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UNDERSTANDING BUSINESS RISKS

WHITE PAPER

It's a fact of doing business that you and your business face a host of risks every day. We've organized protection for these risks into five categories:

1. Insurance for familiar risks
2. Insurance for abstract risks
3. Standard business asset protection
4. Protection of assets from employee-related risks
5. Protection of an owner's assets

In today's insurance environment, almost any risk that can be quantified can be insured. In this White Paper we outline risks in these five categories and make the case that the consequences of these risk events increase as you near your exit. Finally, we suggest actions you can take today to minimize the probability and/or consequences of a risk event.

FAMILIAR INSURABLE RISKS

Most businesses purchase standard commercial insurance policies to protect them against "familiar insurable risks." These include liability claims for bodily injury and property damage arising out of:

- Premises
- Operations
- Products
- Completed operations
- Advertising

Your company may also rely on insurance tailored to your specific industry (e.g., builder's risk insurance, and professional liability insurance).

Still, there are other "familiar" events that are typically not covered in standard insurance policies. The following list is not exhaustive, but it is a starting point for a conversation with your property and casualty insurance agent.

- Business interruption
- Sexual harassment: We've seen these claims arise when employees learn of a pending sale.
- Data breaches: These events are occurring more frequently and can lead to serious losses—financial, customers and reputation.
- Fraud and embezzlement
- Environmental impairment
- Death or permanent disability of an owner or key employee

The death or permanent disability of an owner or key employee are two events that can prove disastrous to your business and, by extension, to your family's future financial security, so let's look at them first.

The Death/Disability of an Owner

The sad, but inevitable, reality is that:

- If the success of your business depends on you and you die, your business will not continue.
- If you die and your business is a large (or the largest) percentage of your wealth, your estate will take a huge hit when your business closes.

If you are a sole owner, we can explore the value of a stop-gap remedy; namely, creating a Stay Bonus Plan that rewards your important employees if they remain with your company (after you die or become permanently disabled) until the business can be transferred or liquidated. This Plan is funded with life insurance on your life. The better (and more permanent solution) is to develop a management team that can continue the business—with minimal interruption to cash flow—without you. If you are a co-owner, consider insurance on your life and the life of your co-owner to provide the funds to hire a top-notch replacement.

Lastly, if your business relies on your personal guaranty for debt or bonding, your death or disability will threaten your company's financial stability and ability to continue even if you have capable management in place. Again, life insurance on your life can provide the capital needed to satisfy creditors.

The Death/Disability of a Key Employee

As you near your business exit date and you work to create a company that a buyer would want to purchase (one that can run without you at the helm), the risk that the death or disability of a key employee poses to your business is especially acute. Why? Because (ideally) you will have transferred most of the responsibility for running your company to them.

To mitigate this risk in the short term, owners can acquire key person insurance on the lives of key employees. The longer-term remedy is to hire, train, and retain employees who can step into the shoes of other key employees.

We can work with you to mitigate any of these familiar insurable risks and turn now to the more abstract risks.

ABSTRACT INSURABLE RISKS

We include in this broad category risks that can be insurable, but the cost and scope of doing so can make insuring against them impractical for most businesses. Through proper planning and action, however, it is possible to mitigate or avoid many of these more abstract business risks. Examples include:

- **Operational risk:** Incidents caused by external events or inadequate or failed internal processes, people, and systems.
- **Reputational risk:** A threat or danger to the good name or standing of a business or entity. Actions of the company, an employee, or group of employees can damage a company's reputation, and the omnipresence of social media increases the magnitude of this risk. Companies need to be socially responsible and environmentally conscious to avoid or minimize reputational risk.
- **Intellectual property (IP)** is a category of property that includes intangible creations of the human intellect. The most recognized are copyrights, patents, trademarks, and trade secrets. The first three can be protected by appropriate filings and registrations. The fourth, trade secrets, requires a bit more explanation. A trade secret is a *practice or process of your company that is 1) generally not known outside of the company*, and 2) gives your company a competitive advantage over its

competitors. Once you've identified your company's trade secrets, it's essential to protect them. There is no formal government protection for trade secrets: Every business must guard its own. [1]

Only after identifying your company's trade secrets, can you create strategies to protect them. Owners typically consult an intellectual property attorney to determine whether non-disclosure agreements, post-employment restrictive covenants or other security practices are appropriate.

