The ESOP blindside – and how to protect it

Most employee stock ownership plans, or ESOPs, often insure in the event of the death of a key employee-owner, but many fail to consider the greater risk of disability. A look at why companies should make sure they're protected.

By Edward A. Tafaro

Since the 1970s, the employee stock ownership plan (ESOP) has proven to be a valuable vehicle for helping employees own a share of a business. It's similar to profit sharing in that the company establishes a trust fund and either contributes new shares or buys existing shares of its stock. Alternatively, the ESOP can borrow the funds to purchase existing or new shares and then make cash contributions to the plan to repay the loan.

In essence, ESOP owners create a reservoir of human capital that drives the success of the company. When employees leave the company, they receive their share options, and the company must buy them back.

But what happens to the company if a key employee-owner leaves early due to a disability, creating a critical knowledge and experience gap that could do harm to the company's success?

True, most ESOPs typically insure in the event of the death of a key shareholder, but during the working years, the risk of disability is a far greater risk than death. Given this fact, why is disability insurance so under-utilized in the ESOP world?

Kelly O. Finnell, J.D., CLU, AIF, founded Executive Financial Services Inc. in 1981. Based in Germantown, Tenn., Finnell's firm specializes in employer-sponsored retirement plans, including 401(k)s, ESOPs and nonqualified plans for executives. Recognized for his retirement planning expertise, Finnell's keenly aware of the void that's created by neglecting to put disability insurance into the ESOP mix.

"For ESOPs to have life insurance is quite commonplace," Finnell says. "But there's a definite need to educate investors on how to protect their company against a possible disability risk. If they knew there were ways to do this, they would want to protect their investment against the possibility of a significant loss."

Disability more likely, yet less insured

Like other complex financial transactions, no two ESOPs are the same; yet, there are common threads that run through most transactions. There's a key shareholder who is seeking to trade equity for cash. Subsequent to that, there are various forms of financing that the ESOP can deploy. Typically, it will utilize a combination of bank financing (senior debt) coupled with a promissory note (subordinated debt) funded through corporate cash flows. Most frequently, these loans have 5-year durations, although it should be remembered that every ESOP is different.

What seems consistent is that once the loan agreement is put into place, a significant sum of key person life insurance is usually purchased to protect the selling shareholder and the lenders against the risk of premature death. However, the greater statistical risk is disability. And that's the "blindside" that exists in most ESOPs, particularly where the business is highly dependent on the vision, relationships and knowledge held by its owners.

For these unique individuals, disability is all but certain to end in disaster for both themselves and their company if the risk is not properly mitigated with disability insurance.

James Steiker, chairman and CEO of SES Advisors Inc. in Philadelphia, is a corporate, pension and tax attorney with more than 20 years experience in ESOP design, installation and transactions for privately held companies. He believes that disability is an under-insured event in ESOPs because most people fail to focus on the fact that it's even available, let alone that it's important.

"It makes sense for an ESOP-owned company to have a combination of life and disability insurance on key ESOP participants that can address payment of significant account balances upon a participant's death or disability," Steiker explains. "Unlike traditional disability insurance, which focuses on replacing income for a disabled person, corporate-owned disability insurance addresses the corporate finance and repurchase obligation effect of the disability of a key selling shareholder or ESOP participant. Corporate-owned disability insurance spares the company the double whammy of losing the services of a key employee and needing to fund an accelerated payout of their ESOP stock."

Finnell agrees. "Not having disability coverage on key persons in the ESOP could wreak havoc on the financial structure of the company if the buyout funds can't be paid."

While death is a certainty, the likelihood of disability often feels remote. The reality is that during the working years, the risk of disability is far greater than the risk of death, as the chart below reveals.

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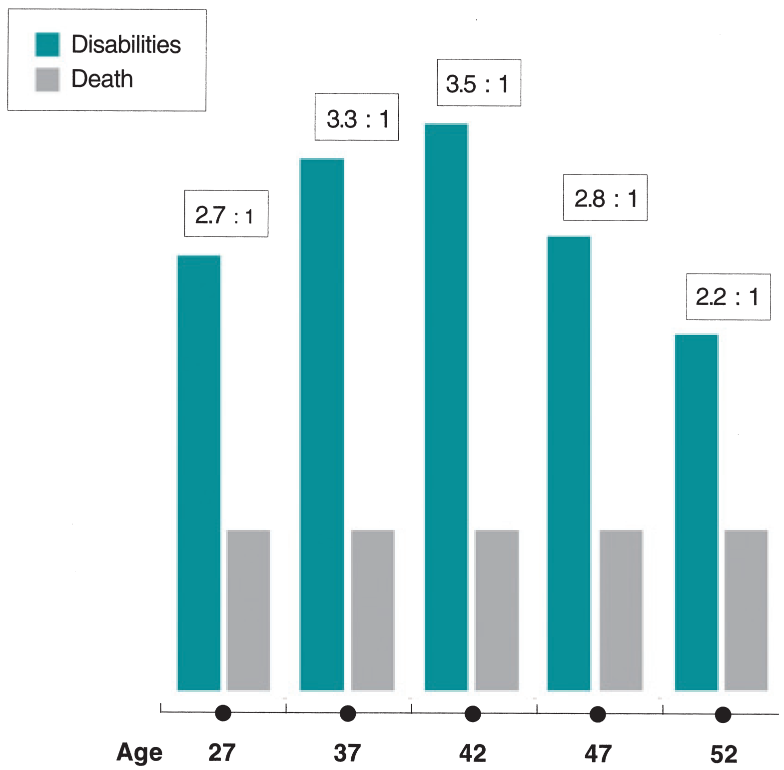

