

## Golden opportunity

What happens to a business when one of its key persons becomes ill, disabled or dies? Gerry Warner outlines what business protection really means



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If someone was to ask where the opportunities to generate more protection business and to grow the market currently lie, what would the answer be? Pensions term has come and gone, and all we have to show for it is lots of wasted effort and huge costs that will take many years from which to recover.

The abolition of the age-70 rule will allow whole of life plans with no surrender value to be sold under the Insurance Conduct of Business (ICOB) rules. But there will not be huge amounts of new term business sold beyond age 70 as a result of these changes, and we should not assume that advisers that come under the ICOB regime overnight will wish, or feel able, to become involved in the Inheritance Tax mitigation segment.

Mortgage-wise, a large percentage of borrowers are still running with no cover, and this problem may be exacerbated with lenders prepared to use higher multiples, stretching the purses of their customers and perhaps forcing many to forgo valuable protection. Interest-rate rises have not helped the situation either.

There may be some interesting moves in the mortgage-protection market in the coming months, but more immediately, there is the hugely underdeveloped business-protection segment that is screaming out for attention.

It may be tempting to sweep this area aside without further thought as too complicated, time-consuming and not worth the effort. However, nothing could be further from the truth. The products are essentially the same that we would recommend to individual, private customers, and the medical underwriting is broadly similar. Sums assured are going to be, on average, higher, and they have to be justified financially. Yet the premiums will be higher and the commission compensatory for guiding customers through the process — and that process need not be correspondingly more onerous for customers or advisers, given the levels of support available from switched-on providers. However, customer needs will be considered more in this segment, as well as the opportunities that already exist in abundance.

### Key person cover

In every office, shop or factory in the country, there is a notice proclaiming that the employer has taken out insurance to cover accidents to employees at work. Every car or lorry owned by a business has to have at least the minimum level of insurance required by law. Most prudent business people will have arranged for insurance on the factory or office buildings, even on the desk at which

the owner of the business works.

However, one valuable asset of the business is often left uninsured. Few businesses — often estimated at less than 5% — have any insurance to cover the one eventuality that can literally mean the end of the business and the income it provides — the death or serious illness of a key person. So, what is a key person?

**Few businesses are insured for the one eventuality that can mean the end of the business**

A key person is someone whose death, critical illness or disability would have a serious effect on the future profits of the business. In any business, a number of people could be regarded as 'key', including partners, senior employees or, indeed, the owner in the case of a sole trader. Although the number of key employees will vary from firm to firm, there will usually be at least one.

They will often be an 'ideas person' on whose innovative approach the company depends, or a key salesperson without whose contribution the company's profitability would suffer. The key,



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therefore, is that the absence could result in a drop in profits or, in an extreme case, the winding up of the company.

If the key person is also the business owner, what would happen if they were no longer around? Staff could leave, fearing their jobs are at risk; valued customers could be lost to rivals; suppliers may require payment in advance; and, worst of all, the bank could call in any overdraft.

This could lead to the liquidation of the company or, at best, some real problems for those who are carrying on the business.

### Prevention

All this could be prevented if a suitable life-assurance policy existed to provide cash at a time when it is most needed. A product or products, written on the life of the employee but owned by the company, that can provide income in the case of disability or a lump sum in the case of a critical illness or death. This could enable repayments to the bank, the provision of salaries and payment of suppliers. And this would provide time — time to build up the business

again, or to find a buyer.

A further area of business protection to consider is the position of shareholders. Consider a situation where a business is owned by a number of shareholders and one dies without making suitable arrangements for what happens next.

- Who will own the shares?
- Who will control the company?
- What happens if a sale of the shares is needed?
- Who will be able to buy them?
- Who can afford to buy them?

The problems for shareholders are similar to those of partners should a member of the partnership die or suffer a critical illness, and then wish to retire from the business or be unable to return to work. In the event of death, the shares may be inherited by a spouse whose presence in the business is neither welcomed nor of any real value. The spouse could have trouble selling the shares for a fair price or could even sell them to a competitor.

It would then be far better that plans had been made to ensure that the remaining partners had the right to buy the deceased's shares with funds going to the spouse, therefore

ensuring minimal effect on the business. Careful planning, some legal documentation in the form of cross-option agreements and a number of term assurances written in trust will ensure the objective is met.

When a shareholder dies, their shares will fall into their estate and will pass, in accordance with their will, to their beneficiaries. If there is no will, the shares will pass under the 'rules of intestacy' — sometimes in ways the shareholder did not foresee and (worst of all) wanted to avoid.

Some problems immediately become apparent:

- What will the beneficiaries do with the shares?
- Do they really want them?
- Will they try to sell them?
- Do the surviving shareholders want to have the beneficiaries as co-shareholders?

