

# Unprepared for the **UNTHINKABLE**

By Russ Alan **PRINCE**, Hannah Shaw **GROVE** and Edward A. **TAFARO**

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FEW BUSINESS OWNERS ARE PREPARED FOR THE UNTHINKABLE – **THE DEATH OR DISABILITY OF A PARTNER.** IT'S A TOPIC MOST PREFER TO AVOID, BUT WHEN IT HAPPENS IT CAN BE THE RUINATION OF THE BUSINESS.

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## Letter from **LEWIS SCHIFF**

In the past year, all of us have had to confront huge problems—credit crunches and massive financial uncertainty—that we did not create. Now, virtually every business owner I speak to tells me they are preparing for another unforeseen macro-economic event.

The topic of this research paper—how to properly plan for unknown events between you and your partner(s)—falls into the same category. Only in this case, the trouble begins at home.

Let me sum up this research for you in one simple statement: most business owners are ill-prepared for unexpected events between themselves and their partners. This shouldn't be too surprising. When one is working towards growth everyday and putting out fires all the time, it's hard to find room for things that haven't yet happened.

My advice? Find the room. Because an unexpected event—a partner's divorce, an accident or illness, even the death of a key colleague—can lay asunder years of hard work. We looked to Russ Alan Prince and Hannah Shaw Grove, our friends who always have an ear pointed in the direction of business owners, for guidance on this serious topic. Their research shows us both the worst and best practices in this crucial area of business emergency preparedness.

When you read this research, don't just get scared. Act. As the old saying goes, the best time to plant an Oak Tree was 30 years ago. The second best time is today.

Like all emergency planning, we hope you never have to confront the challenges that set up the solutions outlined in this paper. But inevitably, some of you will. When that happens, be prepared.

Sincerely,

**Lewis Schiff**

*Chairman, Executive Director  
Inc. Business Owners Council*



### **ABOUT INC. BUSINESS OWNERS COUNCIL**

**Inc. Business Owners Council** ([www.inc.net](http://www.inc.net)) is *Inc.* magazine's membership organization for top entrepreneurs and family business owners. **The Council** brings thought leaders together with Council members to explore best practices and develop insight that help members make smarter business decisions.

#### **Contact:**

**Inc. Business Owners Council**  
7 World Trade Center  
New York, NY 10007  
[www.inc.net](http://www.inc.net)  
[membership@inc.net](mailto:membership@inc.net)  
(800) 536-0046

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## Key THEMES

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- About 40% of business owners are financially prepared in the event their partner(s) dies. Only about 15% are prepared if their business partners are disabled.
- Most business owners are not taking the necessary steps to protect themselves because they think it will be too costly. The second most common reason for not taking action is the belief that the parties involved can “work it out.”
- The use of buy/sell agreements that cover both disability and death is usually the most efficacious way to deal with this issue.
- There are basically two types of buy/sell agreements—cross-purchase agreements and redemption agreements. Which is best is a function of the needs and preferences of the business owners.
- There are a variety of ways to fund buy/sell agreements. However, the most common and regularly the simplest way are by using insurance.
- Buy/sell agreements need to be constantly monitored to ensure they reflect the value of the business as well as the needs and preferences of the owners.

## About the AUTHORS

### Hannah Shaw GROVE



Principal  
HSGrove Private Wealth  
Consultancy

Ms. Grove is a respected author, columnist and speaker and a leading authority on the mindset, behavior, concerns, preferences and finances of high-net-worth individuals. She is the executive editor of *Private Wealth*, the first and only magazine for professionals with ultra-affluent clients, and the author of nine books and numerous reports on private wealth and related topics. She co-authors columns for *Elite Traveler* and *Robb Report China* and is widely quoted in the national, trade and online press.

She spent nearly 20 years in the financial services industry where she worked closely with institutional and high-net-worth investors to develop sophisticated financial, planning and servicing solutions. Grove is the principal of HSGrove Private Wealth Consultancy, and a long-time partner of Russ Alan Prince, the president and founder of Prince & Associates, Inc.

### Russ Alan PRINCE



President  
Prince and Associates, Inc.

