

Disability Buy-Out and Overhead Expense: Important and Often Overlooked Extensions of Business Continuation Planning

By
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Producers who work closely with business owners have most likely discussed their client's plans for continuation of the business in the event of death. A natural extension of this planning is to make your business clients aware of two equally important needs that can be and are usually overlooked; Disability Buy-Out and Overhead Expense Plans.

Since death is inevitable, business owners readily accept the concept of funding the Buy/Sell Agreement against this contingency and while death is certain, the time of death is not. The truth of the matter is the likelihood of total disability of one of the owners prior to Age 65 far exceeds the possibility of premature death. Statistically, 67% percent of people who suffer heart attacks, the number one killer in America, survive. Cancer survival has reached the plateau of 56%. The greatest number of disability cases involves people 30-49 years of age with the average age being 41. In turn, the disability of a business owner may create economic problems which are far more devastating than death if a proper plan is not put into force. This fact has been under discussed; leaving the advisor facing possible accusations of malpractice should the disability of a business owner occur.

Many Buy/Sell Agreements include a disability Buy-Out Provision but are not supported by a funding method. Therefore, when you meet with a business owner, prospect or client, ask them for permission to review their Buy/Sell Agreement. If you discover that the agreement has a buy-out provision, ask to review the policies that will fund the Buy-Out. In most cases you will find that there are no such policies in force. This could create a major economic problem for the business because, legally, the healthy owner(s) would be required to buy out the disabled owner's interest in that company. Which leaves one big question, could the healthy owner(s) afford to write that check, with out having to sell off some, if not all, of their interest in the company as well.

Disability Buy-Out Insurance provides the funding for the purchase of a disabled owner's interest in the event of a long term, total disability. Overhead Expense Insurance covers the operating expenses of a business when a "revenue generating" owner can no longer generate revenue due to a disability. The two products work nicely in tandem. Overhead Expense Insurance fills the gap immediately following the onset of disability to keep the business open. About 30% of American's ages 35-65 will suffer at least one disability lasting 90 days or longer at some point during their working career according to the American Association of Health Plans (formerly HIAA). That is close to a one-in-three chance of sustaining such a loss. If the disability become long term and the Buy/Sell Agreement is properly funded then the owner(s) can meet their obligations with out having to write a substantial check and placing their company in further financial trouble.

The market for Disability Buy-Out and Overhead Expense Insurance is primarily small, closely held businesses. The owners play an active role in the business, and often their personal service is essential to the business' survival. By offering Disability Buy-Out and Overhead Expense Insurance, you can address the full line of business continuation needs of this market. You'll also be in a good position to generate additional compensation by expanding your market and product lines.

Disability Buy-Out and Overhead Expense Insurance offer many benefits for your customers, such as:

Overhead Expense Insurance provides the following advantages:

- Helps relieve a “double burden” – you have both personal and business expenses. Overhead Expense insurance can help provide the funds to pay the business bill and employee salaries.
- Provides a measure of “job insurance” – you’ve probably spent many years building and maturing your business. Overhead Expense Insurance helps protect your asset.
- Maintains goodwill – Overhead Expense Insurance allows your business to remain on good terms with customers, vendors, and creditors, and helps protect from a drain on business capital.
- Helps retain business value – should you decide or be forced to sell your business due to a permanent disability, being able to pay your bills and keep the operation running smoothly helps ensure the valuation of your business remains strong.

Disability Buy-Out Insurance provides the following advantages:

- Maintains business continuity and credibility, which are concerns of customers, creditors and employees.
- Assures that the disabled owner and his/her family will not have to manage the business in the event of total disability.
- Assures that the active partner(s) will retain control of the business.
- Assures the disabled owner that his/her financial future is not contingent on the strength of the business: and
- Provides funds needed to pay medical bills and living costs for the disabled owner.

Your Clients will consider these issues to be very important if you ask the proper questions, like **“If one of the owners becomes disabled, how would you want the transfer of ownership to occur?”** or **“Do you want the spouse of your disabled partner to assuming his/her role at your company?”**

When discussing Disability Buy-Out and Overhead Expense Coverage, you should understand how the following could impact their situation:

- Tax Consequences. Disability Buy-Out and Overhead Expense have important tax consequences that your client should understand. Premiums for Buy-Out Coverage are not deductible; however, disability benefits are tax free. In the case of Overhead Expense Coverage, premiums are deductible and benefits are taxable to the business. However, this is offset by the deductibility of the expenses to the business.
- Payout methods and elimination periods. If you are already working with clients on Buy-Sell agreements, it makes sense to look for tie-ins with disability Buy-Out and Overhead Expense protection as well. You might experience resistance from clients with limited premium dollars who consider Buy-Sell protection in the event of an owners' death to be a higher priority. In this case, **showing the client that the odds of becoming disabled are three times higher than premature death might open their eyes to the risks they are taking.** Ask them why they are more comfortable insuring the least likely event. To save cost and to obtain the coverage that fits with in the client's budget, you could propose coverage with a longer elimination period, such as 2 years. Another cost savings approach is the Installment Payout Method. Monthly benefits typically do not continue if the insured dies within the installment period and, therefore, the cost of funding the disability benefits in this manner are less. For this reason I favor the lump sum option, which is handled essentially like a life insurance benefit. If, for some reason the Insured wants an installment Buy-Out basis, the Lump Sum proceeds can be paid to a Trustee to hold, and then the funds can be released on an installment basis.

You must ask your clients the tough questions now, when all the owners are healthy, rather than waiting to ask them later when it literally may be "too late." These business continuation products are great door openers and create many new business opportunities; such as life insurance, individual or key person disability coverage and other salary continuation plans. Keep in mind that Bankers are becoming increasingly aware of the hazards to their loan repayment potential because roughly 25% of all bankruptcies are tied to an illness or injury. Oftentimes, when you find a client with an old Buy-Sell Agreement, the existing life insurance is inadequate to cover the current value of the business entity. Please do not avoid this market because it appears complicated or you have an unusual situation. Just rely on your DI Resources and get the assistance you need to be involved in this important market.

P.S. One more statistic to keep in mind: The Federal Home Loan Bank reports that over its many years it has determined the major cause of mortgage loan foreclosures is disablement of the mortgagee; 48% vs.. 3% due to death.

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