

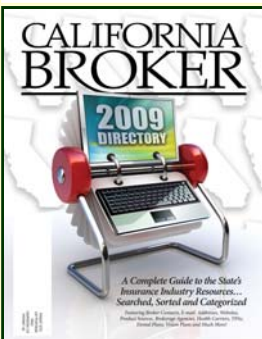
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A Complete Guide to the State's Insurance Industry Resources...
Searched, Sorted and Categorized

Disability

Using Disability Buy-Out to Create Value Where No Value Existed

by Michael Hagedorn, CFP, CLU

Asking a business owner one simple question can lead to multiple and progressively higher premium insurance sales and introductions to the business owner's professional advisors including the tax advisor and attorney. It can also position you as the quarterback of the business owner's advisory team to implement several advanced planning strategies. In short, one question can enrich your client and your client's dependents, business partners and associates, advisors, and yourself. The question is, "What is the date on your business' buy/sell agreement?"

Only 21% of small businesses (less than 500 lives) have a formal business succession plan and most of those plans are stale since they are more than two years old without a review. Consequently, more than 80% of small businesses fail to transfer management successfully and the business dies. Given the statistics, any answer is an opportunity to start talking about implementing a buy/sell strategy or ensuring that the current plan is coordinated and will perform as expected.

Businesses owners often approach planning with a checklist mentality. They check off buy/sell planning as completed when they sign their buy/sell agreement and pay the first premium on their cross-owned life insurance policies. But this is only the beginning of a process and your opportunity to demonstrate the importance of coordinating the efforts of the business partners' advisory team.

Business owners can do buy/sell planning using how-to books from numerous online vendors, buy/sell planning software with pre-formatted templates, and attorneys who draft legally enforceable buy/sell agreements (using legal software), which are designed to facilitate buy/sell without using insurance. When you bring common sense and a few simple questions, your marketing opportunities will unfurl like a huge flag at a football game half-time show.

A buy/sell agreement is a legally enforceable obligation to pay an amount that has been agreed upon. But it must be reasonably current in order to be enforceable. So a stale agreement that has not been revalued recently is an invitation for a partner to sue for revaluation. Many buy/sell agreements include a formula valuation methodology that remains perpetually current. You simply enter current financial information provided by the business' tax advisor and the agreed upon amount is calculated, which is binding on the owners.

Problems With Formula Valuation

Formula valuation addresses the problem of keeping the agreement perpetually current, but it creates the problem of over- or under-funding the obligation when insurance is the funding vehicle. Assume that two partners cross purchase insurance to fund the expected business value of \$500,000 each. Disability or death occurs 10 years later and the formula valuation methodology executes contractually and irrevocably. The calculated value is \$425,000 using current information provided by tax advisor.

Oops! The liability is over-funded in the event of death; the cross owned policy pays the surviving business partner \$500,000; and he buys the deceased owner's business interest for \$425,000 -- as agreed but not as expected. He pockets \$75,000 in addition to the business interest. The grieving widow expects \$500,000, but gets only \$425,000. The consequence is upset.

If the formula valuation results in a higher valuation than the existing insurance funding, the surviving partner faces an unfunded liability to the extent that the calculated value exceeds the insurance proceeds. For example, the formula values the deceased partner's business interest at \$625,000, leaving the surviving partner with an unfunded liability of \$125,000. Ooops! Upset again.

Upset can be magnified when the buy/sell agreement extends to an owners' disability without any insurance funding in place. These agreements are generally created with software templates designed to be legally enforceable independent of insurance funding and they include provisions for buy out in the event of disability, death, or severance (voluntary or involuntary termination).

To summarize, after an irrevocable mutual agreement is executed, it binds the owners to a current value that may be uncoordinated with existing insurance and may include provisions for disability, death, and separation. Any unfunded liability is binding on the remaining partner or owners.

Individually, the advisors would not be at fault in this situation. The tax advisor provided timely and accurate accounting information. The attorney created a legally binding and perpetually current buy/sell agreement that addressed the common triggers, such as death, disability, and separation. The insurance agent provided the requested insurance to fund the expected obligation.

The Plan Needs A Quarterback

But, all three advisors collectively created a plan that is likely to create an underfunded, if not unfunded, plan or an overfunded plan that fails to benefit the deceased owner's dependents or the disabled owner's interests. Someone should quarterback the planning process to ensure that the business owners' expectations are met through coordinated performance of each aspect of the plan. That someone is you, the agent.

Now the marketing motherload is mined. Restructuring the buy/sell agreement is not difficult, but it may require new and more insurance and revisions to the existing buy/sell agreement. I will defer to the business owners' attorney, but an introduction is necessary to explain the required changes. Referral #1: The attorney is equally happy to meet since this is a revenue-producing meeting. Referral #2: The tax advisor should be consulted to determine how adequate the existing insurance funding is regarding the current business valuation methodology and to explain how legal and insurability considerations will affect future valuation.