Mr. Prince is the president of Prince & Associates, Inc., the leading market research firm specializing in private wealth. He is one of the most prolific authors on the topic of high-net-worth individuals and has completed work on more than 40 books covering subjects ranging from investor psychology to luxury spending, from prospecting in the mass-affluent segment to the political philosophies of the super-rich. His body of work is regularly consulted by family offices, private bankers, wealth managers, estate planning specialists, elite advisors and producers, academia, the press — even the wealthy themselves. Collectively, the cache of research-based insights within Prince's publications is the most complete longitudinal data and the largest, most comprehensive database on the topic.

Prince consults to high-net-worth families on accessing various family office and wealth management services. He also works with financial and legal experts who provide cutting-edge strategies and concepts to families with exceptional wealth. He is a highly sought consultant to the ultra-high-net-worth and elite advisors, and is regularly cited in the worldwide press.

## About the **AUTHORS**



Edward A.  
**TAFARO**



President & CEO  
Exceptional Risk Advors, LLC

Ted is one of the country's foremost experts on high-limit specialty life, accident and disability products for clients with exceptional insurance needs—including celebrity athletes, entertainers, highly compensated executives, entrepreneurs and professionals. Ted is a Lloyd's of London underwriter responsible for managing various underwriting authorities at Lloyd's that exceeds \$50,000,000 per individual risk.

In 2008, Tafaro was named as one of the "Top Forty Executives Under 40" by New Jersey's premier business news publication NJBIZ.

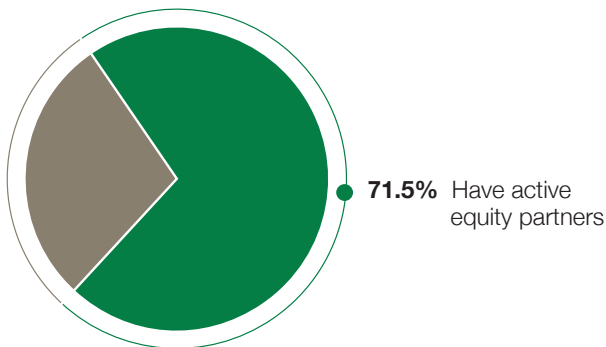
Prior to launching Exceptional Risk Advisors in 2006, Tafaro was the President and Chief Operating Officer of The Hanleigh Companies—an industry-leading underwriter of insurance for entertainers, professional athletes and highly compensated executives. In 1999, Hanleigh was named the first ever US-based Lloyd's broker. During his tenure, Hanleigh managed a year-over-year growth rate in excess of 25%. Hanleigh was acquired by The BISYS Group (BSG - NYSE) in 2002.

To understand the current mindset among business owners regarding their retirement planning and savings options, we undertook a research initiative. We spoke with 1,402 owners of businesses.

To begin with, about 70% of the business owners we surveyed had participating equity partners in the business (Exhibit 1).

### EXHIBIT 1: Have Participating Equity Partners in the Business

[ N = 1,402 BUSINESS OWNERS ]

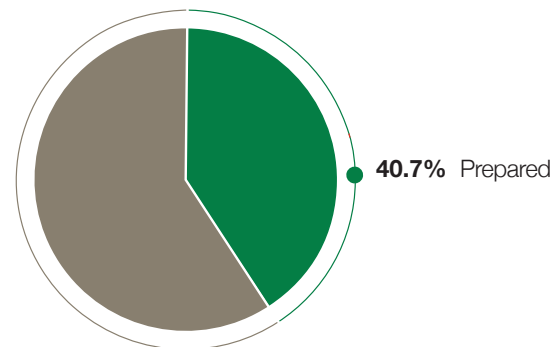


## Business Owners are UNPREPARED

Looking at those business owners sharing equity with others in the business, we found that only two-fifths of them are prepared if their business partners died (Exhibit 2). Far fewer were prepared if a partner became disabled (Exhibit 3).

