The Most Overlooked Risk in Private Equity

Disability and key person life insurance help protect a valuable human asset

» BY EDWARD A. TAFARO

While investors go to great lengths to cover their bases on all of the potential issues in the private equity realm, a few things too commonly get overlooked. "They just don't think about it," said Daniel J. Krekeler, who has spent the last 20 years designing and implementing key life and disability insurance plans for corporate executives involved in private equity transactions. Krekeler is currently a vice president of Aon Hewitt in St. Louis, Mo. and a member of its executive benefits team.

"The private equity professionals think of key person life insurance to help protect their investment, but that's where most of them stop. Their largest exposure is in the first two or three years after they close a deal." Krekeler goes on to say, "It's often difficult to get across the idea that a key executive's disability risk is many times greater than that of death during this time period."

Krekeler understands the thinking, since a term life policy is only about one-third the cost of key person disability coverage. Yet, he questions it. "We always point out what would happen to their investment if the key person, the one who shoulders the burden of the success of the transaction, should become disabled and be taken out of the picture."

THE REALITY OF DISABILITY

While ignoring the probability of permanent disability may seem like a cost-saving opportunity, the odds may not be as favorable as they appear. In fact, the gamble is far less favorable than most of us may think. As it turns out, the Council of Disability Awareness does a good job of illustrating this:

- 90 percent of us underestimate our chances of becoming disabled.
- 85 percent of us express little or no concern that we might suffer a disability lasting three months or longer.
- 56 percent of us don't realize that the chances of becoming disabled have risen over the past five years.

Even in light of these findings, there are those who are still quick to dismiss the chances of becoming disabled as little more than scare tactics promoted by life insurance companies. As we might expect, 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.

Based on the facts, it would seem appropriate for private equity firms to recognize the potential catastrophic effect that a disability event could have on their investment. Accordingly, the second step would be to mandate adequate disability protection on the CEO or other prime movers of the companies they acquire.

As Krekeler reminds his clients, "Hiring the right CEO isn't easy and when the need arises suddenly, as in the case of disability, the situation is even more intense."

A KEY PERSON'S VALUE

Also to be considered is that a company's acquisition is often closely tied to the CEO, who, more often than not, is the founder and visionary that drives its success. In addition, many private equity firms run lean, with few, if any, back-up personnel capable of stepping into the CEO's shoes.

What's at risk is enormous: should the CEO be taken out of the picture suddenly, their investment is at risk and the company's viability may well be put into serious question.

Key person insurance

The safety net provided by key person insurance (or, as it was called in the old days, "key man" insurance) can enhance the value of a business, in addition to providing peace of mind. Nationwide's version of the coverage, for instance, touts the following:

- Coverage is a business asset that enhances your company's creditworthiness for commercial borrowing.
- The policy's cash value may be available to your business through a loan or withdrawal, if needed.
- The policy can be transferred to the employee at retirement as a bonus.

Since building and maintaining investor confidence is a critical concern for private equity firms, they are best served by viewing the combination of key life insurance and key disability insurance protection as prudent moves that help to reduce risk. Consider the following case study:

The subject was a 48-year-old male, who was the founder and CEO of a privately-held technology company providing unique nanotechnology solutions to emerging global markets. He was an individual with distinctive personal talents and capabilities. He also held patents on technology in his own name.

Beyond that, he was a highly regarded thought leader who served as the face of his company. The brand was intimately related to his family name and public image.

The close of an $85 million majority equity investment was contingent upon securing key person life and disability coverage on this executive, since his commitment was essential to an efficient transition and the ongoing success of the business.

After thoroughly quantifying the potential impact an unforeseen death or disability would impose on the organization and, therefore, the transaction, $20 million of key person life and disability insurance was stipulated as a prerequisite for the consummation of the investment.

As it turned out, the existing insurance advisor could obtain $20 million of key person life insurance through traditional carriers. However, this advisor was unable to obtain $20 million of key person disability coverage from traditional insurance carriers, as they lacked the needed capacity to protect the exposure.

As a result, a broker with a Lloyds of London relationship was called in, and a five-year key person disability policy was bound, with a lump sum benefit payable after a 12-month elimination period to protect the private equity firm's investment.

Krekeler notes, "In the final analysis, it's the intellectual capital that's at stake in a private equity transaction, and, more often than not, that can't be replicated at any price. «

Edward A. (Ted) Tafaro, president & CEO of Mahwah, New Jersey-based Exceptional Risk Advisors, LLC, is an expert on high-limit specialty life, accident and disability products for clients with extraordinary insurance needs. For more information, contact him at ted.tafaro@exceptionalriskadvisors.com.