Protect Your Largest Asset

By: Edward A. Tafaro

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Funding Buy-Sell Agreements

Life insurance benefits are easy to understand. If an insured person dies, their named beneficiary receives a monetary benefit. Disability risks are far less tangible. None of us believe we will have the misfortune of suffering from a disability and many of us never will. However, the reality is that during our working years, the risk of disability is far greater than the risk of death.

Research shows that many small-business owners are prepared for the death of a business partner, however only a surprisingly low 15 percent are prepared for the disability of a business partner which is a risk two to three times greater than death during working years. When advanced preparations for such a possibility are not taken, the results are not only emotionally devastating, but financially devastating as well.

Prince Associates and the Inc. Business Owners Council of *Inc. Magazine* surveyed more than 1,400 business owners on this very important topic. Here are some findings that may surprise you if you own a small business:

- Only 40.7 percent of business owners were prepared for the death of a partner.
- Only 14.8 percent were prepared for the disability of a partner.
- And 30.1 percent cited "they will work it out" as a solution in the event of death or disability of a partner.
- Lack of time is often cited as a key reason businesses have not yet prepared for either death or disability of a partner.

The first step in preparing your business for a death or disability of a key partner is getting your governing documents in order. These documents take many forms depending on your structure, size, number of shareholders, etc. A business lawyer can assist you in drafting these documents.

Having completed the process for the third time, I can honestly say it is fast and easy to accomplish. For my company, it consisted of a one-hour meeting with our law firm, the review and revision of various documents and then execution. Altogether, it took about one day of my time over the course of two months. The total cost for our attorney in northern New Jersey was about $5,000. I know a ton of business owners and leaders. I can't think of a single one of them that wants to be partners with their business partner's spouse, but that is exactly what will happen if their business partner dies or becomes disabled and the legal framework is not in place to transition the business properly.

Once you get your legal house in order and lay out your succession plan, you then need to fund the plans with appropriate insurance, or make the decision to self-insure all or part of the risk.

Most business owners that create shareholder agreements fund the death risk by purchasing life insurance, but the majority of those business owners responsible enough to create the governing documents and fund the risk of death FAIL to hedge against their greater risk of a business partner's disability. Please do not get me wrong - life insurance needs to be secured. However, while I understand that disability insurance is often a more complex insurance product to grasp, it too is necessary.

The cost of transferring a disability risk to an insurance company generally runs from .25 percent of the face amount of the coverage, up to around 1 percent of the face amount, depending on age. As entrepreneurs, our largest asset tends to be our business and our ability to earn our income and grow our business entities, so in the grand financial plan, the cost of this coverage is relatively inexpensive when compared to the risk. Furthermore, the wealth of many highly successful business owners is often leveraged in favor of their business and consequently they lack diversification: hence the need to protect their equity value since the risk of disability during working years cannot be overlooked. Is disability insurance protection more expensive than term life insurance? One unique challenge that some successful entrepreneurs and their insurance advisors encounter is a problem inherent to the insurance marketplace. A very large carrier pool exists to underwrite life insurance exposures. Alternatively, when disability insurance needs to be secured, only a handful of carriers exist to offer buy-sell disability protection. Even more problematic is the fact the benefit limits available are grossly inadequate for successful business entrepreneurs valued above $5 million. Traditional disability insurance carriers are able to provide adequate coverage for small organizations, however for the larger private companies coverage becomes increasingly difficult to underwrite and the process is often abandoned as a result. This is when utilizing the non-traditional market's capacity is necessary.

Consider this scenario: a highly profitable software firm that designs and distributes back-office business process software for community banks and financial institutions on the East Coast is valued at $22 million and has five equity partners with individual equity stakes ranging from $2 million to $12 million. Because most traditional U.S. disability carriers do not issue policies up to the necessary coverage limits, our firm was brought in to fashion a unique solution.

We created a stock redemption program that was funded with term life insurance to protect against the risk of death and a disability insurance program that would pay a lump sum benefit to the corporation in the event of a permanent disability. The timing could not have been more advantageous. Six months later, the CFO went into atrial fibrillation and suffered a stroke that permanently disabled him. Twelve months after the stroke, we delivered a $2 million check to the company that was used to redeem the CFO's stock.

This allowed the company to navigate the corporate tragedy, as they were better equipped to redeem the CFO's equity shares and begin the process of finding a replacement.

The need for small businesses to look at disability insurance as their business life-preserver in the event their corporate ship starts to list cant be understated. Some key items to keep in mind:

- The largest asset that exists on the personal balance sheet for entrepreneurs tends to be the equity in their business.
- Proper buy-sell planning with well constructed documents and properly funded and updated insurance plans are a must.
- Although most businesses have life insurance protection, the greater risk of disability often goes unfunded as traditional disability carriers lack the ability to deploy the necessary capacity.
- When compared to term life insurance, the cost of an equivalent amount of disability insurance looks high, yet death vs. disability statistics explain the pricing differential.

The question you must ask yourself is would your company's succession plan be complete if one of your business partners were to suffer a serious disability?

Here's the final example:
A 51 year old successful businessman owns a 60% controlling stake in a $50 million company and draws a pre-tax income of $4 million annually. He maintains an individual disability income policy with a face amount of $15,000 per month. His company owns various term insurance policies on his life totaling $12 million to fund their stock repurchase plan.
His insurance advisor told him that he was unable to secure additional disability insurance, as his net worth was too great. After a few months of the requisite "back-and-forths" with the insurance advisor, owner, CPA and attorney, we helped redesign his disability program with the goal of accomplishing two key objectives:

1. Protecting the entrepreneur's lifestyle with more adequate disability income replacement coverage. This was delivered in the form of a disability income product with a monthly benefit of $185,000, bringing his total disability income protection to $200,000 per month.
2. Protecting the entrepreneur's equity. The insurance advisor updated his life insurance portfolio to more appropriately insure his equity ownership.

Simultaneously, we underwrote a $36 million disability buy-sell policy, with a two-year elimination period and an own-occupation definition.

Most closely held businesses are highly dependent on the vision, relationships and knowledge held by their equity owners. Entrepreneurs create a foundation of human capital that drives the success of the company. Deaths and disabilities within these groups virtually all end in disaster for both the company and shareholder's family if there is a poorly designed and/or poorly funded buy-sell agreement, or worse yet, no agreement at all. The sad reality is that few business owners are prepared for the death or disability of a partner, an oversight that can bring down the sturdiest of companies.

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Exceptional Risk Advisors is one of the country's foremost experts on high-limit specialty life, accident and disability products. They are located in Mahwah, NJ and can be reached at info@exceptionalriskadvisors.com