Risk management consultants can review your company's internal business practices (e.g., contracts, employment practices, branding protection), and your CPA can review your company's financial controls and compliance with local, state, and federal regulations related to income and sales taxes, and proper classification of workers. Both professionals will suggest strategies designed to better protect your company.

STANDARD BUSINESS ASSET PROTECTION PLANNING

Businesses use several "standard" techniques to protect themselves from risk. Let's look at three before we move on to the special category of risk related to employees.

1. Entity Compliance
2. Multiple Entities
3. Buy-Sell or Buy-Back Agreements among owners

Entity Compliance

Whether your company is a corporation, partnership, or limited liability company, it should meet all state and federal requirements to preserve the integrity of the entity as an asset-protection or tax vehicle (or both). In the past, the Internal Revenue Service has used poor recordkeeping, the absence of meeting minutes, and the failure to file annual reports as reasons to deny certain tax benefits afforded by the entity to taxpayers.

It's easy to overlook the need to maintain complete corporate records, but just as easy to maintain them.

Multiple Entities

Some owners set up multiple entities to gain additional asset protection for themselves and their companies. They separate high-risk business activities from lower-risk activities so that potential liability in one entity does not affect another entity. We can help you assess whether setting up multiple entities in your business would decrease your exposure to risk.

Buy-Sell or Buyback Agreement Among Owners

If you co-own your business, you may wish to consider a provision in your buy-sell agreement commonly known as a "Texas Shoot-Out." This provision provides that an owner can offer to buy all of a co-owner's equity interest at any time. Recipients of the offer must accept it and sell their interest, or must buy the offeror's interest at the same price and terms as the initial offer. This provision eliminates a deadlock among owners with equal percentages of ownership interest. The right to liquidate can be used with the Texas Shoot-Out provision to give equity owners the additional option of liquidating a company and winding up its affairs.

A Mandatory Buyback for Minority Ownership can be used to protect a company and its majority ownership in the event a minority shareholder terminates his or her relationship with the company for any reason. It provides that the company will redeem or purchase the minority shareholder's shares for a value specified in the buy-sell agreement.

Lastly, some buy-sell agreements require written spousal consent to the agreement when the agreement is signed. Even in non-community property states, this requirement can protect a business should provisions of the buy-sell be invoked.

PROTECTING BUSINESS ASSETS FROM EMPLOYEE-RELATED THREATS

Employees and minority owners can be significant threats to your business, and there are a variety of strategies to limit your company's exposure to them.

Minority Owner Issues

There is an entire subset of entity law related to the relationship between majority and minority equity owners. Duties of majority owners to their minority owners apply across the board to corporations, partnerships, and limited liability companies. For instance, majority equity owners have a duty to deal fairly with minority owners, which means they cannot 1) usurp an entity opportunity for themselves without the consent of the minority owner, 2) engage in other self-dealing at the expense of the company and other equity owners, or 3) otherwise place themselves in a position in which their own economic or other interests are at odds with those of the company or other equity owners. Further, with respect to executive compensation, the majority owner's compensation and benefits cannot be plainly excessive.

Employee-Related Issues

Ideally, as owners draw closer to the day they will leave their businesses, they typically move away from day-to-day operations because key employees have assumed responsibility for critical business functions (e.g., customer, employee, and vendor relationships). Once owners remove themselves from overseeing day-to-day operations, businesses are most vulnerable, and the departure of a key employee can have immediate and devastating consequences. You know from experience that relationships are difficult and time-consuming to establish and replace, so imagine what can happen to your business if a key employee quits and attempts to take with them other employees, customers, or vendor relationships.

- Your exit is delayed.
- If potential buyers are even interested in your business, they will make lower offers.
- Typically, the very existence of your business is jeopardized.

If you take no action to encourage your key employees to remain with your company, you may put at risk the survival of your company and, by extension, the financial security of your family.