As mentioned previously, in many cases it is likely that it will be the deceased's widow (or widower) who is the beneficiary. Receiving through the estate a shareholding in the company may not be very helpful to them. It may be the only asset apart from the family home, and the only source of potential income.

- What benefit will the shares be to the widow(er)?

- Do they have any experience of running or taking part in the management of a company?

- Can they draw a salary?

- Will the surviving shareholders want them as a director?

If nothing else, will they be entitled to any dividends? Even if they are, it is not very likely that a satisfactory income can be derived from dividends, as dividends are not often declared in small companies, and even if they are, the income will generally be low. It is therefore likely that the beneficiaries will be far better off with a lump sum in order to provide for a regular income from another, independent, source.

### A small minority of businesses have insurance — so why are we not meeting this need?

Another question is: What are the shares worth? The obvious answer is to sell the shares, but how much will they be worth? The shares will not be quoted on the stock market, and therefore there is no ready market for them. Furthermore, the sale of shares to a potential buyer would require valuation of the shares at the point they are to be sold. If a key shareholder has just died, this could cause a considerable drop in the value of the company, and therefore the value of the shareholding.

Another factor to be considered is that there may be provision in the company's Articles of Association for 'pre-emption rights' to exist. These rights could state that no shareholding could be sold without first being offered to the current shareholders for a price to be determined in accordance with the Articles. The problem here for the beneficiary is that the method of valuation may not be very favourable. Also, the shareholders do not have to take up the rights.

So, at the end of it all, the shares may still be in the hands of the beneficiary, with little prospect of being sold for a reasonable price.

The problem should also be looked at from the other shareholders' point of view. The surviving shareholders may resent not having a choice of whether to work with some remote individual, particularly if that person is incompetent or uninterested, or

simply totally unsuited. They may have the power under the company's Articles to refuse to permit the new shareholder to join the company, but exercising this power could, at worst, lead to long legal disputes and, at the very least, end up with a dissenting shareholder with a considerable grievance.

## Solution

Obviously, the best solution would be for the existing shareholders to buy the shares from the personal representatives of the deceased. Equally, from the deceased's beneficiary's point of view, it may be better to sell the shares to people willing and able to buy them.

For the beneficiary, the lack of a ready and willing buyer of the shares can bring its own problems. If the company is affected too, those problems can only get worse as the value of the company declines.

The result is that the position may continue to be unsatisfactory for some time. The shareholders need to come to an agreement at an early stage as to how the shares will be dealt with so that there is a ready and willing buyer of the shares of a deceased shareholder. Secondly, cash will be needed. We will take the latter point first.

It is unlikely that the surviving shareholders will have sufficient funds to buy the shares. It is possible that they could borrow the money (and even obtain some tax relief on the interest), but this could be very expensive. The bank will want the capital to be repaid and will also require security, perhaps in the form of a charge on the borrower's house, perhaps in the form of a life policy, and very likely both. In any event, the surviving shareholders may be unwilling to borrow money to purchase part of what they already regard as their own.

Forward planning may make it possible to avoid completely the need to borrow money and all the problems this involves. A life assurance policy on the life of each of the shareholders is a means by which funds can be provided at the time they are most needed — on the death of the shareholder.

Businesses borrow funds for a number of reasons, but lenders will usually insist on appropriate term cover on the life of the proprietor. This is pretty straightforward, but we are often talking about large sums assured having to be arranged in very short timescales. The cover is

secondary to the central issue here, and yet without it, the funds may not be released.

The solution is simple term assurance, perhaps with critical illness included, and usually short-term cover — but speed is of the essence.

That is the briefest of summaries of the main elements of the business protection market, though each is equally worthy of an article in its own right. Seems pretty straightforward, and yet many advisers seem to be less keen, or less well-equipped, to address the needs of this community where some one million new businesses are formed every year. A small minority of businesses have some form of insurance protection — 5%, 10%, maybe even 20%, depending on which research you heed. Whatever, the gap is massive, so why are we not meeting this need? Well, some will view it as complex. We are talking large sums assured, often older and sometimes unhealthy clients with more complex underwriting issues.

Dare we trust a close and valued client relationship to an insurer that may not be as competent around financial underwriting, or inclusive in medical underwriting terms? Why risk that? Then there are complications when shareholder plans have to be written in trust, and cross-option agreements are produced. Speed is of the essence, and yet the new business process can irritate beyond belief.

## Good news

The good news is that there are a number of insurers out there who understand the issues. Feedback shows that advisers want support with technical and legal documentation. They want access to the most competent of underwriters who specialise in large-case handling and who will talk them through the process before and after the client meeting. They want support through quality literature and case studies. They want sales support that is always there, keeping them abreast of market developments.

We talk a lot in this industry about the protection gap, and while it correctly focuses on the basics, on mortgage and family protection, it extends way beyond that. The very real business-customer needs are evident, and we can all help to fill that gap. **C**

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