

Commercial Insurance Update

Topics Affecting Buyers of Commercial Insurance

MSP C 04/2008 – “Business Continuation Planning”

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Business Continuation Planning

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You’ve established a successful business and continue to put every effort into running it. But are you taking the steps necessary to make sure your business can survive the retirement, disability, or death of an owner or key employee?

When these events occur, your business may be irreversibly impaired or forced to shut the doors rather quickly, not because you did something wrong, but because you did nothing. Few owners have planned for the eventual transfer of their business interests or even know what their business is worth. This is not surprising considering their main focus is on driving profitability and maintaining a successful business.

Business continuation planning is imperative to ensure the successful transfer of your company or business interests. This newsletter will discuss stabilizing and maximizing the value of a business and transferring it to the parties desired under controlled, defined circumstances. It is designed to help you retain control of your company and assure you that funds will be available

to afford maximum financial flexibility in the event of retirement, disability, or death of a key person.

The owners of today’s small to mid-sized businesses face many challenges when it comes to how they will distribute or dispose of their business interest at retirement, disability, or death. Typically three things can happen to a business during these events: the business is continued by another person, sold, or liquidated.

Continuation of the Business by a Family Member

If the business owner wants to keep the business in the family, it is important to ask:

- How will the surviving spouse’s income needs be met?

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- How will the business owner equitably distribute assets among those heirs active in the business and those who are not?
- Are those members sufficiently prepared to run the business?

Sale of the Business

The sale of the business to business partners or family members poses several questions.

1. Who will purchase it? The surviving partner may find that he or she is forced into a business relationship with an inexperienced stranger who knows nothing about the operations of the business.
2. What will be the selling price? If the business owner doesn't determine the fair market value of a business, the IRS will.
3. Where will the funds come from? Funds can come from one of four sources: installment payments through the business's annual leftover profits, money set aside in a sinking/investment fund, borrowing money, or life insurance.

Liquidation of the Business

An unpremeditated sale poses a serious threat to the future viability of a business and can drastically reduce its value:

- Family control of the business will most likely vanish.
- Intangibles, such as reputation, customer base, and location could dissipate.
- Outstanding accounts receivable will be difficult to collect.
- The fair market value of inventory and equipment may not be obtained in the sale.

Other Potential Problems

The lack of a business continuation plan commonly produces the following problems:

- Vehement hostility between the decedent's family and the remaining owners
- Vexation on all sides and possible litigation
- Prolonged delays in continuing business growth and settling the estate
- Loss of staff and customers

Solution: A Written Agreement

An obvious solution to the problems created by a key person's death is to draft a comprehensive buy/sell agreement between the business and its owners prior to the occurrence of any triggering events. A business

continuation plan is a critical step toward the long-term survival of your business.

Taking the time now to see that the business will pass in an orderly manner at time of death will benefit all parties and their heirs. An agreement that is favorable to all parties involved will be considerably more difficult to create after a crisis occurs. A properly structured plan funded with life insurance can help you:

- Afford liquidity to your estate to keep business management within the control of remaining owners or to buy out a deceased owner's interest at a mutually agreeable sales price and by mutually agreeable terms of sale
- Help ensure that the family will not sustain substantial financial loss
- Provide ways to avoid liquidation and maintain stability for staff, customers, creditors and investors

What If A Partner Becomes Disabled?

According to the Social Security Administration, Fact Sheet 2007, a person has a three in 10 chance of becoming disabled before reaching retirement age. Moreover, the Commissioners Disability Table, 1998, shows that one in seven individuals who become disabled can expect to be disabled for five years or more before retirement.

When a co-owner or partner suffers a long-term disability the consequences of these statistics can have a severe and grave impact in the small to mid-sized business settings. If the partner has been an active player in the firm, his or her extended or permanent absence can have a considerable, adverse impact on ongoing business operations.

