HIDDEN EXECUTIVE DISABILITY RISK

Why Various Forms of Executive Compensation Create Risk

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Reviewing Your Executive Client More Closely

Would it surprise you to know that your executive clients' disability insurance may only cover a fraction of their total compensation? Probably not. But what if I told you that it likely covers far less than you suspect?

Executive compensation design has become increasingly more complex with the continued pressure on strategic pay alignment, regulatory issues, disclosure, transparency, and for some, shareholder approval and interests. With these complexities brings new challenges to insure executives against illnesses or injuries that can abruptly end financially lucrative careers.

Executive compensation is commonly composed of financial compensations and non-financial awards: typically a mixture of salary, bonus, shares of or call options on the company stock, benefits and perquisites. The financial incentives are usually broken into two main categories, short and long-term pay.

This article will discuss basic areas to review in your executive disability protection, focusing on the main forms of insurable compensation within a client's short and long-term pay. Possible insurance solutions and the associated premiums that the private insurance marketplace provides today are included.

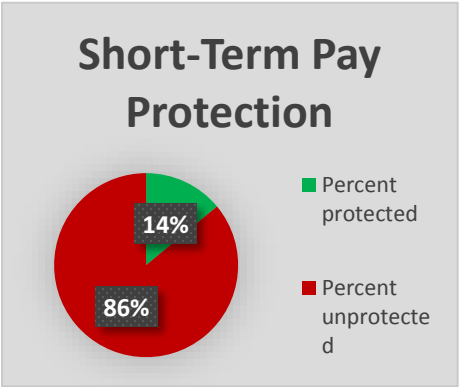
The analysis is not designed to be replicated for your client. This case study is unique to an individual's personal lifestyle, financial responsibilities, risk tolerance, and overall financial plan. Each client requires personal consultations and customized coverage that suits their needs.

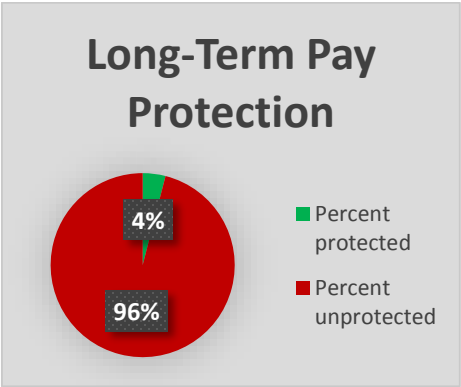
Case Study

The following case study provides a hypothetical male and female executive with identical information to help illustrate the premium differences by gender. Possible solutions to accomplish ideal compensation protection are listed throughout the article.

Tip: If working with multiple executives from the same employer, females can take advantage of substantial premium savings by accessing multi-life discounts. These are offered by many insurance companies when two or three policies are purchased within a specified period of time. Employer sponsorship can also create medical underwriting advantages and premium discounts.

Male CEO Publicly-Traded Corp. (Age 45)	**Female** CEO Publicly-Traded Corp. (Age 45)
Short-Term Compensation	**Short-Term Compensation**
Base Salary: $900,000	Base Salary: $900,000
Incentive Bonus: $450,000	Incentive Bonus: $900,000
Total Cash Awards: $1,300,000	Total Cash Awards: $1,300,000
Long-Term Compensation	**Long-Term Compensation**
Stock Awards – 3-year vesting schedule	Stock Awards – 3-year vesting schedule
$100/Share 30,000 Shares	$100/Share 30,000 Shares
Total Awards Projected Value: $3,000,000	Total Awards Projected Value: $3,000,000
Existing Employer Disability Insurance	**Existing Employer Disability Insurance**
60% - $15,000/mo. (180-day EP – 2 Yr. Own Occ)	60% - $15,000/mo. (180-day EP – 2 Yr. Own Occ)
Annual Benefit Assumption: $180,000	Annual Benefit Assumption: $180,000
Cash Compensation Protection: 14%	**Cash Compensation Protection: 14%**
Total Compensation Protection: 4%	**Total Compensation Protection: 4%**





Part One: Short-Term Pay Review

First Area of Review: Employer's Long-Term Disability Program

When beginning a detailed review, the most common starting point is examining the employer's long-term disability program to determine its quality and potential benefit amounts. The facts are alarming: 75% of employer disability plans have benefits caps of $10,000 per-month or less, 77% of these plans are taxable benefits, and around 73% cover three-years or less of Own Occupation definition of disability (source MarketShare, LLC). These statistics illustrate how only a fraction of an executive's compensation is covered.

