



The ESOP blindside – and how to protect it

Most employee stock ownership plans, or ESOPs, often insure in the event of the death of a key employee-owner, but many fail to consider the greater risk of disability. A look at why companies should make sure they're protected.

By Edward A. Tafaro

Since the 1970s, the employee stock ownership plan (ESOP) has proven to be a valuable vehicle for helping employees own a share of a business. It's similar to profit sharing in that the company establishes a trust fund and either contributes new shares or buys existing shares of its stock. Alternatively, the ESOP can borrow the funds to purchase existing or new shares and then make cash contribu-

tions to the plan to repay the loan.

In essence, ESOP owners create a reservoir of human capital that drives the success of the company. When employees leave the company, they receive their share options, and the company must buy them back.

But what happens to the company if a key employee-owner leaves early due to a disability, creating a critical knowledge

and experience gap that could do harm to the company's success?

True, most ESOPs typically insure in the event of the death of a key shareholder, but during the working years, the risk of disability is a far greater risk than death. Given this fact, why is disability insurance so under-utilized in the ESOP world?

Kelly O. Finnell, J.D., CLU, AIF, founded Executive Financial Services Inc. in 1981. Based in Germantown, Tenn., Finnell's firm specializes in employer-sponsored retirement plans, including 401(k)s, ESOPs and nonqualified plans for executives. Recognized for his retirement planning expertise, Finnell's keenly aware of the void that's created by neglecting to put disabil-

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ity insurance into the ESOP mix.

"For ESOPs to have life insurance is quite commonplace," Finnell says. "But there's a definite need to educate investors on how to protect their company against a possible disability risk. If they knew there were ways to do this, they would want to protect their investment against the possibility of a significant loss."

Disability more likely, yet less insured

Like other complex financial transactions, no two ESOPs are the same; yet, there are common threads that run through most transactions. There's a key shareholder who is seeking to trade equity for cash. Subsequent to that, there are various forms of financing that the ESOP can deploy. Typically, it will utilize a combination of bank financing (senior debt) coupled with a promissory note (subordinated debt) funded through corporate cash flows. Most frequently, these loans have 5-year durations, although it should be remembered that every ESOP is different.

What seems consistent is that once the loan agreement is put into place, a significant sum of key person life insurance is usually purchased to protect the selling shareholder and the lenders against the risk of premature death. However, the greater statistical risk is disability. And that's the "blindside" that exists in most ESOPs, particularly where the business is highly dependent on the vision, relationships and knowledge held by its owners.

For these unique individuals, disability is all but certain to end in disaster for both themselves and their company if the risk is not properly mitigated with disability insurance.

James Steiker, chairman and CEO of SES Advisors Inc. in Philadelphia, is a corporate, pension and tax attorney with more than 20 years experience in ESOP design, installation and transactions for privately held companies. He believes that disability is an under-insured event in ESOPs because most people fail to focus on the fact that it's even available, let alone that it's important.

"It makes sense for an ESOP-owned company to have a combination of life and

disability insurance on key ESOP participants that can address payment of significant account balances upon a participant's death or disability," Steiker explains. "Unlike traditional disability insurance, which focuses on replacing income for a disabled person, corporate-owned disability insurance addresses the corporate finance and repurchase obligation effect of the disability of a key selling shareholder or ESOP participant. Corporate-owned disability insurance spares the company the double whammy of losing the services of a key employee and needing to fund an accelerated payout of their ESOP stock."

Finnell agrees. "Not having disability coverage on key persons in the ESOP could wreak havoc on the financial structure of the company if the buyout funds can't be paid."

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

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