Top 5 Contractual Disability Obligations That Can Crush Ultra-Successful Clients

By Sean McNiff

Whether your client is a corporation, small business owner, private equity firm or an ESOP (Employee Stock Ownership Plan), they are constantly making decisions that require navigating a minefield of contractual obligations that could topple them at any moment should they not step lightly. Potential dangers often lurk when large financials decisions are made, and obligations are set within a contract.

Whether it's a company merger or acquisition, the establishment of a business continuation plan, the hiring or firing of a key employee, or the application for a business loan, exceptional clients rely on sophisticated advisors to protect them from financial danger. They are seeking advisors who are acutely aware it's a minefield out there, and they know how to play the role of minesweeper.

So, let's identify the mines and start sweeping.

1. Disability to a Key Person. Contractual key person insurance obligations are most often found inside the mergers and acquisitions arena. They're established when one company buys another company and the acquisition agreement, or purchase agreement, requires "key person insurance." In this scenario, your average advisor will traditionally recommend life insurance on the named key executive, but what statistics have shown us is that a person is four times more likely to become disabled than die during their working years. And therein lies the mine just waiting to be stepped on.

For example, let's say there's a private equity firm that has acquired a new portfolio company, and suddenly the CEO of the newly acquired company suffers a stroke. Fortunately, they survive but are unable to perform their duties. If there was only a life insurance policy in place, the deal could crumble like three-day-old pound cake.

This is precisely why sophisticated insurance advisors keenly understand that a "key person insurance" clause within a purchase agreement requires corporately owned key person life and disability to keep the company — and the deal — afloat.

2. Disability to a Successful Business Owner. A majority of privately held business owners have the majority of their wealth tied up in their businesses. Protecting their equity from the event of a disability to either themselves or to one of their partners becomes a clear focal point as the value of their business rises.

Many business owners utilize buy-sell agreements to establish a succession plan in the event a partner dies or becomes disabled. And while these agreements are terrific tools to provide security for a business owner's equity, they can also establish contractual obligations that can burden the remaining partners.

For example, let's take the case of a Chicago investment firm run by five partners all in their 40s and 50s, and let's assume their firm carries a $50 million valuation. A classic entity purchase buy-sell agreement establishes a requirement for

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the entity (remaining partners) to repurchase all outstanding shares of a deceased or permanently disabled shareholder. Funding this obligation for death is an easy task utilizing the power of the American life insurance market. However, finding sufficient coverage to fund the obligation for share repurchase upon disablement requires an advanced approach.

In the U.S. disability markets, advisors can secure up to around $2 million in buy-sell disability insurance. But when an owner's equity value exceeds that $2 million mark, there is a void that requires a specialized approach. For these titans of business, sophisticated advisors utilize surplus lines carriers like Lloyd's of London to design buy-sell disability solutions with the capacity needed to fully fund the disability buy-out obligation should a partner become permanently disabled. Carriers such as Lloyd's can provide benefits exceeding $100 million per person, allowing business owners to preserve both their wealth and their partners' wealth.

3. Disability to a Lendee. There are very few businesses that can start-up or expand their operation without benefit of an infusion of capital. And that injection usually involves securing a loan from a bank or some other financial institution. But like any loan, the lender will be looking for collateral, and that collateral is required should a death or disability prevent an owner from paying back the loan. So by protecting the lendee, we also protect the lender.

Case in point: An entrepreneur is looking for a $1 million loan to open a new branch office. But the loan institution is asking for a disability insurance policy to cover the balance of the loan should the entrepreneur become disabled to the point where he can't make his loan payments. What he needs to keep all parties happy is a disability policy structured to pay $16,667 per month for five years to coincide with the payment schedule. And if you customize the policy with a reducing benefit structure, you can protect the outstanding balance while also saving premium dollars.

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4. Disability to a Severed Executive. It's no coincidence that producers have sold a lot more of this product since the pandemic inflated our unemployment numbers. What happens if you have had a CEO who gets a separate agreement, and inside the severance agreement, the company says, "We're going to extend your current benefits for two years." The dilemma is that the disability coverage terminates upon the termination of their employment. Therefore, they don't really have the coverage. Perhaps inside the termination agreement, they've guaranteed to that executive $10,000 per month of coverage until they're retired. But if that executive is only in his 40s, that's a multimillion-dollar land mine that the companies don't know how to step around.

A plan needs to be in place to eliminate that exposure to the corporation, and that plan often takes the form of a severance disability insurance (SDI) policy. SDI is a corporately owned risk mitigation tool that's used to transfer the risk that's created upon executing a severance agreement, such as a severed executive becoming disabled and making a claim on his now canceled disability insurance.

5. Disability to an ESOP Shareholder. Employee stock ownership plans can serve as a tremendous tool for business owners to exit their business while taking care of their employees. However, the creating of an ESOP should not only focus on transferring the business to its employees, but protecting that business for its employees. For ESOPs, the contractual land mine establishes an obligation to repurchase an employee's shares on death, disability and natural retirement. It is true that ESOPs typically insure against the death of a key shareholder, but what if your client has an ESOP already in place and you've got people that have shared values in excess of, say, $500,000? And what if that person becomes disabled? How does the repurchase obligation impact cash flow and operations? Further, how does it impact the company valuation and other participating ESOP owners? Unlike traditional disability insurance, which focuses on replacing income for a disabled person, specialized disability programs speak to the need of avoiding the one-two punch of no longer having the services of that key employee plus needing to fund the repurchase of the ESOP stock.

We are living in unprecedented times, where now more than ever, clients rely on advisors to protect them from a wind tunnel of events that are constantly affecting their business. Clients are focused on utilizing their unique abilities to build both successful companies and their personal wealth and may not be aware of where they are stepping. And it's your job to make sure you have the insurance products they need so that the next sound they hear isn't... boom! IJ

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