Potential Consequences

A partner who was once active but suffers an extended or permanent period of disability will no longer be able

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to contribute as a productive member of the management team, yet still might be entitled to receive his or her salary and share in the business's profits. The disabled individual may find it necessary to liquidate his or her share in the business as quickly as possible if they are in need of cash to help with treatments, etc. The resulting uncertainty and perturbation can spread like wild fire among employees and customers, and delineates the importance of having a disability buyout provision in the business's continuation agreement.

This critical element of the business continuation plan for a business should cover:

- What formally determines a disability and how long will a firm proceed with business as usual when an active, disabled partner is unable to fulfill his or her duty?
- At what point will the disabled partner be required to sell his or her business interest and how will the purchase price be determined?
- How will the buyout of the disabled owner be financed by the remaining non-disabled partners?

Self financing a buyout may be an unrealistic option when you take into consideration most businesses reinvest their profits back into the business and profits may be lower at this time due to the lack of participation of the disabled partner.

Because the continuation problems created by the death of an owner or partner are similar to those created by disability, it is natural to incorporate a provision in the life insurance buy/sell agreement to consider the contingency of an owner or partner's disability. The disability provision (funded by insurance) would trigger payment of benefits to the remaining partners or to the business itself, as spelled out in the agreement. These benefits can then be used to fund the purchase of the business interest held by the disabled partner.

Understanding how a business would be impacted, both immediately and in the long-term, should a partner become disabled is a necessary undertaking. Taking the next step and preparing for that possibility can be critical to the survival of a business.

Buy/Sell Agreements

Many small, closely held businesses do not continue after the first generation, often due to a lack of succession

planning. A buy/sell agreement can be an excellent way to provide for the future of the business. Any closely held business faces the possibility of an owner dying, retiring, or becoming disabled. A business owner's death or disability can create major problems, jeopardizing a lifetime of hard work and investment, leaving beneficiaries in a difficult position of sorting things out. The remaining business owners are faced with difficult questions:

- How will the business continue?
- Who will control the business?
- Can and will family members of the deceased or disabled owner get involved?
- How will the continuing owners finance the buyout of the owner who is no longer there?

A properly structured and funded buy/sell agreement can ensure an orderly transfer of the business when an owner retires, divorces, becomes disabled or dies.

What Is a Buy/Sell Agreement?

A buy/sell agreement is the arrangement for the sale of a business interest upon a triggering event such as the owner's death, disability, or retirement. A well drafted and properly funded buy/sell agreement can protect the interest of the business owners and help facilitate the continuation of the business.

How Does a Buy/Sell Agreement Work?

Businesses should transfer by plan, not chance, and that's the purpose of a buy/sell agreement. Essentially, it's a contract that spells out what will happen to a surviving owner's business interest in the event of the retirement, death or

disability of another owner, or another triggering event.

Buy/sell agreements can take different forms. These include entity purchases, stock redemption, or cross-purchase. The type of agreement used depends on several factors, including the structure of the business and number of owners. An entity purchase agreement allows a company to buy out its deceased owners, while a cross-purchase agreement allows owners to buy out one another.

When a buy/sell arrangement is funded with life insurance, the policy owner (and usually the co-owners of the business – or the business itself) uses the policy



2008 FOCUS Seminars

Cavignac & Associates' FOCUS Room
Bank of America Plaza
450 B Street, 18th Floor, San Diego, CA

- Fleet Safety Management and Defensive Driver Training
Friday, May 23, 2008 — 9:00 AM - 12:00 PM
- Sexual Harassment Prevention Training
Satisfies requirements for AB1825 Training
Friday, June 20, 2008 — 9:00 AM - 11:00 AM

All training sessions available to our clients
Reserve early — seating is limited!

For more information about upcoming seminars:

- Visit our Web site at <http://www.cavignac.com/home.html>
- Contact Darcee Nichols at dnichols@cavignac.com or 619-744-0596

NOTE: Due to the high demand for our seminars and the limited space available, we regret that we are unable to provide refunds or credits with less than 72 hours advance notice of cancellation.