It is strongly recommended to review the employer's complete disability certificate booklet, rather than relying on benefit summaries. If you are unfamiliar with disability insurance contractual language, it is recommended to seek expert advice from a disability insurance specialist.

A few key areas of review within the employer certificate include, but are not limited to:

1) Definition of Covered Earnings and Disability Earnings
2) Definition of Total and Residual Disability
3) Benefit Reductions, Limitations and Exclusions.

Tips on the First Review

Even if bonus income is not part of the covered earnings calculation, it may be part of the partial disability benefit calculation and used to lower monthly benefits under a partial disability.

The Any Occupation protection is often simply based on training, education and experience, and does not take prior earnings into consideration. It is important to understand that assumed annual benefits may change drastically after the claim is evaluated under Any Occupation. It is recommended to prepare the client for this possible contractual risk in many employer policies.

There are specific benefit limitations that do not protect the mental health of your executive client for more than two years. An executive position demands strong mental health, and an employee's performance can adversely impact, should they go through prolonged struggles with depression, stress or anxiety.

Second Area of Review: Supplemental Individual Disability Insurance

Some executives have options available through their employer to purchase supplemental individual disability insurance. However, many high-income earners do not have access to these programs, and supplemental insurance is necessary to properly insure executive level compensation. Review possible employer options in detail, and compare their quality against available options in the private market.

Advantages of many employer-sponsored supplemental individual disability programs are discounted premiums and simplified medical underwriting. However, convenience should not be the sole reason to purchase this insurance through the employer - contractual quality and customization should also be considered.

Just like how the review of the employer disability program used a full certificate booklet, it is recommended to request the same for the supplemental policy, prior to purchase. Again, if you are unfamiliar with disability insurance contractual language, it is recommended to seek expert advice from a disability insurance specialist.

A few key areas to review within the employer supplemental policy program include, but are not limited to:

1) Definition of Total and Residual Disability
2) Benefit Limitations and Exclusions.
3) Claim Appeal Procedure Through ERISA

Below you will find a few ways to maximize an executive's short-term pay protection through the private insurance market by using a multiple-policy strategy. We have also included a solution to reach a 65% short-term pay replacement target. Each insurance carrier has specific underwriting requirements and rules, so selecting the right combination of carriers and the timing of policy purchase are critical in the maximization strategy - one carrier will not be the answer.

Tips on the Second Review

Make sure your client properly completes applications and discloses all in-force insurance to avoid any problems with future claim payments. Non-disclosure may result in fraud and will not be protected under the two-year incontestability clause.

Be aware that many employer supplemental disability plans still come with ERISA claims appeal language, which is a more restrictive appeals process than individual policies purchased outside the employer.

Female executives may financially benefit the most from employer-sponsored supplemental disability insurance if the carrier in question offers premiums on a gender-neutral premium structure.