Source: *Exceptional Risk Advisors white paper "Unprepared for the Unthinkable"*

Extra protection eases lending process

Acquiring disability insurance for key shareholders also helps make traditionally large transactions more palatable to lending institutions, because most are aware of the inherent risk that the disability factor creates and how it could possibly affect their investment.

"Most ESOP investors I've talked with don't even think of the possibility that they may become disabled," Kelly says. "But if they knew there was up to $75 million of insurance available, that would definitely get their interest."

It definitely caught the interest of a California-based insurance advisor consulting with the CEO and founder of a glove manufacturing business who was about to take his company into an ESOP. Prior to the transaction, the founder held 100% of the stock. To partially fund the ESOP, the company secured a $4 million bank loan and subsequently loaned the ESOP all of the funds to acquire the founder's shares. Because of the unusually tight ties between the CEO and his customers, the ESOP trustees and the bank were concerned about his premature death or disability, which it felt would have disastrous effects on the company and its ability to repay the debt.

The risk of premature death could be mitigated with the acquisition of a $7.5 million life insurance policy, which was partially assigned to the bank. But the corresponding request for $7.5 million of disability protection was a major challenge because most traditional insurance carriers had neither the capacity nor the appetite to take on that much risk on a selling shareholder.

Once it came to light, however, that such a key man disability policy *did* exist that would protect the $4 million bank loan and, in the event of a catastrophic disability, pay out an additional $3.5 million to the company to cover additional obligations relative to the ESOP transaction, the company was appropriately positioned.

Steiker isn't surprised that ESOP transactions are far different and more complex than many other business dealings.

"If you equate the successful performance of an ESOP to the high performance of a star quarterback, then think of disability insurance as that hulking right tackle protecting his blindside from the potential of a financial sacking."

"In conventional companies (those that are not ESOPs) and are not heavily leveraged, corporate risk management typically doesn't address the disability of a key executive," Steiker says. "In an ESOP company with significant leverage and emerging repurchase obligations, corporate risk management should focus on both mortality and disability risk in connection with key executives and/or ESOP participants with significant account balances."

He points out that it's often key shareholders who are also key executives who finance ESOP transactions. "If a key selling shareholder/executive becomes disabled, the corporation's ability to generate the income to pay the ESOP seller's financing debt may suffer," he notes. "This is bad for the corporation and bad for the selling shareholder and is why disability insurance covering a selling shareholder/executive in an ESOP transaction may be important."

Tailor coverage to fit ESOP

That coverage also has to fit an ESOP's particular situation. As Steiker sees it, with newer ESOP transactions, it's important to have disability insurance that focuses on coverage around the key seller/executive who is providing the financing. While for older more mature ESOPs, the focus should be on participants with large account balances.

In the ESOP world, as in real life, death is inevitable, while disability is, unfortunately, an even more likely occurrence. With the ESOP Association reporting that there are approximately 11,500 existing ESOPs in the United States, covering 10 million employees, with total assets estimated at $901 billion, there's an enormous potential risk should a major player go down.

"If I am selling an investment to my customers, I would do everything I can to protect that investment against a significant loss," Finnell says. "I would want to protect that nest egg any way I can."

No company, ESOP or otherwise, wants to get blindsided by unforeseen circumstances. If you equate the successful performance of an ESOP to the high performance of a star quarterback, then think of disability insurance as that hulking right tackle protecting his blindside from the potential of a financial sacking.

Edward A. (Ted) Tafaro, president and CEO of Mahwah, N.J.-based Exceptional Risk Advisors, is an expert on high-limit specialty life, accident and disability products for clients with extraordinary insurance needs, including celebrities, athletes, entertainers, highly compensated executives and professionals. Contact him at (866) 512-0444.