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proceeds to buy out the business interest of another owner who retires, becomes disabled, or dies. If an owner wants to retire, the cash value of the life insurance policy can provide a down payment and help fund the buy out of his or her share of the business.

A well constructed buy/sell agreement anticipates how the value of the business may change over time, and provide for appropriate adjustments in the amount of the buy out price. The amount of life insurance can be designed to vary with the buy out price, so you are always properly covered. A buy/sell agreement is used to create liquidity, set a fair selling price, fix the value of the business, and maintain harmony.

Upon a business owner's disability, retirement, or death, his or her family continues to need cash and pay ordinary living expenses as well as any potential estate tax liability. Estate taxes are usually due nine months after the date of death. Selling a business under these circumstances can result in the family receiving less than their fair market value, which is why liquidity is so important.

Setting a fair selling price while all owners are still active in the business is extremely important. Once a business owner has left the business, negotiating a fair sales price becomes more difficult for the remaining owners (or the deceased owner's estate) because the remaining owners hold most of the cards.

Fixing the value allows the owners to command their estates and reduce the risk of costly valuation

disputes among business owners upon the state tax audit. A buy/sell agreement ordinarily sets the valuation for estate tax purposes.

Due to the pressures of business ownership and everyday life, it is difficult for owners of a closely held business to maintain friendships and camaraderie. Maintaining harmony becomes more difficult after the family of a deceased owner enters the business. A buy/sell agreement can protect the remaining owners from problems that can arise if a deceased owner's family joins the business.

Funding a Buy/Sell Agreement

Buy/sell agreements need a funding mechanism to make sure the money is available to carry out the agreement if a triggering event occurs, without causing financial hardships to the parties involved. Without the proper funding, even the most carefully drafted buy/sell agreement may prove useless if there are no funds available to purchase the deceased owners interest. Life insurance is potentially the least costly method of funding a buy/sell agreement. It is also the only method that makes the necessary dollars available at the exact time the funds are most needed (at the death of an owner). The advantages of funding a buy/sell agreement with life insurance include:

- Cash is immediately available to the entity or its surviving owners to purchase the deceased owners interest. This also provides the deceased owner's family with cash to live on, generate income, or pay estate settlement costs
- Insurance proceeds are typically received income tax free (although beneficiaries maybe subject to state income taxes and Federal Alternative Minimum Tax)
- Eliminates financial strain on the buyer at the time of purchase
- Cash value accumulations can be used as a substantial down payment in the event of other triggering events, such as disability or retirement
- Choice of a wide variety of life insurance products to meet the funding needs.

Several funding methods besides life insurance are available, but all have disadvantages:

1. Using funds from current working capital to fund an installment buyout may limit the company's ability to function, and can be costly because monies paid from the business interest are non-deductible, after-tax dollars.

In addition, these payments would stop if the business were to fail.

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1. Borrowing funds from a third party would result in the total amount paid for the business being much greater than the purchase price, with the final cost depending on the interest rate and



length of the loan. In addition, a lender may not be willing to lend funds to the business at the very time those funds are needed (when an owner dies).

2. A sinking fund can be a viable solution when a business owner is uninsurable. The problem with this approach is that it may take many years to build the necessary funds, but the death of an owner or other triggering events can occur at any time. Also a sinking fund is expensive because deposits are made with personal or business after tax dollars. Earnings on the funds may also be reduced by income tax.

A well drafted and adequately funded buy/sell agreement is an important piece of a business owner's succession and estate plan. Without a well drafted buy/sell agreement, a business owner (or his or her family) can lose much or all of the equity that the owner worked a lifetime to create. Not only is a buy/sell agreement beneficial to the family of a deceased shareholder, but a buy/sell agreement also protects the interests of surviving shareholders by providing them with the opportunity to control ownership after the death of an existing shareholder.

