BY MAUREEN GLENN

Living dangerously? Then insure

Executives who indulge in high-risk sports need appropriate insurance


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Much has been written about the recent tragic death of Micron Technology Inc. executive Steve Appleton. Flying experimental airplanes or circumnavigating the universe may be pursuits within reach of Richard Branson and Appleton, but not your average client.

Yet heli-skiing in British Columbia and bungee-jumping in Zambia (where an Australian woman barely escaped death in January) are possible activities for many executive clients. Just like champion athletes, highly successful businesspeople tend to be results-oriented, disciplined, and goal-setting high achievers. They may be attracted by the adventure and precision required to excel at high-risk sports, or participate simply because they can afford it. But this can present an additional risk for the corporation they own or control.

A sudden or premature death can have a significant financial impact, not only on the person's family, but also on the business. The purchase of business-funded life insurance can help manage the risk of financial loss to the business in the event of an owner-manager or key executive's death.

Often referred to as key-person insurance, the value of the insurance to the business will usually far exceed the cost of the life-insurance premiums. The corporation is the owner and beneficiary of the life-insurance policy. And while the premiums are not typically deductible by the corporation, there are cost savings and other opportunities available by funding the policy from corporate coffers.

A business case

Personnel who hold key positions in a firm are easy to identify: controlling shareholder, president and CEO, or a key employee in the IT or finance department. Their knowledge, experience, reputation, business connections and skills make them invaluable to the firm. This holds true for small-business owners as well as TSX60 CEOs.

Even with comprehensive continuity plans in place, losing a key executive would put the firm at risk of a severe financial impact. Additional capital received from an insurance policy can be used to bridge this period of weakness — providing cash flow to hire a top-notch replacement, working capital to avoid disruption of operations, and capital protection for heirs of the business owner, including buyout agreements. In addition, key-person insurance can be used for buy/sell arrangements for partnerships, as well as to fund shareholder agreements.

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Large corporations are often in a much better position to deal with turnover of key executives due to the existence of formal business succession plans. However, even the largest firm will struggle through a period of uncertainty after the loss of a key individual. The unexpected loss of an integral member of the executive team will create shock waves throughout the organization, possibly jeopardizing imminent business deals, timing of key projects and productivity across the board.

Take the case of Michael Chowdry and Atlas Air Inc. As founder of Atlas Air, Chowdry was considered a visionary and driving force for the young and vibrant company. He was piloting his private fighter jet when he died in a sudden crash in January 2001.

Despite analyst beliefs that the company had a solid financial footing, many downgraded their estimates for the company's stock, which saw an immediate 13% fall the day after the announcement. The company was quick to announce a successor.

Key individuals have a profound impact on the morale of the entire organization and a sudden death can result in a prolonged period of reduced productivity.

Beyond the time and cost involved in finding a skilled successor, some excess cash may be helpful in withstanding operational disruption. Lenders may curtail credit and debtors may see this as an opportunity to delay making payments to the corporation.

Customers may begin losing confidence in the brand, and competitors will use this time of weakness to aggressively attack market share. Other employees may also lose confidence and explore other options or be poached by the competition. Excess capital can be used to boost public relations and team-building activities to counteract these attacks.

Entrepreneurs often rely on the future sale of shares to fund their future, given that the business itself makes up a vast majority of their wealth. In the early years, profits are reinvested in the business.

This restricts the amount of funds available outside of the corporation for the future security of heirs. Life-insurance proceeds received by the corporation as a consequence of death are paid tax-free to the business. In the situation of corporate-owned insurance for shareholders, the funds can flow through the Capital Dividend Account (CDA).

When a private corporation receives life-insurance proceeds, the excess of the death benefit over the adjusted cost base of the policy is added to the CDA. Under the Income Tax Act, the corporation can elect to pay a tax-free dividend to the shareholders of the corporation equal to the balance in the CDA. The dividend must be directed to the appropriate shareholder or estate to meet the original needs envisioned in the arrangement. This highlights the need for a solid shareholder agreement.

Shareholder buyout

Shareholders generally want to ensure if one of them dies, the surviving shareholders will be able to purchase the deceased's shares from his or her estate. The use of corporate-owned life insurance can provide enough liquidity to enable the company to acquire the deceased's shares.

There are two common types of buy-sell agreements:

- **Share purchase arrangement:** the surviving shareholders use the insurance benefits to purchase the shares from the deceased's estate.
- **Share redemption arrangement:** the company redeems the deceased's shares. As a general rule, the after-tax cost of premiums is less where the company owns the policy due to lower corporate tax rates.

When relying on life insurance to provide funds for a buyout of shares, shareholders have to remember that life insurance coverage has to be reviewed regularly to ensure sufficient funds whenever needed. Provisions should also be included in the shareholders' agreement to address the situation where the insurance is insufficient at the time of buyout.

Insuring risk

The need for key-person insurance is clear, but in light of the risky activities discussed earlier, how easy is it to put in place? Life-insurance companies endeavour to reduce their risk when taking on an insurance policy through a variety of means:

- pricing
- duration of products
- guarantees
- non-medical questionnaires
- medical testing and reports

As part of the non-medical underwriting procedure, the insured is asked to disclose any risky hobbies or sports. A lifestyle questionnaire specific to the activity is an additional requirement for the underwriter's review (see "Key-person insurance questionnaire," this page).

It is important for the insured to share all details of their sports activities with the insurer. Any omission could result in the cancellation of the policy or a denied claim on the grounds of material misrepresentation. The more details provided to support the insured's advanced skill level or professional training, the better the opportunity to show the underwriter that the activity is a controlled risk and extra premiums may be minimized.

If the insurance company deems the activity a significant risk, they have several options:

- decline coverage
- apply an additional premium to the policy, or
- exclude the activity for life-insurance claim purposes.

For the corporate owner of the policy, this is a double-edged sword. Just when they have identified a risk that needs to be managed (the key person's life), they find themselves limited in the insurance options available. Shopping around with various insurance companies to find coverage options is worth the effort, and the best life-insurance premium in these situations.

It's also good practice to stay in contact with the life insurance company over time, since involvement in high-risk sports may reduce as years advance and the corporation may ask to have the extra premium reviewed in later years. Remember that the insurance underwriter does not look at the sporting activity in isolation, but instead as a part of the insured's entire risk profile.

While business owners may not be able to resist the adrenaline rush of high-risk sports, they should regularly consider their insurance needs for corporate planning purposes to ensure the best risk-management strategies are in place. AER

KEY-PERSON INSURANCE QUESTIONNAIRE

LET'S TAKE CLIMBING AS AN EXAMPLE OF A HIGH-RISK HOBBY. THE QUESTIONNAIRE WILL REQUIRE ANSWERS TO MANY OF THE FOLLOWING QUESTIONS:

- What types of climbing do you plan to do?
- How many years have you been climbing?
- Number of climbs per year?
- In which locations do you climb?
- Height and duration of average climb?
- What courses have you taken for this type of climbing?
- What is your technical level of expertise?
- Do you ever climb alone?

WHY GET KEY-PERSON INSURANCE?

- Cash flow to hire the best replacement
- Income to withstand delays, disruption and reduced efficiency for a period of time
- Working capital to overcome credit issues
- Resources to prevent customers from losing confidence in the company
- Capital protection for the heirs of the shareholder or business owner

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