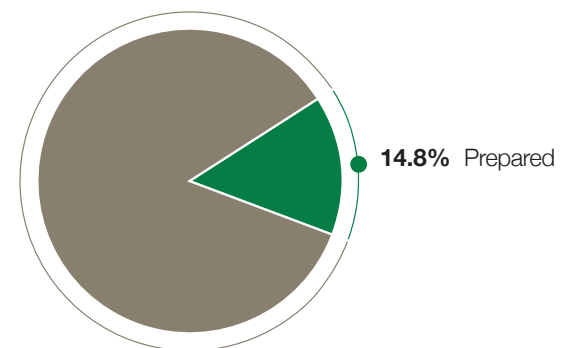
### EXHIBIT 2: Prepared If a Partner Died

[ N = 1,402 BUSINESS OWNERS ]



### EXHIBIT 3: Prepared If a Partner Became Disabled

[ N = 1,402 BUSINESS OWNERS ]



Turning to factor analysis to identify the principal motivations for not being financially prepared in these situations, we found that the motivations for not being prepared for the injury or death of a business partner parallel each other (Exhibit 5). The biggest obstacle is the perceived cost. Half the business owners saw this with respect to death and nearly three-quarters saw this with respect to disability.

If a business partner died, almost a third of those surveyed said they would work it out. Meanwhile, the same sentiment was expressed by a fifth of the business owners when it came to disability. Although this is a very noble sentiment, in our experience it just never seems to happen – at least without lawyers present. More often than not, the result of “working it out” is far more costly and disastrous to the business than if the business owners took action before the fact.

About one-sixth of business owners are too busy to deal with the potential death of a partner. For less than 5% of business owners being very busy is the reason they didn’t address the disability of a partner. A few business owners just didn’t consider the death or disability of their partners.

#### EXHIBIT 4: Reason Business Owners Are Not Financially Prepared

Business owners	Disability	Death
<b>Too expensive</b>	72.9%	50.6%
<b>Will work it out</b>	20.5%	30.1%
<b>Do not have the time</b>	4.8%	15.3%
<b>Did not think about it</b>	1.9%	4.0%
<b>N =</b>	855 Business Owners	595 Business Owners

## DISABILITY

There are a variety of types of disability policies that should be considered, aside from ones that provide income for a period of time while injured. One type that should be considered by business owners upon whom the business is truly dependent is business-overhead disability. Business-overhead coverage will pay a monthly benefit to cover business expenses while the business owner is disabled.

For business owners with a number of partners, we recommend examining disability insurance in a buy/sell agreement. With such a strategy in place, it’s possible for a disabled business owner who is entitled to a share of the businesses profits to be cost-effectively bought out. Thus, eliminating a disabling financial drain on the business or the other partners. Basic provisions of buy/sell agreements include:

- A lump-sum payment usually available after a waiting period often lasting two years.
- A series of annuity payments over a specified period of time, which is often two to five years after a waiting period of one to two years.
- A combination of the above two.

The cost of disability insurance is a function of the amount of the coverage, the risk of becoming disabled, the length of the waiting period and the length of the payout period. The longer the waiting period and the longer the payout period, the lower the premiums will be. The waiting period is defined as the period of time from the date of the accident or illness causing the disability to the time the benefit payments starts.

## DEATH

Few business owners want the heirs of a deceased partner to have equity with a say in the management of the business. Nevertheless, we find that this does indeed occasionally come to pass. When advanced preparations for such a possibility are not taken, the business owners are in the difficult position of having to buy out the heirs. It's not uncommon for negotiations to become difficult to complete because the heirs don't typically have the same business background as the decedent.

## Type of BUY/SELL AGREEMENTS

There are basically two types of buy/sell agreements:

- **Cross-purchase agreements** have the surviving or healthy partners individually purchase the equity of the deceased or disabled partner.
- **Redemption agreements** have the company purchase the interests of the deceased or disabled partner.

Considering taxes, the cross-purchase agreement may be superior because the remaining partners will be able to obtain a stepped-up tax basis in the acquired shares. This doesn't happen with a redemption agreement. Either of these agreements can be written into the company formation documents or they can be stand-alone documents.

Business owners not only need to decide on the type of buy/sell agreement, they must also decide whether to make the buy out mandatory or optional. If the buy-out is optional the next question is who has the option. For example, is the option given to the deceased or disabled business owner's family or the remaining business owners of the company.

## Funding BUY/SELL AGREEMENTS

What's essential is to have the monies to buy the interests of the deceased or disabled partner. Some business owners do not fund the buy/sell agreements expecting to use the cash flow from the business to pay for the equity. This approach has a fair amount of risk associated with it. Some business owners set up a sinking fund into which they place monies. These funds are invested. If a partner dies or is disabled, the monies in the sinking fund are used to purchase the equity. Like the cash flow method there are potential problems with this approach—specifically, not having enough money in the sinking fund when the forced transition occurs.

