RISK & INSURANCE

Rethinking Human Capital Risk Exposures

BY: Ted Tafaro

Risk managers need to evaluate the risk to key personnel by looking at how they are leveraged against the success of the company, and the impact should they not be able to perform their duties.

In 1971, the Magic Kingdom rose from the alligator-infested muck of central Florida at a cost of approximately $331 million. But the investment didn't stop there. From the day the gates first opened, you can bet every building within this dream world was insured, protected from one calamity or the next.

But with all that investment, it's likely there was more emphasis placed on protecting the animatronic figures than protecting Roy O. Disney, the older brother of Walt Disney and the man who was responsible for making his brother's dream a reality. Walt had died in 1966. Which leads us to this very important question: Why do so many risk managers protect the *vision*, but ignore protecting the *visionary*? Hundreds of millions of dollars are spent insuring towering steel-and-chrome skyscrapers, but the key person in the corner office is unprotected. If a Martha Stewart or Emeril Lagasse were unable to head up their empires, is there realistically someone else to fill that void?

If a company leader left in the middle of the night, what would be the impact on the company? And what would be the cost to replace that person? Or are they irreplaceable?

Some larger companies have the luxury of having a key person available to take charge during a severe but non-life-threatening illness, such as a nonfatal heart attack. For instance, when Kraft Foods Inc. CEO Michael Deromedi was hospitalized for a severe viral condition, the company's chairman, Louis Camilleri, took temporary charge, with no adverse effects to the company.

According to Robert Robins, a professor emeritus at Tulane University, and a noted expert in the area, a determining factor in planning for disability issues is the CEO's personality and work style: Is he willing to work with the board and senior management on a transition, even if an illness is not terminal but merely makes him unable to perform his duties?

"The end of work to many is the same as the end of life," Robins said. "Giving in will be resisted in every way possible. And the situation is worse in companies whose CEO has a hands-on rather than a delegatory style."

In the case of Intel, founder and CEO Andy Grove was able to carry on during treatment for life-threatening prostate cancer, and was able to smoothly leave when it was best for both him and the company, Robins said. The situation was more awkward at Southwest Airlines, when shareholder questions about 69-year-old Herbert Kelleher's prostate cancer pushed him to relinquish his interim presidency and CEO position in 2001, although he retained his chairmanship of the board.

In today's competitive business environment, protecting the value of a star executive is critical. And the risk management tools are available. Using markets once reserved for elite athletes and entertainers, carriers such as Lloyd's of London have developed key person disability products designed to protect a company's most critical asset. These carriers have the ability to deliver disability benefits up to $100 million for the loss of an individual whose vision, knowledge and experience are critical to a company's operation and future. But if it's so important, why do so many risk managers ignore this enormous exposure?

Many risk managers are reluctant to go through the due diligence needed to secure life and disability coverage. It's not because they are lazy or careless; it's just not part of their business culture. They don't comprehend the exposure that's out there. And it's complicated and maybe a little awkward going to the boss and saying he may be putting the company at risk because of his health or his lifestyle. Also, because it involves health issues and personal information, there's the danger of opening a secret door and having some unpleasant news come spilling out.

Many companies have life insurance on key persons and some have succession plans in place, but fewer than 35 percent of the corporations that secure key person life insurance secure the corresponding key person disability coverage. Statistics show, however, that a 45-year-old executive is three times more likely to suffer a disability lasting longer than 90 days than she is to die before the age of 65.

Obviously, there are factors that can increase a disability risk, such as excess body weight, tobacco use, high-risk activities or behavior, chronic conditions such as diabetes, high blood pressure, back pain, anxiety or depression, frequent alcohol consumption or substance abuse.

While risk managers may be wary of daredevils, like Richard Branson, *it's far more likely that a key person will succumb to a stroke or cancer or be hit by a car* than it is that they'll be disabled or killed while sky-diving over the-Pyrenees.

International travel can be hazardous, though. In a recent situation, a private equity firm made a significant investment in a defense contractor. Shortly after the investment closed, the company named a new CEO. With hundreds of millions of dollars at stake, the private equity firm sought to hedge their investment by acquiring $50 million key person life and disability insurance. As of the day of the request, the insurance adviser had eight business days to secure the insurance before the CEO departed for the Middle East, with stops in such hot spots as Iraq and Afghanistan.

Because of the abbreviated time frame, traditional life and disability insurance was not an option. The adviser needed to turn to a specialty underwriter that deals with exceptionally large and complex human capital risks.

Within 72 hours, a policy was issued that covered the private equity firm's loss of the CEO directly due to an accidental death or disability, as well as a result of acts of war or terrorism.

The premium for $50 million in insurance was $62,500, covering a two-week period. Sickness coverage was included for certain elements of the insurance policy. Few domestic life and disability insurance carriers possess the ability to underwrite large risks when there's high-risk exposure to the world's hot zones.

Unfortunately, many times, risk managers and their insurance advisers don't look beyond traditional channels to secure the needed key person disability coverage for their clients, partly because the cost of key person disability coverage is far greater than the cost of term life coverage. However, the risk is proportionally greater. The impact top CEOs and corporate leaders have on the success of their businesses is almost unfathomable.

And if you think about how many companies are dependent on one or two individuals, risk managers may need to re-examine how they insure human capital risk.

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June 10, 2013