Stacking Coverage Solutions

Male CEO Publicly-Traded Corp. (Age 45)	**Female** CEO Publicly-Traded Corp. (Age 45)
Existing Employer Disability Insurance	**Existing Employer Disability Insurance**
60% - $15,000/mo. (180-day EP – 2 Yr. Own Occ.)	60% - $15,000/mo. (180-day EP – 2 Yr. Own Occ.)
Annual Benefit Assumption: $180,000	Annual Benefit Assumption: $180,000
Individual Carrier A (Non-Cancelable)	**Individual Carrier A (Non-Cancelable)**
180-day EP (Own Occ. to Age 65)	180-day EP (Own Occ. to Age 65)
Includes Residual and COLA Riders	Includes Residual and COLA Riders
$16,000/mo. Benefit	$16,000/mo. Benefit
Plus $8,000/mo. Catastrophic Rider	Plus $8,000/mo. Catastrophic Rider
Annual Benefit Assumption: $192,000	Annual Benefit Assumption: $192,000
Annual Benefit w/ CAT Rider: $288,000	Annual Benefit w/ CAT Rider: $288,000
Annual Premium: $6,464	**Annual Premium: $8,909**
Individual Carrier B (Non-Cancelable)	**Individual Carrier B (Non-Cancelable)**
180-day EP (Own Occ. to Age 65)	180-day EP (Own Occ. to Age 65)
Includes Residual and COLA Riders	Includes Residual and COLA Riders
$9,000/mo. Benefit	$9,000/mo. Benefit
Plus $10,000/mo. Catastrophic Rider	Plus $10,000/mo. Catastrophic Rider
Annual Benefit Assumption: $108,000	Annual Benefit Assumption: $108,000
Annual Benefit w/CAT Rider: $228,000	Annual Benefit w/CAT Rider: $228,000
Annual Premium: $3,640	**Annual Premium: $5,594**
Individual Carrier C (5-Year Term)	**Individual Carrier C (5-Year Term)**
180-day EP (Own Occ. – 5-Year Benefit Period)	180-day EP (Own Occ. – 5-Year Benefit Period)
Includes Residual and COLA Riders	Includes Residual and COLA Riders
$33,125/mo. Benefit	$33,125/mo. Benefit
Plus $6,750,000 Lump Sum (66 Mo. EP – Permanent Total Disability)	Plus $6,750,000 Lump Sum (66 Mo. EP – Permanent Total Disability)
Annual Benefit Assumption: $397,500	Annual Benefit Assumption: $397,500
Annual Premium: $17,550	**Annual Premium: $17,550**
Total Annual Benefit without CAT Rider: $877,500 (68% Replacement)	Total Annual Benefit without CAT Rider: $877,500 (68% Replacement)
Total Annual Benefit with CAT Rider: $1,093,500 (84% Replacement)	Total Annual Benefit with CAT Rider: $1,093,500 (84% Replacement)
Annual Premium: $27,654 (2.1% of Short-Term Pay)	**Annual Premium: $32,053 (2.5% of Short-Term Pay)**

Note: All of the policies above include a modified Own Occupation definition of disability and Residual Disability protection throughout the entire benefit period.

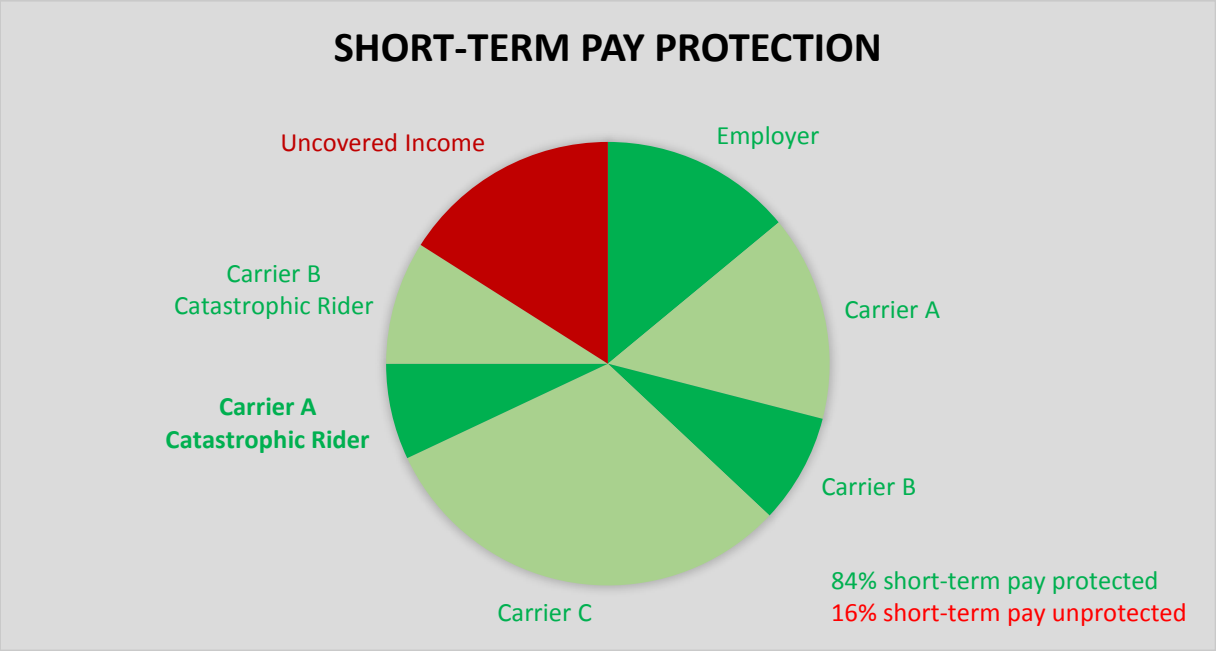
Catastrophic Disability Rider Solutions

The Catastrophic Disability policy rider can provide additional monthly payments under a defined catastrophic disability. This tends to be more restrictive than the Own Occupation disability, which protects the client's ability to perform their occupation. Instead, it generally requires the loss of two out of six activities of daily living, a severe cognitive impairment, or presumptive disability in order to access additional policy benefits.

