



THE MAJOR  
RISKS TO

CORPORATE  
EXECUTIVES  
*AND OTHER*  
HIGHLY  
COMPENSATED  
EMPLOYEES

*Part 2 of a 3 Part Series*

- ROBERT D. BIRDSELL -

“The reality is that the majority of an executive’s compensation... is excluded from coverage in Group Long Term Disability plans.”

### *Part 2 of 3: Risk of Disability*

In Part I, I discussed the the Risk of pre-mature death and now I will now switch gears and begin to review our second risk assessment, that being the risk of a permanent disability. Unlike a possible aversion to talking about death, the subject of disability should be less disconcerting since many us have likely known someone who is disabled. Let’s begin with an overview of what is at risk when we discuss disability.

Most executives assume they are adequately covered with their Group Long Term Disability Plan (GLTD). Few understand, however, that GLTD generally only covers cash compensation and even with that there are substantial limitations on the amount of coverage provided. The reality is that the majority of an executive’s compensation is now paid in the form of variable compensation such as RSUs, options, and variable compensation all of which is excluded from coverage in GLTD plans.

In analyzing compensation, we have discovered an increasingly higher percentage of an executive’s total compensation falls into the category of variable as opposed to fixed. The reason for this is fairly straightforward, in today’s business environment, boards are under pressure to align executive compensation with positive financial results and as a consequence, the amount of variable compensation is increasing, thus putting at “risk” the majority of the executive’s compensation. That philosophy sounds great except for one thing: executive benefit programs have not kept up with this changing approach to compensation.

Insurance companies underwriting GLTD and some Group Term Life underwriters have not addressed this deficiency because they either have no credible solution or there is little demand for such benefits.

Another possibility for this benefit deficiency may be that the Board or their advisors feel that with a generous level of total compensation, the executives can secure and fund any need for the additional benefits themselves.

This may be true, except for two issues. First, as stated above, the executives may be unaware of this substantial shortfall since they spend almost no time studying their benefit programs. Secondly, they don't have access to the programs that would allow them to backfill this deficiency.

Companies on the other hand, may have an obligation to address this issue by designing plans that provide an opportunity to shore up the growing shortfall. This could be done by either funding a plan to reduce or eliminate the shortfall or providing the executives with an option to purchase adequate supplemental coverage under a company sponsored program.

The issue then becomes who funds the cost: the executive or the company? If the company funds the cost, more than likely it would require board approval which may or may not be an impediment to the implementation. On the other hand, if the plan is voluntary, board approval is probably not required.

If the executive funds the cost any benefits received would be tax free and if the company funds the cost the benefits would be taxable when received.

Under either option, the most important item is the ability and opportunity to secure guaranteed issue. Without guaranteed issue, the plan will fail to get traction and therefore as one company suggested, "It's not worth the trip".

If just one executive is refused the benefit because of health or other underwriting issues, ill-will and frustration could ripple through the organization causing unwanted negative publicity within the ranks of the very people the organization is attempting to attract and reward.

There is a higher probability of disability than death. The table below provides a summary of the probability of a disability:

Age	Probability of Disability before Retirement
40	12%
45	12.5%
50	13%
55	13.5%
60	14.5%
65	15%

### *The following illustration*

...projects the level of “risk” incurred by an executive in a typical publicly traded company. Let’s look at an example of an executive with the following annual compensation:

Salary	Bonus	NQ Options Value	RSUs Value	Total Comp
\$500,000	\$250,000	\$250,000	\$500,000	\$1,500,000
0	0	0	0	0

In most LTD programs, only the base salary of \$500,000 is covered and then only 60% of salary is insured under the LTD plan.

In other words, \$1 million (two thirds) of the total compensation remains entirely uninsured.

Over the career of this executive that will amount to millions of dollars!

You might ask, “Can’t our provider of LTD simply insure this risk and make it part of the existing package of Group LTD?” The simple answer is **no**.

Traditional underwriters have not decided to underwrite this risk. Or, the executive might postulate that perhaps his or her employer can assume the risk. This is highly unlikely since the employer is not in the business of assessing and managing risk of this nature. Also, traditional underwriters of individual disability policies are also not interested in this line of business, at least not yet. It will require a company that underwrites what is referred to as “Excess Lines” of insurance, and there are only two companies in that business who have the credibility and financial resources to undertake such risks. They are Lloyd’s of London and Munich.

Even with these organizations, underwriting this risk is not an open-ended proposition. Lloyd’s and Munich will generally underwrite a risk for substantial benefits but limit the duration of the benefit to five (5) years.

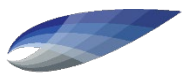
In the example listed above where the amount at risk (i.e., the amount of compensation that is uninsured) is \$1,000,000 a year to be able to secure a benefit of \$5,000,000 (\$1 million for five years) is certainly worth more than a causal look!

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