Two Vignettes on the Importance of the Business Use of Life Insurance

By

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In December 1980, a fire broke out in the Stouffer's Inn in Westchester County, New York, killing twenty-six people. Among the fatalities were thirteen high-ranking executives of Arrow Electronics, Inc., then the nation's second largest electronics distributor.

The Value of Key Employees

Employee stock options, deferred compensation payments, survivor death benefits, additional accounting costs, hiring replacements and personnel relocation charges resulting from the tragedy cost Arrow more than $5.5 million pretax, or approximately $3 million in net after-tax expenses. As a result, Arrow's earnings fell from $5.5 million in 1979 to $5.27 million in 1980, despite a substantial one-third increase in revenues over the same period ($264 million to $352 million).

Said one New York analyst: "Arrow Electronics was a decent company that was going well. It had a good management team that was bringing it along, but two or three of the top people were killed in that fire. They have a new president now, but it will take time for them to put things back together."

Key Employee Life Insurance

The loss of human life to loved ones, friends and business associates can never be replaced. But the death of a key employee and the financial losses that such a death brings to a corporation can be defrayed and indemnified. While most corporations insure their tangible assets like inventory, equipment and real property, they often fail to insure their most valuable asset: the lives of their key employees who create corporate profits.

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Life insurance is the only financial instrument that can enable a business to survive the financial impact of the sudden unexpected death of key employees. Insuring key employees is especially important for smaller, closely-held corporations where the death of one key employee, often the business owner on whom all depends, could result in bankruptcy.

Financial institutions and their insurance agents can protect their business clients from such a disaster by insuring the increasing value of their key employees. Key employee life insurance may be the easiest sale you ever make.

Protecting Partnerships with Life Insurance

What follows could be the story of a typical business client any banker services. This is a story no banker can afford to watch unfold and no bank customer can afford to experience. Yet, it is a tale that too often occurs. In it everyone loses.

Mr. Able and Mr. Baker had been partners for ten years. Business was good. Profits were up. Family incomes were secure. Then, Mr. Baker died.

Suddenly, Mr Able was *unable* to continue his business because, as his attorney explained, in the absence of an express agreement to the contrary, the partnership was legally dissolved. Mr. Able was *unable* to borrow money for the business unless he did so at his own risk, and he was *unable* to offer credit to his customers without personally assuming liability for the debt. The fact was his partner's death had transformed Mr. Able into Mr. Un-Able.

How Mr. Able Became Un-able

As the surviving partner, Mr. Un-Able found that he was legally required to serve as "liquidating trustee" of the partnership and wind up its affairs without delay. As liquidating trustee, he had no legal right to initiate any new business transactions. If he did initiate new business, Mr. Un-Able would become personally responsible for any business losses and would be compelled to share any profits with Mr. Baker's estate.

A written, partnership buy-sell agreement with purchase-financing provided by life insurance can establish a method in advance of death to determine the price of a business partnership.

Mr. Un-Able's alternatives to liquidating the business weren't promising either. He could form a new partnership with Mr. Baker's heirs, but some heirs were unwilling, or, as minor children, unable to do so. Mrs. Baker was not conversant in the business and felt her interests were best served in getting financial value out of her deceased husband's partnership in order to replace the income she lost when he died.

Mr. Un-Able tried quickly to locate a new partner to buy Mr. Baker's interest from his heirs. But, as Mr. Un-Able discovered, this was not easy to do. He had trouble finding a person with money who could be helpful to the business. One potential buyer couldn't reach an understanding with Mrs. Baker over a fair purchase price for her husband's share of the partnership. Another was unsuitable for the business. Ultimately, Mr. Un-Able realized there was little time to find a new partner.

Mr. Un-Able's best option was to buy Mr. Baker's interest in the partnership himself. However, Mr. Un-Able could not negotiate a price for the business that Mrs. Baker considered fair. Furthermore, Mr. Un-Able could not raise the cash necessary to finance the purchase. Mr. Baker's estate would not agree to the sale and had the right to demand liquidation. The former Mr. Able, now *unable* to do anything but liquidate the business he had nurtured for a decade, learned the hard lesson that many before him had learned: Death is the Great Enemy of partnerships.

The Remedy: The Business Use of Life Insurance

Mr. Un-Able could have defeated the Great Enemy and preserved his business if he and Mr. Baker had been properly advised when they formed their partnership. With proper planning, Mr. Un-Able would have been *able* to do all he had planned and *able* to maintain the business he had built. A Mr. Able could have paid Mr. Baker's heirs in full and owned 100 percent of the business.

If Mr. Able and Mr. Baker had set up a written, partnership buy-sell agreement with purchase-financing provided by life insurance, they could have established a method in advance of death to determine the price of their business at any time. They could have legally required the deceased partner's estate to sell to the surviving partner, and they could have required the surviving partner to buy the business from the deceased's estate.

With life insurance financing the partnership buy-out, all parties, including the surviving partner, would have benefited. Mrs. Baker and her children would have been paid in full, and Mr. Able would have owned 100 percent of the business.

Bankers and bank insurance agents can't afford to watch their customers' businesses fall apart when a financial plan utilizing life insurance could easily have protected them. Bank insurance agents should make sure their partnership clients know how they can fund buy-sell agreements with life insurance. Show your corporate and partnership clients how you can enable them to continue their businesses with an appropriate life insurance policy. In the event of the death of a partner or key employee, the life insurance policy you sell them will protect their families and their business. This is good for your clients and good for your bank.

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