Owners use several tools to protect their companies from the damage that can result from the departure of one or more key employees.

1. Covenants Not to Compete
2. Non-Solicitation Agreements
3. Trade Secret Agreements
4. Employment Agreements
5. Employee Handbooks / Manuals
6. Forfeiture Provisions in Employee Non-Qualified Deferred Compensation Plans (NQDCs)
7. Forfeiture Provisions in Employee Stock Bonus or Stock Purchase Plans

Covenants Not to Compete

Under common law, a covenant not to compete is an agreement that restrains or prevents a person or business from performing a lawful profession. Covenants can prohibit key employee working for a competitor if they leave, establishing a new business or otherwise negatively affecting their previous employer. Further, because these covenants are generally used for key employees, they often include incentives not granted to non-key employees.

A covenant not to compete can be used to prevent a key employee who leaves one business from reaping the benefit of the additional incentives (e.g., those earned by participation in an NQDC) to establish a competing business.

The law on the enforceability of covenants not to compete varies from state to state. It is essential to involve an attorney who understand state laws that govern covenants not to compete as well as Non-Solicitation Agreements.

Non-Solicitation Agreements (NSA)

An alternative to a covenant not to compete is a non-solicitation agreement (NSA) combined with a non-disclosure of business information agreement. Because these agreements do not prevent employees from leaving and competing with your business, employees are more amenable to them than they are to covenants not to compete. Once employees see that your goal is to protect your business rather than prevent their employment elsewhere, their concern decreases. Likewise, courts look more favorably upon NSAs because they do not prevent employees from seeking employment.

We find that when departing employees are prohibited from taking with them other employees, customers, vendors, or proprietary, their departure usually causes a minimal and temporary disruption to a company's ongoing revenue. That's precisely the purpose of NSAs and non-disclosure agreements: protect a company's existing value and revenue. When NSAs and non-disclosure agreements are in place, most businesses do not need covenants not to compete.

Trade Secret Agreements

A third tool used to protect business assets is a Trade Secrets Agreement (or provision in an employee manual) which prevents employees and others from taking, using, or disclosing information such as customer lists, marketing plans, and pricing strategies.

Employment Agreements

A fourth tool used to protect a business are employment agreements that are signed by key employees. This is agreement between employer and employee (usually key employees) establishes each party's rights and responsibilities and clearly states who owns any proprietary information. It also spells out the key employee's benefit package and includes a covenant not to compete or a non-solicitation provision as well as confidentiality and trade secret agreement provisions.

Employee Handbooks / Manuals

Another tool used to protect a business from exposure to liability associated with employees is an Employee Handbook or Manual. While a Handbook can be helpful, it can be a significant liability if poorly written. An Employee Handbook should never make promises of fair treatment, continued employment, or access to personnel records.

In addition to detailed descriptions of vacation and holiday policies, a Handbook should include statements about harassment (sexual or otherwise) and set forth an effective complaint procedure. These statements reduce the risk of liability for co-worker—but not supervisor—harassment. They should clearly state that: 1) Employment is "at will," 2) The Handbook is not a contract and 3) The Handbook can be modified at any time. Employees should sign the "at will" portion and can initial company's trade secret and confidentiality policies.

If applicable, a Handbook can describe computer policies related to out-of-office access, security, and telecommuting policies. It may also include policies related to the use of company property such as automobiles, laptops, etc.

Forfeiture Provisions in Employee Non-Qualified Deferred Compensation Plans (NQDCs)

Non-Qualified Deferred Compensation Plans with forfeiture provisions related to a vesting schedule are another tool used to protect companies. If, for example, an employee is entitled to deferred compensation under an NQDC, the plan should include a vesting schedule (perhaps a five-year vesting schedule) during which the employee vests in deferred compensation at a rate of, say, 20 percent per year. If, during that five-year period, employment is terminated or the employee leaves, the forfeiture provision can require that the employee forfeit all or a portion of his unvested benefits.

Even vested benefits can be subject to forfeiture if employees engage in prohibited conduct, such as violating the confidentiality and trade secrets provisions in their NQDC plan or violating the terms of a covenant not to compete or NSA.