Tips on the Catastrophic Disability Rider

It is important to make sure you understand the carrier specific underwriting rules before stacking insurance carriers and policy riders. Some carriers are more flexible than others.

Updated Short-Term Pay Protection



Part Two: Long-Term Pay Review

The traditional private insurance market has had difficulty protecting equity compensation before it is collected and reported on an executive's tax return. Other challenges around a client's net worth have created roadblocks to securing additional coverage for highly-compensated executives. With the continued shift toward equity compensation for executives, some non-traditional insurance markets have introduced new solutions for these clients. The following review will focus on protecting the most common types of financial risk these equity compensation plans experience with respect to an executive's disability.

The insurance solutions available are for publicly-traded companies. Privately-held organizations do not have the same insurance solutions available.

First Area of Review

If an executive is terminated due to a disability, the forfeiture risk of unvested stock options or grants can have major financial consequences to an executive's projected wealth accumulation. Not all stock plan agreements are the same, and unless the client has a lot of negotiating power in the drafting of their stock plan, these liabilities may come with standard provisions that forfeit unvested options or stock awards.

Second Area of Review

Future award risk involves the loss of future stock awards that an executive will no longer receive as a result of their termination due to a disability. Both forfeiture risk and future award risk can have substantial consequences to the executive's overall wealth projections.

The ability to protect future unearned income is a new concept in the disability insurance market. Many traditional insurance carriers only insure reported income provided in a tax return or W2 statement. New solutions provide protection for publicly-traded stock awards of executives. These solution use the average of the past three years of stock awards, and can cover up to five-times that average.

For executives with challenging medical history, insuring multiple (three or more) executives with a common employer can bring additional premium savings and preferred medical underwriting. Referred to as a Multi-Life Discount, these solutions can provide an additional 20% premium savings as well as up to $50,000,000 or more in benefit protection for the highest-paid executives.

Below you will find ways to cost effectively cover stock awards. The first option is designed like a traditional insurance policy and replaces only a portion of the expected stock award value. The second option uses the maximum strategy that replaces the loss of future awards due to a disability at five-times the past three-year average of those awards. Customization is the key to cost effective disability risk management.

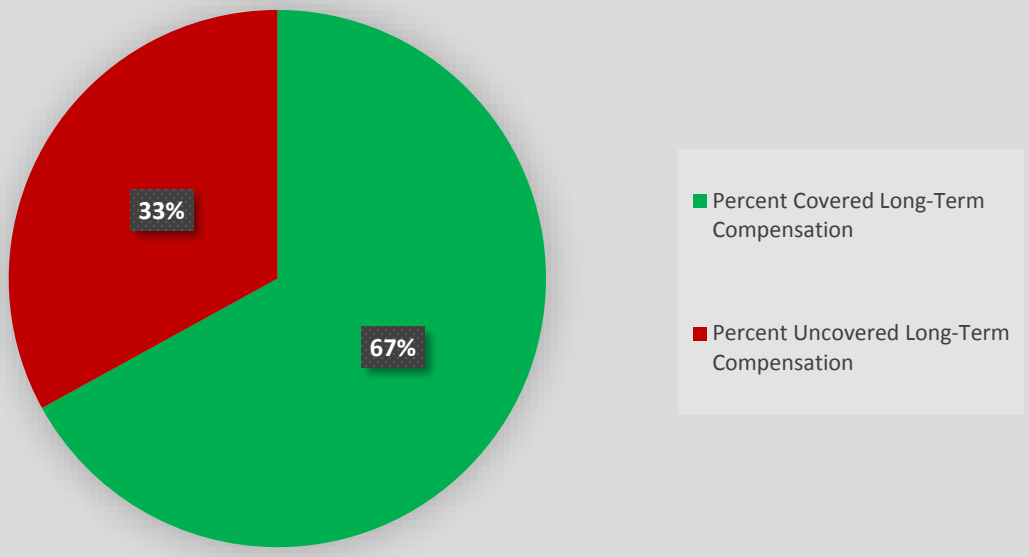
Tips on the Long-Term Pay Review

It is recommended to review the executive's complete employment and stock plan agreements for the specific rules governing a termination due to a disability or death.