Unlike life insurance, disability buy-out is a reimbursement policy. It reimburses the policyholder for the expense of buying out a disabled owner up to the policy's benefit amount. It is necessary to coordinate the buy/sell agreement and the disability buy-out policy to provide maximum value to the disabled owner. A formula valuation methodology calculates the buy out value independent of the policy's benefit amount. The business owner will be reimbursed for actual expense paid as determined by the calculation which may be less than the policy's benefit amount. In short, unless the agreement's valuation equals the policy benefit amount, the policyholder overpays for insurance, receiving less than the policy's benefit amount. Ooops! Upset again.

Disability buy-out provides a valuable additional benefit through its claims-administration process. Disability buy-out relieves business owners from the burden of determining disability. The insurer is a professional, third party administrator that determines disability. Many buy/sell agreements require a vote of the partners/owners to determine when the buy/sell agreement executes. This creates an obvious conflict of interest for the non-disabled owner since their vote may bind them to an unfunded buy-out of his business partner.

Additionally, the business owner may not be qualified to determine their business partner's disability objectively. Lastly, the non-disabled business owner's ignorance of the law and what constitutes disability may create the perfect storm of adverse consequences.

Assume that the generic buy/sell agreement includes the dreaded "vote of partners executes disability buy/sell" clause. An affirmative vote of the non-disabled partners executes the buy/sell agreement irrevocably and binds the partners to the formula valuation buy-out, which may or may not match the disability insurance policy's benefit. It may create a partially unfunded liability to the extent of the difference between the formula value and the policy value. The nightmare really begins when the

disability insurer denies the claim because the policy's definition of disability does not match the buy/sell agreement's definition.

The insurer's denial does not void the partners' decision to execute the buy/sell. It creates a completely unfunded disability buy-out even though the partners own disability insurance that should have funded the liability. The business partners could execute the buy/sell agreement and create an unfunded liability if they fail to coordinate the buy/sell agreement's disability definition with the buy-out policy's definition and fail to defer to the insurer for the determination of claims.

In short, for the buy/sell agreement to work as expected, the agreement must be revised to coordinate with the existing funding mechanisms. A formula valuation methodology in the buy/sell agreement can (and most likely will) create an underfunded or overfunded liability since the funding mechanisms are life and disability insurance with fixed values and insurers require proof of insurability to increase the policy benefit amounts.

Implementing a fixed value buy/sell agreement solves the coverage gap and creates an annual opportunity to sell more insurance. As the value of the business increases, be sure the business owners' insurability is determined before binding the owners to a new higher fixed value buy/sell agreement.

Eliminating The Partners' Contractual Obligations

Next, eliminate the partners' contractual obligation to determine disability. Defer it to the disability insurer's professional third party disability claims administration. If there is no disability buy-out policy, promote the advantages having a disability insurer have the liability of for determining disability. Even having a small disability buy-out policy that creates an unfunded liability is better than requiring the partners to determine disability and trigger the buy/sell agreement. Rules for issuing and participating in a disability buy-out may limit the amount of coverage that a business can purchase. With a two-tier buy/sell agreement the partners are obligated to pay cash above the disability buy-out's benefit amount in order to satisfy the liability created by the buy/sell agreement. In these situations, the insurer's third party administration mitigates any alleged conflict of interest if the non-disabled partners' votes determine whether to execute the buy/sell agreement.

Even though the probability of disability is far greater than the probability of death at any given age, more buy/sell agreements are funded with life insurance than with disability insurance. In fact, many buy/sell agreements do not address disability at all. Ignoring the risk of disability and funding with life insurance actually increases the need for disability buy-out.

Once the buy/sell agreement establishes the valuation methodology for the business and the partners purchase life insurance to fund the potential liability, no partner can deny the intention to buy out another partner or dispute the valuation methodology.

The problem arises when a disabled owner extends that agreed upon value to encompass disability. It forces the remaining owners/partners to create buy/sell provisions for disability after the fact including the definition of disability and methods of funding a disability buy-out. At this point, it is too late to amend the agreement and purchase insurance and the cost of disability buy-out may be prohibitive or even life threatening to the business itself.

The solution is a fixed value buy/sell agreement, which is revalued annually after insurability has been established and is funded with disability buy-out and life insurance. This design mitigates the risk of creating underfunded and unfunded liabilities for the business owners; it integrates the capabilities of the legal, tax and financial advisors; and it positions the agent as the business owners' trusted advisory team quarterback. Most importantly, it creates a reasonable expectation of performance that can be realized and that is satisfaction.

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