

THE MAJOR  
RISKS TO  
  
CORPORATE  
EXECUTIVES  
*AND OTHER*  
HIGHLY  
COMPENSATED  
EMPLOYEES



## *Part I of 3: An Introduction and the Risk of Death*

One of Winston Churchill's more memorable quotes is, "the length of this document defends it well against ever being read." I will keep that bit of sage advice in mind as I begin an effort at unearthing some of the mysteries of the subject of "risk," and more importantly how this issue relates to executives.

Perhaps the starting point in examining the issue would be to define "risk."

According to Wikipedia: "Risk is the potential for uncontrolled loss of something of value. Values (such as physical health, social status, emotional well-being, or financial wealth) can be gained or lost when taking a risk resulting from a given action or inaction, foreseen or unforeseen (planned or not planned)." Furthermore, "Risk perception is the subjective judgement people make about the severity and probability of a risk, and it may vary from person to person."

This discussion of "risk" will be presented in three parts since an attempt to review all four concepts listed below would violate Winston Churchill's admonition.

We will restrict the discussion of "risk" to only those that an executive would generally assume, encounter, or suffer while gainfully employed, therefore we will look at:

- The risk of death
- The risk of disability
- The risk of market exposure
- The risk of running out of financial resources which, by its nature, would influence an executive's short and long-term health, both financial and emotional

Of the four risks outlined above only two risks can be controlled by an individual executive: the risk of death and the risk of disability. It is obvious that an executive does not have control over when and if he or she dies or becomes disabled, but what is under the executive's control is the mitigation of the consequences of a pre-mature death or disability.

**Here in Part I of this discussion I present a high-level overview of how an executive can effectively transfer the risk and consequences of a premature death.** Then in Part II, we will examine the same issues as it applies to disability. Finally, in Part III, we will examine a concept that suggests how an executive might mitigate the risk from stock, options, or RSU's the executive has been awarded by his or her organization. In addition, a brief review of the "risk" associated with financial planning will be presented.

An interesting footnote, few if any executives we have met have actuarial backgrounds, however, most possess an analytical mindset and understand the simple rules of probability. They rely on these skills to evaluate business decisions in the normal course of the business careers. These skills are key to their success and without them, few would remain in the ranks of the elite executive population.

What is fascinating is that, although executives by their nature are brilliant influencers of most things relating to business, they are often poor evaluators of their own personal psychological and financial well being. This is true whether you are a CEO, Executive Vice President, Senior VP, or simply on your way to becoming one. These individuals will employ all the skills they have acquired to make decisions relating to the success of their businesses but often abandon these talents when viewing their own morbidity, mortality and financial health to simply rely on what others appear to be doing.

To illustrate this point, I recall a number of years ago when we were working with a company on an executive benefit plan which we designed and were now assisting on its implementation; the program included a personal financial consulting package. When meeting with one senior executive who was eligible for a large block of stock options, we asked him what he wanted to do with his options? To which he inquired, "What is everyone else doing?" This is confirmation of the old adage: "follow the herd."

Executives often rely on what the human resource department recommends, what their colleagues are doing, or what they read in an industry journal regarding what is in vogue or perceived as "best practices" in today's business environment. They generally don't take the time to determine what is in their own personal best interest. The other problem is executives may overly rely on

surveys that suggest what other organizations within their business sector are doing, or they may rely on what they have overheard at a conference or cocktail party. These too often become the major influencers on what executives ultimately end up choosing to do.

We are confident that if executives understood what is at “risk,” they would not be as cavalier and would devote more time to understanding and evaluating what they truly have at “risk.”

As suggested earlier, although few executives are certified actuaries, most are accomplished at the science of “evaluating probabilities.” Therefore, let’s set forth a simple schedule of probabilities for “the risk of death.” This may appear somewhat simplistic on the surface but may nonetheless shed a light on how most executives would or should approach the subject.

A friend who is a retired certified actuary graciously assisted me with the schedule shown below. Not every age is presented, but since we are dealing with analytical individuals, I am confident executives will be capable of interpolating any ages not listed.

<b>RISK OF DEATH</b>	
Age	Probability of death Before retirement
40	.08%
45	.08.5%
50	.09%
55	10.0%
60	10.5%.
65	11.0%

There are two additional elements in this analysis that require some attention:

- a) the amount of benefit that is required and
- b) the type of insurance that would be appropriate. Since there are far too many variables involved in attempting to determine what type of insurance is appropriate, that issue will not be addressed.

The level of benefit also has many variables, but certain rules can be more easily applied in an effort to determine the appropriate level of insurance required to mitigate this risk of loss. Generally speaking, the amount of death benefit that would be appropriate would range from ten times to fifteen times total earnings. Younger executives will generally require the higher multiple because of two simple reasons. First, they will likely have younger dependents at home, and second, they have not yet had the time to accumulate other assets.

When an executive begins to evaluate the probability of his/her death before retirement, he/she will then be able to begin to assess the value and the corresponding cost associated and then either proceed with a plan to mitigate that risk or take a pass on electing to insure his/her life.

Whether an executive decides to increase the amount of protection or not may come down to something as simple as drawing an analogy between the loss of life vs. the loss of property. For example, if an individual were to invest \$5 million in a new office building and borrow 90% of the cost of construction, do you think a lending organization would demand insuring that property for loss at least equal to what the loan amount is? The answer is obviously YES. But, the “probability” of that building burning down or being destroyed due to other natural causes, is far less than our investor dying in the next 20 or 30 years. The building will generate substantial income over the 20 or 30 years just as an executive will, assuming he lives.

We believe that calculating and mitigating the risk associated with a premature death is relatively simple, but the largest impediment to moving ahead with the purchase of a life insurance policy may be nothing more than an aversion to the subject, after all who wants to discuss their own mortality.

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