To take the risk out of the process, life and disability insurance is generally used to fund buy/sell agreements. The insurance would be structured so that the owners or the entity itself would own it. With a cross-purpose agreement, each of the surviving or healthy business owners would receive the insurance proceeds and would use these funds to purchase the deceased or unhealthy business owner's equity. With a redemption agreement, the company would receive these proceeds and use them to purchase the equity.

Most often the insurance policies are obtained on the life of each of the business owners when the buy/sell agreement is set up. However, as time passes, if the value of the entity increases, the buy-out price for a disabled or deceased owner's estate, if determined by a formula or fair market value appraisal at the date of death or disability trigger date, will increase. To remedy this situation, it's wise to regularly review the agreement and the funding to ensure that—in case of a disaster—everything will work out well. Additionally, when obtaining the insurance, it's critical that the policy issued on each business owner's life not be owned by the insured owner or paid to the insured owner's estate, as that would result in the unnecessary taxation of those insurance proceeds.

Once it is determined that insurance is needed, the question of how to pay for it arises. Several different methods can be used to fund the life and disability insurance part of the buy/sell agreement. The individual business owner can pay for his or her own policy out of his or her after-tax income. The alternative is for the business itself to pay the premiums on the insurance. One way to do this is to have the business pay out a bonus to the business owner in the amount of the premium. The business owner's cost is the income tax on the bonus. If the business is a tax pass-through entity such as a partnership or limited liability company, then there may be a pass-through tax that the premium payment represents. Each situation should be evaluated with all the tax consequences taken into consideration before using a bonus plan.

Additional funding options are available, however, they tend to become more complicated from here on out. Life insurance, for instance, can be purchased through a qualified retirement plan with pretax dollars. Because we are dealing with a qualified retirement plan there are limitations on the amount of the death benefit.

There are other strategies that can be used to mitigate the costs of life insurance used to fund buy/sell agreements. For example, loans can be used to pay the premiums. These loans can be secured by the policy, itself. In some situations, you can even use the business' accounts receivable to pay for the policy.

## Buy-Out PRICE FORMULAS

There are various ways to decide the value of a business for the purposes of a buy/sell agreement. The three basic approaches are:

- **Formula Approach.** Here the value of the business is based upon a set formula that reflects standards that are acceptable in the specific industry. This approach is often attractive because it's based on some objective standards that have been agreed upon by the business owners in advance.
- **Certificate of Agreed Value Approach.** The business owners agree to set the value of the company and consequently the value of the equity owned by each business owner. With this valuation approach, the business owners should review and update the Certificate of Agreed Value on a regular basis. By revisiting the company's value on a regular basis the Certificate of Agreed Value reflects current fair market value for the Company.
- **Appraisal Approach.** Unlike the previous two approaches, at the time of a forced equity transition, an appraiser is hired to determine the fair market value and therefore the purchase price of the deceased or disabled business owner's interest. Under this approach, it's important to include in the buy/sell agreement whether the appraiser will or will not take into consideration minority and marketability discounts when determining the value of the business owner's equity, as this may make a difference of 35% percent or more of the buy-out price.

## Ongoing MONITORING

What we repeatedly see is that most buy/sell agreements funded with either disability or life insurance do not cover the true costs of the equity owned by the injured or deceased business owner. This occurs because the value of the business substantially increases over time, making the amounts of insurance purchased inadequate. That's why it is critical to monitor the details of a partnership plan periodically.

