LIFE AUDIT PROFESSIONALS, LLC™
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Professional Thought Leader Series | Issue #5

Are You Practicing Good Defense? – What Happens If You or Your Client Become Disabled?

Will you or your clients' businesses succeed if a stakeholder is disabled or dies? What is the effect on the remaining stakeholders, employees, and the related families?

If a key stakeholder dies or become fully disabled, what effect will these outside influences have on the continued success of the business?

- Will key relationships continue?
    - Customers
    - Vendors
    - Other relationships contributing to the success of the venture
- Will banking relationships remain intact or will loans be modified or called?
- Will bonding relationships change? If so, what effect will the elimination of a bond have on the venture?
- What other relationships can be adversely affected if a key stakeholder or employee is no longer able to perform their job responsibilities?

Will these internal stresses adversely affect the continued success of the business?

- Have operating and employment agreements been well thought out and executed?
    - If a key stakeholder is disabled, how long will salary continue?
    - If a key stakeholder is disabled, will a buy out of their ownership position take place or will the disabled stakeholder continue to be involved when they are disabled having a different agenda from those stakeholders operating the business?
    - If there is a death, do the agreements provide for a buy out and if so at what price?
    - Has the operating agreement and entity selection of the business been created with an eye towards the ultimate goal of the business?
        - Sale of the business
        - Long-term operation of the business
        - Estate conservation
- Creditor protection. Have the agreements been funded with insurance or is the financial burden of buying out the disabled employee's ownership position been shifted to the remaining stakeholders in the event of death or disability?
- Have key person issues been addressed? If so, have they been quantified and funded with insurance?

<u>Could you, as the client's trusted advisor, by playing good defense contribute a much different outcome if a stakeholder were to die or become permanently disabled?</u>

Let's review this fact pattern of a recent case where no names are used to protect the previously uninformed.

The business operates successfully with three partners, one of which is the key player and majority shareholder. All serve to contribute to the success of the venture. They are all in their mid to late 30's with much of their personal net worth tied up in their business. All of their income is earned from the venture.

Currently in place is an operating agreement calling for an unfunded purchase of the stock of a deceased shareholder far below the current fair market value of the venture. There is no funding vehicle in place, requiring the remaining shareholders to fund the buyout of the deceased shareholder. There is no key person coverage.

The agreement is silent on disability and the venture is without a funding mechanism to purchase the shares of the disabled shareholder.

There are no employment agreements providing for the terms of the shareholders salary, their bonuses or how long salary would be paid if the shareholder were to be totally disabled.

No personal disability insurance was in-force for any of the shareholders!

<u>Could a team of proactive professionals create a much different outcome?</u>

Our process, after meeting with the client, was to immediately involve the corporate attorney, estate planning attorney, wealth advisor, and CPA. The client's team of professionals worked in unison to implement the following plan:

1. **<u>Personal Disability Coverage</u>** - Each shareholder immediately purchased personal disability insurance to protect their income. This was purchased on a group basis which provided:
    a. Significant discount compared to an individual purchase of the coverage.
    b. The group purchase provided coverage for mental and nervous issues to be treated as any other illness when on an individual basis these ailments would have been limited.
    c. The policies are portable, including the discounts, if any, of the shareholders were to leave the employ of the company.

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2. **Operating Agreement was restated** - to reflect the buyout of a deceased and/or disabled shareholder. This included amounts of the buyout and if disabled, when the buyout would take place.
3. **Employment Agreements were created** – to reflect salary, bonuses and how long salary would be paid if a full disability were to take place.
4. **LLC was formed to hold all corporate coverages** - to avoid "Transfer for Value" (the potential income taxation of benefits should a shareholder die) issues since there are three shareholders. The LLC purchased:
    a. Sufficient term insurance coverage, with a disability waiver of premium rider to fund the full buyout of a deceased shareholder.
    b. The maximum amount of disability buyout coverage available. The shareholders also addressed within the restated operating agreement the terms of the unfunded portion of the buyout. Due to the disparity of current ownership, the purchase completely funded the two minority shareholders. The main shareholder could not purchase sufficient coverage to fully fund the disability buyout. The shortfall was addressed within the restated operating agreement.
    c. Business overhead coverage in the amount of each shareholders' earned income. This coverage will pay to the entity an amount equal to the disabled shareholder's salary allowing the entity to continue salary to the disabled shareholder until the disability buyout is triggered (two years after permanent disability). This was agreed to and evidenced within the updated operating agreement.
    d. Key person term life insurance was purchased having a disability waiver of premium rider. Upon the death of a key shareholder, the venture will receive sufficient funding to:
        i. Fund the cost of the replacing the deceased shareholder.
        ii. Provide sufficient liquidity to avoid financing and/or bonding issues.
        iii. Fund the decrease in enterprise value resulting from the death of a shareholder.
5. **Entity conversion to "LLC" from an "S" Corporation** – creating a more appropriate vehicle to provide long-term estate planning and creditor protection benefits to the shareholders of the entity.

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<u>Do you have clients who have not protected their businesses and incomes? Who loses if they go without planning?</u>

- Your client does -
  - They are putting their family at risk!
  - They are putting their partners at risk!
  - They are putting their employees at risk!
  - They are putting their customers at risk!
  - They are putting their vendors at risk!
- You as their professional –
  - You may be missing the fees you could have charged to plan their affairs!
  - You may be missing referrals to other professionals!
  - You may be losing referrals to the client's friends!
  - You may lose a client either because the firm is no longer a viable operation after the disability or death of a shareholder!

You may lose the client after the survivors realized you could have made a difference by being the professional who took a more proactive role with their clients in areas they never thought to.

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