Discovery Health Money Podcast Series
EP10 – Breathing New Life into your Organisation with Business Assurance with Daniel Stoch and Harry Joffe

Bruce Whitfield [00:00:00] Hello and welcome to this very latest Discovery podcast with Harry Joffe, the Head of Legal Services at Discovery, and Daniel Stoch, who's a Senior Risk Specialist at Discovery. Big question today, business assurance. What should business owners consider for their organisations when it comes to business assurance? This isn't I don't think Daniel Stoch business insurance, which would cover things like business interruption, which has been such a big issue in 2020. This is about the key people within the organisation, I assume.

Daniel Stoch [00:00:33] Correct, Bruce.

Bruce Whitfield [00:00:35] So take me through it. What are the big issues to consider?

Daniel Stoch [00:00:37] So I think COVID-19 has really brought new perspectives to all of this in that I think from a macro level, businesses are seeing themselves impacted like never before. But it's also brought to our attention impacts at a micro level. So, risks that business owners would face on a day to day basis. And the problem with running a business if anything happens to one of the owners of the business or one of the key individuals within the business.

Bruce Whitfield [00:01:06] Harry Joffe, from a legal perspective, of course, there're massive responsibilities on directors to ensure, one, that the business is run responsibly on a day to day basis. And surely a key part of that responsibility as a director is to ensure that there is coverage, should one of the directors, the founders, disappear off the face of the earth or get sick or go mad, whatever the case might be?

Harry Joffe [00:01:31] What's interesting about business assurance is, of course, there's different categories. So, we have business assurance where we cover debt. So, for example, if the business borrows money from the bank and incurs debt and one of the directors or more than one will have to sign a suretyship. So we got what we call contingent liability business assurance, which covers the debt, which I think is a very important responsibility as you say of directors, because without that you know a director dies, the bank calls in the loan. The business goes bankrupt very quickly. So that's a very valid point. Then the second kind of business assurance is what we call key man insurance where the director is insured because they are the key individuals so they are the ones with all the contacts, they are the ones with all the skill, the other directors are really just, you know, a sideshow. And that key person policy ensures that if that director dies, or is disabled, then they can, the company can go to the market and procure replacements. And then the third kind is what we call buy and sell insurance, which is if one of the directors dies or one of the shareholders dies, the

remaining shareholders don't want to be in business with their family. They want to be in business only with themselves. So that is a policy which is a little bit different where the surviving partners or shareholders insure the deceased or disabled shareholder so that if he or she dies, they could then purchase those shares from the family and ensure the person stays in-house and you don't have outside family members coming in. So, there's a whole lot of issues which come up. Three very different categories, three very different needs, all of which need to be covered.

Bruce Whitfield [00:03:01] Excellent. Thank you, Harry. Let's get back to you, Daniel Stoch. I mean, just take me through each category then. The debt assurance, for example. Just explain to me how that works.

Daniel Stoch [00:03:10] OK, so if you look at a typical contingent liability policy, one of the owners of the business may have stood surety for a loan that the business took out maybe to help cover the initial costs of setting up the business. And if that partner were to pass away, for example, because he stands surety for the loan the estate actually is, is liable to repay that loan. And that could obviously place a hell of a lot of pressure on the family of the deceased and at the same time, it could take some, some time to actually recoup that money. Once a contingent liability policy is in place, if the, life assured passes away, that payment is then paid to offset the loan and, relieve any pressure that there may be on the estate.

Bruce Whitfield [00:03:58] OK, so there's debt there, the key person one I think is easier to understand. In the case of Discovery, for example, should something terrible happen to Adrian Gore, that would be significant should something happen to Harry Joffe, for example, Daniel, less consequential, uncomfortable for their legal services department, but not really that big in the life of Discovery right?

Daniel Stoch [00:04:19] So you would look at the relative impact that the individual has within the business. And then there are a number of different metrics that you can use in order to determine how much cover you may need to to ensure as little disruption as possible should something happen to one of the key people.

Bruce Whitfield [00:04:34] The buy and sell insurance is particularly interesting here, Daniel, because we watch these American soap operas and dramas where the founder of a business dies and suddenly the drug addicted Ferrari loving, fast living, cocaine snorting son and heir comes in and starts calling the shots and everything falls apart and it makes for great TV drama. I suppose the buy and sell insurance is precisely to prevent that sort of thing from happening.

