareholder Protection?

In its simplest form, Shareholder Protection combines legal agreements and insurance policies to ensure that, on the death of a shareholder, the remaining owners have the funds available to purchase the shares from the deceased's beneficiaries.

The benefits of a Shareholder Protection arrangement can broadly be split into two categories: ensuring that the shareholders' beneficiaries receive fair value from the shares and ensuring that the ownership structure of the company is not adversely affected by a shareholder's death.

Protecting the Family

Without a Shareholder Protection agreement in place, a deceased shareholder's beneficiaries may inherit shares in a private company that they have little or no involvement in. Whilst the shares may hold significant value on paper, they can be extremely difficult to sell as a market of buyers is not typically readily available. This can lead to beneficiaries owning a valuable asset whilst having limited access to its value or being forced to sell to a third party at a significantly discounted price. A Shareholder Protection agreement lays out a mechanism for the surviving shareholders to purchase the shares from the beneficiaries at a pre-determined price, using cash that has been received from a life assurance policy on the deceased shareholder's life.

Protecting the Business

The consequences of the death of a shareholder are not limited to their family. Of course, a shareholder likely contributes significantly to the day-to-day operations and profits of a business (which can be protected with a Key Persons cover plan), but they are also extremely important with regard to ownership and control.

Let's consider the following examples.

Firstly, assuming that there is no Shareholder Protection agreement in place, a shareholder dies, and the shares are now owned by the shareholder's beneficiaries. Those beneficiaries may not have the knowledge, experience, or willingness to control a private company. This could result in poor decision-making and negative outcomes for the future of the business. At best, it may frustrate or disrupt the governance of the company.

Another example could be that those beneficiaries sell the shares to a third party. Now, part of the business could be owned by someone whose incentives and timeframe do not align with the surviving shareholders. Having a Shareholder Protection agreement in place ensures that there is a clear plan for this circumstance, maintaining continuity for the business and reducing uncertainty.

In addition, even if the shareholders have agreed to purchase the shares from the deceased's beneficiaries at a fair price, where would the funds come from? If the business did have the capital reserves available, using them could put the business into a more vulnerable position than it already is in with the death of a shareholder, as well as have Inheritance Tax implications. If the capital was not available, perhaps assets would need to be sold or debt taken on. Clearly these two solutions are not ideal given that the surviving shareholders may be distressed sellers of the asset, having to settle for a lower price than would otherwise be expected or be burdened with high borrowing costs if a loan were the chosen option. The life assurance aspect of a Shareholder Protection agreement solves this.

Putting the Arrangement in Place

A Shareholder Protection arrangement is more than just a life assurance policy, it must also include a protocol for what is to happen if a shareholder passes away. Just as personal financial planning is very difficult in the absence of a valid will, a company must have made appropriate provisions in its Articles of Association. Unless specified, there is no automatic obligation on the surviving shareholders to purchase the deceased's shares. This agreement can take three main forms.

Firstly, a buy-and-sell agreement. This is the simplest form and means that the deceased's beneficiaries must sell the shares and the surviving shareholders must purchase the shares. Whilst this provides certainty, it generally results in the loss of Business Relief for Inheritance Tax purposes. For this reason, this arrangement is rarely recommended.

To get around the loss of Business Relief, a cross-option (double-option) agreement is preferred. This is where the deceased's beneficiaries and the surviving shareholders both have the option to buy or sell the shares for a specific period of time. If one party exercises this right, the other party is bound to comply. HMRC does not see this as a binding contract, and therefore Business Relief can be retained.

The final method is automatic accrual, whereby each shareholder leaves their shares in the company to the surviving shareholders in their will (an automatic accrual agreement would also have the same effect). The benefit of this is simplicity, and the clear downside is that the deceased's beneficiaries will not be compensated. With this said, the shareholders could also take out a life assurance policy in trust for their beneficiaries to account for this. This approach also runs the risk that shareholders change their will in favour of their family over the surviving shareholders.

Assuming that the shares are to be purchased through one of the above agreements, the first question usually asked is, for how much? This too should be clearly defined. This calculation is reasonably simple if the company is made up of mostly tangible assets, such as property, however, it can be more difficult with intangible assets such as goodwill. If you can't use just the net assets of the business, another common approach is to use a multiple of earnings, excluding any anomaly years. Most companies will use a combination of the two.

Once the value of the shares has been decided, an appropriate level of cover can be taken out. The first way that the cover can be structured is that each shareholder takes out a life assurance policy on each of the other shareholders' lives. If a shareholder were to pass away, the surviving shareholders would now have funds to purchase the shares of the deceased's beneficiaries. In this case, no trust structure is needed however, it can become extremely complex and inflexible as the number of shareholders increases.

A simpler approach is for each shareholder to take a life assurance policy on their own life and place the proceeds into trust for the benefit of the surviving shareholders. By structuring it this way, the funds are available to the correct parties quickly and tax-free, and it limits the number of policies needed. For these reasons, this method is preferred over the former. In addition, to provide for future changes to shareholders,

a discretionary trust is typically used so that the beneficiaries of the trust can be changed to suit any changes to the business's shareholders. This approach also means that underwriting and premiums are based solely on your own life, avoiding another shareholder's health affecting the cost or availability of your cover.

Finally, a point to note would be that the company could also take out life assurance policies on the shareholders' lives, however, the purchase under this method is typically regarded as a disposal for Capital Gains Tax purposes, and the sale would be regarded as a distribution and thus subject to Income Tax.

Tax Considerations

To touch on the tax considerations, premiums paid by the shareholders will be paid out of their taxed income. If the company is paying the premiums on behalf of the shareholders, they will be treated as extra income and therefore subject to Income Tax and National Insurance Contributions. These payments can be treated as a business expense, but employers' National Insurance Contributions will be due. Finally, and as previously outlined, provided that a cross-option agreement is in place, Business Relief for Inheritance Tax is maintained.

Critical Illness

Without going down a separate rabbit hole, similar provisions can also be made in case of critical illness instead of, or in addition to, death.

The diagnosis of a critical illness for a shareholder can be just as impactful as their death. Other considerations come into play with critical illness, for example, a single option agreement may be more appropriate, as the diagnosed shareholder may not wish to sell their shares to the other shareholders. Under a double option agreement, they would be obligated to sell if the other shareholders exercise their option. This could result in an unwelcome Capital Gain Tax liability for the diagnosed shareholder and also a future Inheritance Tax liability as they now hold cash rather than an asset which is eligible for Business Relief.

Conclusion

Business owners spend significant amounts of time planning for growth, profitability and the future success of their company. However, what happens if one of the shareholders were to pass away or suffer a critical illness is often overlooked. As we have explored, the consequences reach far beyond day-to-day operations. The value accrued by that shareholder throughout their life, which they were hoping to leave to their family, becomes challenging to pass on. And for the other shareholders, their ownership and control comes into question.

A well-structured Shareholder Protection arrangement can help to provide clarity, continuity, and financial security for all parties involved. Whilst nobody likes to contemplate these scenarios, putting suitable arrangements in place can help protect both the business and the people who depend upon it should the unexpected occur.

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