## Perspectives From a **LLOYD'S OF LONDON COVERHOLDER**

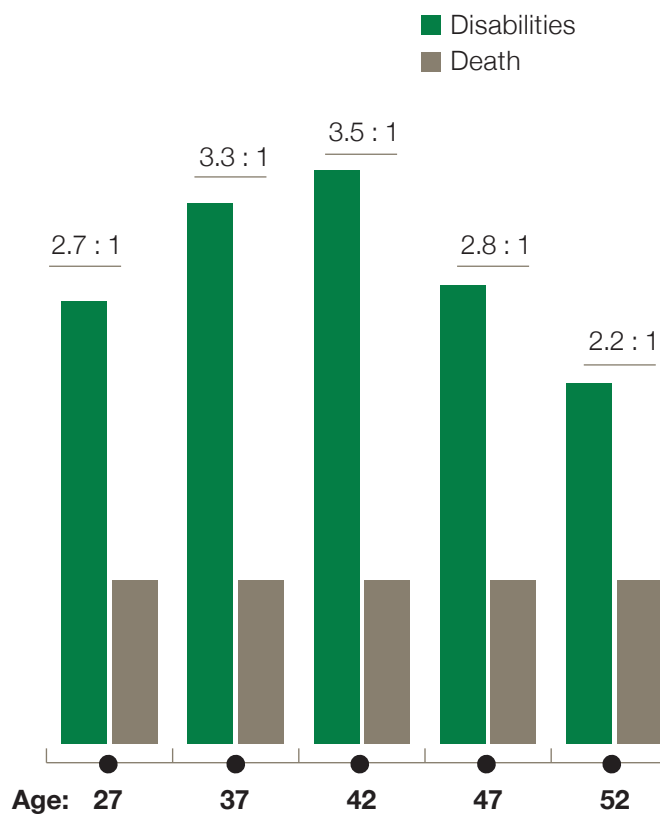
By Edward A. **TAFARO**

Most closely held businesses are highly dependent on the vision, relationships and knowledge held by their owners. Entrepreneurs create a foundation of human capital that drives the success of the company. For these unique individuals, death and disability is all but certain to end in disaster for both the company and shareholder's family when they have poorly designed and funded agreements or no agreements at all.

While death is a certainty, the likelihood of disability 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 reveals.

### What is a Lloyds of London Coverholder?

Coverholders are firms world wide who are authorized by Lloyd's syndicates to enter into contracts of insurance or issue insurance on their behalf.



By Edward A. **TAFARO**

**CASE**  
**#1**

**BACKGROUND:** A highly profitable software firm that designed and distributed back office business process software for community banks and financial institutions located on the east coast, the company was valued at \$22 million. The firm had five equity partners with individual equity stakes ranging from \$2 million to \$12 million.

**SITUATION:** Because most traditional US disability carriers will not issue policies to the limits that were required, our firm was brought in to fashion a unique solution.

**SOLUTION:** We created a stock redemption program that was funded with term life insurance to protect against the risk of death and a modified disability insurance program that paid a lump sum benefit to the corporation in the event of a permanent disability.

**WHAT HAPPENED NEXT:** Six months later, the CFO went into atrial fibrillation and subsequently suffered a stroke that permanently disabled him. Twelve months later, we delivered a \$2 million check to the company that was used to redeem the CFO's stock. Our solution allowed the company to manage through tragedy, and allowed the CFO's family to manage their upset finances.

**CASE**  
**#2**

**BACKGROUND:** A California based logistics company had four equal partners and was valued at \$36 million.

**SITUATION:** While the firm had a life insurance policy for all four partners, the partners didn't have disability insurance. All four partners were in reasonable health and in their early to mid 40's. Operationally, they felt that the company could absorb the loss of any one partner.

To fully fund the \$36 million of disability protection on all four individuals (\$9 million on each), the cost would run about \$130,000 annually. While this group had plenty of cash, they wanted to plow every available dollar back into the business to achieve their growth objectives.

**SOLUTION:** Ultimately, the company decided to "self insure" the first loss. We designed a program that insured all four partners, but the company would self insure the first loss, unless a second partner was to become permanently disabled in a five year period. If a second partner suffered a disability within the policy period, an \$18 million benefit would be paid to the corporation covering both losses. This strategy saved the company thousands of dollars annually.

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623 Fifth Avenue, 11th Floor  
New York, NY 10022  
800.498.3173  
www.heraldnb.com

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## EXCEPTIONAL RISK ADVISORS *llc*

One International Boulevard,  
Suite 625  
Mahwah, New Jersey 07495  
201-512-0110  
Toll Free: 866-512-0444  
www.exceptionalriskadvisors.com

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7 World Trade Center  
New York, NY 10007  
[www.inc.net](http://www.inc.net)  
[membership@inc.net](mailto:membership@inc.net)  
(800) 536-00466