An important aspect of buy/sell planning, which is sometimes overlooked, is funding. Without adequate funding, implementation of a buy/sell may not be possible. Because life insurance provides advantages not available with other methods of funding, it is a common method of funding a buy/sell agreement.

Key Person Life Insurance

Another important use of life insurance is to protect a business against interruptions caused by the loss of one of its key employees or executives.

A key person is any person in an organization whose contributions to the operations and success of the business is essential. This may be the company owner, a talented salesperson, or perhaps an individual with a specialized skill that cannot be easily replaced. If the key employee is an owner, the life insurance coverage can also help protect his or her family financial position. There are three main reasons why key person

life insurance is purchased. Life insurance death benefits can:

- Provide the funds to pay off business debt
- Replace profits that will be lost as a result of the key employee's death
- Provide the funds needed to recruit, hire, and train a suitable replacement

Key person life insurance is relatively simple to implement. The business purchases a life insurance policy on the life of the key employee and is the policy owner, the premium payer and the beneficiary. The business pays the entire premium and receives the entire death benefit. If the key employee dies, the policy's death benefit is paid to the business, which may use it to replace the key employee or in other ways to promote the business and preserve its financial health. The key employee does not have any interest in the policy, nor does his or her family receive any benefits from it when death occurs.

The business pays the premium and is not entitled to an income tax deduction for the premium expense. At the key employee's death, the business receives the death benefit proceeds income tax free. Proceeds from an insurance policy are generally income tax free (e.g., absent a transfer for value), and if properly structured, may also be free from the estate tax.



However, if the business is a C corporation, increases in the policy's cash value are included in the corporation Alternative Minimum Tax (AMT) calculation. At a key employee's death, the death benefit is also included in the company's AMT calculation. Consequently, there's a risk that the life insurance policy could contribute to AMT problems of C corporations.

Advantages of Key Person Life Insurance

Key person life insurance provides income tax free death benefits to replace profits or capital lost due to a key employee's death. Proceeds from an insurance policy are generally income tax free and if properly structured may also be free from estate taxes.

Other advantages include:

- Provides income tax free death benefits to recruit, hire, and train a successor key employee

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- Assures customers, creditors, and other employees of the stability of the company and that it will be in a financial position to keep its promises
- Provides an infusion of cash that may keep the banks and other lenders from foreclosing on business loans, reducing lines of credit, or raising interest rates on outstanding loan balances
- Can fund an entity purchase buy/sell agreement so the estate of an owner or key employee can convert stock into cash.
- Can be used to fund selective benefit programs for owners and non-owner key employees
- Policy cash values are an asset of the business's balance sheet

Disadvantages of Key Person Life Insurance

Premiums are not income tax deductible

- The coverage does not prevent key employees from leaving the business while alive
- Death benefits may be subject to an Alternative Minimum Tax if the business is a C corporation
- The value of a key employee may be difficult to determine

A business can also protect itself from a key employee's voluntary departure by adopting a plan that gives the key employee strong incentive to stay. A selective benefits plan customized to the key employee's wants and needs can prevent a voluntary departure. In fact, a well designed selective benefits plan does three things:

- Formally recognizes the key employee's worth and contribution to the business
- Gives the key employee incentives to continue high level performance
- Is designed to recover the expenses incurred to provide the benefits

With good planning, the same life insurance policy can fund both the selective benefits that encourages a the key employee from walking away voluntarily, and the death benefit needed to replace the lost profit and increased expenses that occur if a key employee dies. One life insurance policy may be able to do double duty. A non-qualified deferred compensation plan, split dollar life insurance plan, split dollar loan arrangement or a death benefit only plan can each be funded by a key person life insurance policy.

Don't let the unexpected devastate your business. Key person insurance can protect your company's solvency in the event of losing an essential employee or founder. It pays the companies benefits that can be



used to keep the company running. This assures creditors that they will be paid on time, and also lets customers know that your business will continue to operate as usual. It can also be used to cover expenses elated to finding and training a replacement.