Forfeiture Provisions in Employee Stock Bonus or Stock Purchase Plans

Forfeiture provisions in an employee stock bonus or stock purchase plan makes an employee's bonused or purchased stock subject to the forfeiture and transferability restrictions contained in a buy-sell agreement.

PROTECTING AN OWNER'S ASSETS

We turn now to the tools we can use to protect you—the business owner—from exposure to personal liability. These include:

1. Observing Corporate (or other entity) Compliance
2. Removal of Personal Guarantees (and the use of personal collateral for business obligations)
3. Estate Planning and Asset Equalization
4. Irrevocable Life Insurance Trust Planning
5. Domestic Asset Protection Trusts Planning
6. Insuring Against Risk

Observing Corporate (or other entity) Compliance

Observing corporate (or LLC or FLP) compliance is important because some entities, if properly maintained, can afford significant, if not absolute, liability protection to the individual business owner.

Removal of Personal Guarantees (and the use of personal collateral for business obligations)

Are you a guarantor on business debt or obligations? Are non-business assets used as collateral for business debt? If so, it is worthwhile to attempt to have such personal guarantees removed, especially if the financial condition of your company has substantially improved since the guaranty was originally required.

Estate Planning and Asset Equalization

To insulate your non-business assets from business creditors, you and your spouse can incorporate the concept of "Asset Equalization" into your estate plan. Doing so not only makes more effective use of your unified credit, it also transfers non-business assets to your spouse's estate and keeps your business and other high-risk assets in your estate.

To be effective, however, you must clearly document any transfers and the estate planning reasons for doing so. It also is important to make sure that: 1) Your spouse is not a guarantor on business debt or obligations, and 2) Non-business assets are not used as collateral for business debt.

Irrevocable Life Insurance Trust (ILIT) Planning

Owners often create Irrevocable Life Insurance Trusts (naming themselves as the insured and their family members as beneficiaries) to protect proceeds from their life insurance from taxation. ILITs serve a second, usually more important purpose as well: Should you die, the insurance proceeds from your ILIT are protected from your and your business's creditors.

Domestic Asset Protection Trusts (DAPT) Planning

A Domestic Asset Protection Trust a trust established by an owner who is a permissible beneficiary and can access the trust's assets. A number of states allow for such trusts, the purpose of which is to shield its assets from a business owner's creditors. In addition to providing asset protection, a DAPT offers other benefits, including state income-tax savings when situated in a no-income-tax state. Typically, a DAPT must be administered by a trustee (or corporate fiduciary) who is a resident of the state to obtain protections afforded by state law.

It is essential to retain an experienced estate planning attorney to set up DAPTs and other asset-protection entities and trusts.

DAPTs are not for the timid. Some successful attacks clearly indicate the need for caution and thorough documentation to prove (if necessary) that the DAPT was not established to transfer assets in order to defraud current or potential creditors.

Insuring Against Risk

- Personal Liability Umbrella Coverage

Umbrella insurance is a type of personal liability insurance that covers claims in excess of regular homeowners, auto, or watercraft policy coverage. It doesn't cover risks related to a business or its operations. It's inexpensive when compared to the value of the assets you wish to protect.

- Contribution and Cross-Indemnification Agreement Among Owners

A contribution agreement or cross-indemnification agreement is an agreement among owners to share in the indemnification obligation in accordance with a specified ratio, generally their respective ownership percentages. This is often a stand-alone contract that is separately negotiated between the owners when the owners sell their business either in an asset or equity sale.

TAKEAWAYS

1. Reviewing business risks—and the consequences of inaction— can be the difference between your successful exit from your business and no exit at all.
2. An experienced P&C firm or risk management consultant can review your existing business insurance policies to confirm that coverage for risk events is in place, and that the amount of coverage is adequate.
3. Advisors (e.g., business and estate planning attorneys, CPAs, exit planning advisors, and risk management consultants) are valuable resources. Use them to conduct informal due diligence designed to uncover your company's (and your) potential liabilities and minimize damage from both familiar and abstract business-related risks.

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[1] https://en.wikipedia.org/wiki/Intellectual_property

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