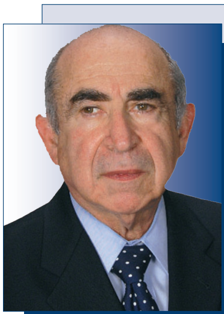
Disability Insurance Insights...

Buyout Coverage: To DBO Or Not To DBO?



EUGENE COHEN

began his insurance industry career in Cleveland, OH, with a company that specialized in disability income protection.

In 1981 Cohen founded the Eugene Cohen Insurance Agency, Inc., Skokie, IL, which specializes in DI, life, LTCI, fixed annuities, and impaired risk cases. The agency is a member of LifeMark Partners, NAILBA, the IDIS and is a founding member of The Plus Group.

Cohen received the W. Harold Petersen Lifetime Achievement Award from the IDIS and NAILBA's Douglas Mooers Award for Excellence.

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We know that business owners have unique planning needs that require a financial advisor to be familiar with additional products and concepts. One of those concepts is succession planning and how to plan for the death of a business owner. Life insurance is typically used for that purpose and the concept is relatively straight forward. The clients' business attorney needs to be involved so that the documents are prepared correctly and that the structure of the buyout is determined. Most properly drafted buy-sell agreements, partnership agreements or operating agreements will have some type of provision that describes what is to occur if a partner also becomes disabled. There are various parts of the planning aspects of business buyout agreements and analysis, such as: Structure, Valuation, Definitions, and Need. For the purpose of this article, we want to really focus on the **need**. While it may appear obvious, we want to take a deeper dive into the need for the actual agreement to have a well written disability provision and subsequently the necessity to fund the agreement as well.

Why is the agreement needed? When a business partner passes away, it's obvious that the person is no longer able to work.

Assuming there was a constantly reviewed and updated buy-sell agreement set up ahead of time, then the process usually will go fairly smoothly. When a business partner becomes disabled it can be a different, more strained, situation as the partner may still be able to have some strong opinions about how the business is operating and the compensation or distributions that should be owed to him or her.

Let's look at some examples of how this can be challenging for the business partners. Take a law firm, accounting firm, or some other professional firm. One of the partners is diagnosed with a high stage cancer, one that with treatment the person can live a few years and, in some cases, beat it all together. Now let's add that this is a senior partner with 35 percent ownership of the firm. The partners are compensated in three ways: A regular salary, end of the year bonus, and a passthrough dividend at the end of the year where the profits are split up. Let's revisit the partner that is fighting cancer. Let's say he's been out for most of the year due to his treatments, recovery and more treatments. He checks in when possible, but the other partners, while very sympathetic to his condition, have taken on more of his work and responsibilities. The partners even had to hire an additional assistant to help with some of the administrative tasks the disabled partner was responsible for as part of his duties. The disabled partner was coming in one, maybe two, days per week, but has been too weak to stay all day, and it eventually comes to a point when he doesn't come in for weeks or months. The firm has sick days, vacation days, and a basic group LTD that pays up to $5,000 a month and he is now on claim.

When the year end comes along, the existing partners take additional bonuses to make up for the extra work and there are no dividends paid. The disabled partner cries foul, as he feels the existing partners took all the profits that he should have been allowed to share in and paid it out as bonuses instead. The existing partner calls his attorney to see what can be done. Since there was no buy-sell agreement or an agreement that spells out what occurs if a partner is disabled, there may be very little the disabled partner can do except take legal action.

Let's take another scenario of a business partner that doesn't come back to work but refuses to relinquish ownership in the company. The other partner(s) need to still do more work and adjust the workload due to the absence. The other partner(s) have even offered to buy out the existing partner, but to no avail. The ailing partner refuses to sell in hopes of returning…even after years of being completely disabled. Now his spouse has been asking for copies of the income statements, bank statements, and annual financials so that their accountant can analyze the books. The disabled partner is causing more work and expense for the firm with all the additional requests and inquiries. If they had a properly structured a buy-sell agreement with a disability buyout provision, this type of scenario could have been avoided.

Once the buyout or partnership agreement is set up and there is a disability buyout provision, then the planning conversation is whether to fund the agreement with a disability buyout policy or to payout the buyout via operating business income. As we said initially, there are many different styles and types of agreements with various corresponding types of policies to help fund them. The financial strain of an unfunded buyout agreement can be devastating to the business. The business may need to get a loan to satisfy the obligations of the agreement. It's possible that the working partners may need to use their own savings to satisfy the obligation as well. Without a properly funded buyout agreement there can be hardship for the business and the partners.

The road to disability buyout insurance policies first starts with a properly structured buy-sell agreement. Once your client has the agreement, you should ask for a copy so that you can work with your disability insurance MGA or company to see how funding the agreement with disability buyout insurance could be an option.