Managing Your Risk

Every business owner wants to increase the likelihood of success and protect themselves and their business from economic loss. In order to protect yourself, your family, and your business, it makes sense to manage the risk of loss at the time of death of a key person or transfer of a business.

Planning today will help you not only retain control of your business, but also make sure funds are available in the event of the retirement, disability, or death of an owner or key employee. Business continuation planning is the keystone to the successful transfer of your business interests. ✨



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Disclaimer: This article is written from an insurance perspective and is meant to be used for informational purposes only. It is not the intent of this article to provide legal advice, or advice for any specific fact, situation or circumstance. Contact legal counsel for specific advice.



Community Bulletin Board

"Neighbors helping neighbors in San Diego"



Happy Trails 'N' Waggin' Tails

14th Annual

Walk for Animals

When Saturday, May 3, 2008
7:30 a.m. to Noon

Where Crown Point Shores

Join thousands of animal lovers for fun in the sun on Saturday, May 3rd from 7:30 a.m. to noon at Crown Point Shores for the San Diego Humane Society and SPCA's 14th Annual Walk for the Animals.

The pledge walk will feature a pancake breakfast and a vendor village, complete with a number of animal-related information booths. More than 3,000 local animal lovers and their pets are expected to join together for this fun-filled, dog-themed event to help raise money for animals in need!

Register to walk or pledge your support online at www.sdhumane.org/walk. To receive a pledge form by mail or for more information, call (619) 243-3408. ✨



Monarch Class of 2008

Commencement Ceremony

Mark June 20th at 2:00 p.m. on your calendar and join us for Monarch School's 2008 Commencement ceremony. Two of our graduating students have been at Monarch for three years. Congratulations to the Monarch Class of 2008!

Volunteer Opportunities!



Monarch has a variety of volunteer opportunities for interested community supporters. If you or someone you know is interested in volunteering, please check out the current opportunities below and contact Monarch's volunteer coordinator, Kristin Shea, at (619) 685-8242, Extension 235:

- **Tutors** – Language arts, high-level math, elementary math
- **Butterfly Enterprises Business Club** – Mondays 3-5 p.m. and possibly some evenings or weekends
- **Clerical Assistance** – Help Development Team prepare PR packets
- **Drivers/Chaperones** for field trips and appointments
- **After School 'Buddy'** – Afternoons 3:00-5:30 p.m. to help chaperone students
- **Special Events** – prepare food for school parties, decorate for graduations, translate at parent meetings, holiday celebrations
- **Group Dinners** – Mondays or Fridays at 5:15 p.m.
- **Breakfast** – 7:30-8:10 a.m.

We welcome you to visit Monarch to 'meet the kids,' visit our classrooms, and tour the facility.

For more information, please contact **Kristin Shea**, Volunteer Coordinator for the Monarch School Project, at (619) 685-8242 Extension 235 or e-mail her at kshea@monarchschoools.org.

You can also visit www.monarchschoools.org to learn more about this unique school. ✨



Community Bulletin Board

"Neighbors helping neighbors in San Diego"

The 11th Annual Heroes Luncheon

Faces of the Future

'08



Senior
Community
Centers

Please join Senior Community Centers as we honor members of our community who are committed to passionately helping San Diego's low-income seniors survive and thrive.

When

- May 9, 2008, 11:30 a.m. to 1:30 p.m.

Where

- Manchester Grand Hyatt

Hero Award Recipients

- Qualcomm, Serving Seniors Group
- Albertsons, Store #6745 Employees
- Erica Schild, Teen-Senior Connect
- Sam Ellis, City Heights Square Resident



Tickets

- Individual \$150
- VIP \$250
- Corporate Table \$1,500
(Corporate Table sponsorship includes 10 seats and event recognition opportunities)

For More Information about sponsorship opportunities or luncheon tickets, contact

Sheona Richardson at 619-235-6572, Extension 305, or e-mail sheona.richardson@serving seniors.org. ✨