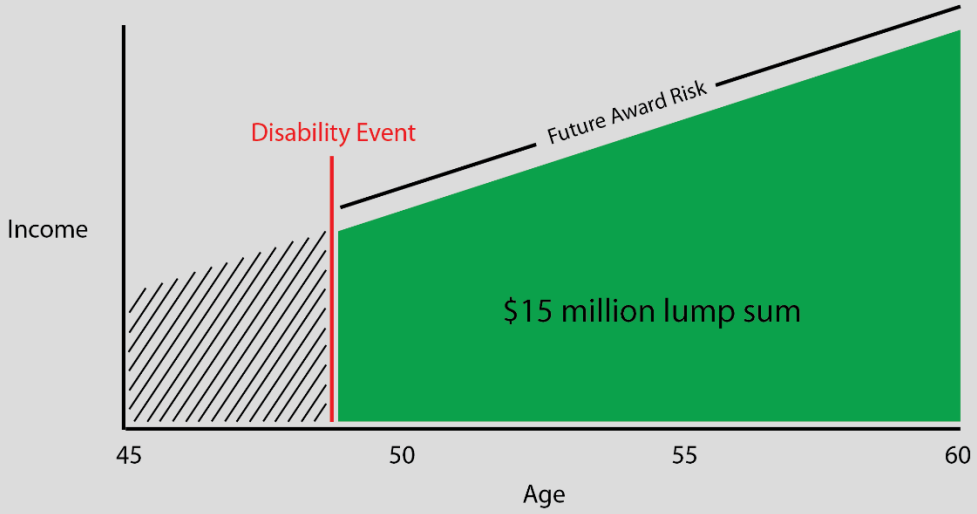
Stock Protection Solutions

Male CEO Publicly-Traded Corp. (Age 45)	**Female** CEO Publicly-Traded Corp. (Age 45)
Long-Term Compensation	**Long-Term Compensation**
Stock Awards – 3-year vesting schedule	Stock Awards – 3-year vesting schedule
$100/Share 30,000 Shares	$100/Share 30,000 Shares
Total Awards Projected Value: $3,000,000	Total Awards Projected Value: $3,000,000
Option 1: Protecting Forfeiture Risk	**Option 1: Protecting Forfeiture Risk**
Individual Carrier C (5-year Term)	**Individual Carrier C (5-year Term)**
365 Day Elimination Period	365 Day Elimination Period
Permanent Total Disability Definition	Permanent Total Disability Definition
No Residual or COLA Riders	No Residual or COLA Riders
$2,000,000 Lump Sum (67% Replacement Target)	$2,000,000 Lump Sum (67% Replacement Target)
Annual Premium: $6,063 (0.006% of annual vested award)	**Annual Premium: $6,063 (0.006% of annual vested award)**
Option 2: Protecting Future Award Risk	**Option 2: Protecting Future Award Risk**
Individual Carrier C (5-year Term)	**Individual Carrier C (5-year Term)**
365 Day Elimination Period	365 Day Elimination Period
No Residual or COLA Riders	No Residual or COLA Riders
$15,000,000 Lump Sum (5x Previous Award)	$15,000,000 Lump Sum (5x Previous Award)
3-year vesting schedule – 5x protects next 15-years of awards (To Age 60)	3-year vesting schedule – 5x protects next 15-years of awards (To Age 60)
Annual Premium: $38,969 (3.9% of annual vested award)	**Annual Premium: $38,969 (3.9% of annual vested award)**

LONG-TERM PAY PROTECTION - OPTION ONE



LONG-TERM PAY PROTECTION – OPTION TWO



Next Steps to Take

An executive has dedicated much of their career to earning advanced levels of education, specialized training and years of experience in order to effectively perform their demanding occupations. They will continue to be compensated with complex packages and arrangements for years to come. Insuring these high-performing individuals is just as complex as their compensation, and requires first-rate consultation, advice and solutions.

Employer coverage is often designed for an average income earner, rather than upper-management. Relying on these solutions is not sufficient executive disability risk management. The next consultation you have with an executive client, challenge yourself to dig a little deeper and you may uncover far more risk exposure then you and your client realized.