Daniel Stoch [00:05:02] It's exactly that and it's put in place to make sure that the business can continue as smoothly as possible and the family receives a fair payment for their ownership within the business to prevent scenarios where exactly that someone comes in without sufficient prior knowledge. And it creates a lot of

disruption within the business. That's completely prevented as that the owners of the buy and sell policies would be the surviving partners. So, they would receive a payout and there would be a contract in place that would require them to pay that money to the family and buy up the shares of the deceased owner.

Bruce Whitfield [00:05:38] Harry Joffe, however, the deceased owner, the the 50% shareholder in the business, dies and sees no fault in their son, their son's just going through a bit of a rough patch. And in his will, he has said that he would like his son to inherit his shares and he would like his son to take over as managing director of the business at the age of 28, for argument's sake. How does that relationship exist, that emotional attachment exist in the world of the buy and sell assurance?

Harry Joffe [00:06:09] That's a very valid point, because this is something we keep stressing to our advisers and our clients that it's no point just having policies in place because policies in place are useless. Someone dies and someone gets paid out. The policies have to be backed up by a very strong and watertight buy and sell contract and what we put in place, are these contracts, which typically say, if Mr. A dies, his policy would pay out to Mr. B and C, who are his co-shareholders and his estate is obliged to sell those shares to Mr. B and C at a prepared value, at a preplanned value or a preplanned method to determine that value. So whatever Mr. A says in his will, is actually overridden by that binding contract which he has signed before he died. And it's so important that it's signed and dated and witnessed, etc, etc. So, we actually bind Mr. A's estate to sell those shares and the executor will have no option but to sell their shares in terms of their agreements.

Bruce Whitfield [00:07:05] What sort of eventualities, Daniel, does the buy and sell assurance cover? What happens if we fall out? One of my favourite stories is the founders of Apple. Steve Jobs and Steve Wozniack were very young and were very impressionable. And they took lots of risk and they brought a guy called Ronald Wayne in to run the business with them because they needed adult supervision. But Ronald Wayne was at a different life stage. He was in his 40s. He had kids at school. He had a house; he had a mortgage. And after about two weeks after signing the articles of incorporation for Apple, in which he was given a 10 percent stake, he bailed and he said, no, no, I absolutely can't tolerate your guys appetite for risk. I can't stick around here. And he sold them back his 10 percent stake in Apple for I think it was 800 dollars. That stake in Apple today would be worth two hundred million dollars, 10 percent of a two-billion-dollar company. And a considerable agreement. Can a buy and sell agreement cover if one partner decides to leave or falls out with the other partners. If humanity gets in the way of the business arrangement, for example.

Daniel Stoch [00:08:13] So maybe Harry can talk to to that question. But the first part of the question is, is more around just the risks that you would cover under a buy and sell agreement. And these are typically death and disability. So sometimes you'll see an agreement with only life cover on it, in which case if a partner becomes disabled

and is unable to work in the business, you have a very real risk that there is no payment for them to actually be bought out. But at the same time, they can't run the business like they previously could. So that is a risk of not including disability cover as one of the insured events. But Harry, maybe you can touch on the contractual element of partners leaving the business.

Harry Joffe [00:08:53] Sure, Dan. I think, Bruce, to stress our buy and sell structures are only operational, only kick in when there's an insured event, so that would be a death or a disability generally. So, if a partner leaves or resigns or has a fallout or goes mad, that is something which is covered in their shareholders agreement typically. So, every company, as you know, will have an MOI and a shareholder's agreement and in that they would regulate their interpersonal relationship; how they share profits, what happens if someone wants to leave? If someone wants to retire, all those issues are covered in a shareholder not in a buy and sell because, as Dan said, they are not being covered by life insurance, we don't really get involved in that.

Bruce Whitfield [00:09:34] OK, and that's a critical thing to understand that you can't insure against whether or not you have a fall out into the future. And sadly, so many partnerships do end in tears. Give me some reasons here, Daniel. I mean, maybe five, but I mean some reasons why business owners should really consider taking out whole life or term insurance cover when it comes to going into this sort of business arrangement.

Daniel Stoch [00:09:55] There are a few reasons and it also just depends on the need for business assurance. So, is it a buy and sell agreement? Is it a key man cover contingent liability? But generally, the sort of theme is to insure as little disruption in the business itself as possible and to easily enable partners to buy out deceased owners or disabled owners. So those are kind of the high-level reasons. If you think about just a key man policy and you consider the situation where one of your key individuals is just unable to work for whatever reason, you need time in order to upskill another individual, you need resources in order to find someone else to fill that role, you may need to compensate existing staff additionally, if they have to take on some of the extra roles and responsibilities of the key individual, that is no longer able to work and those are typically your, your main reasons for needing business assurance.

Bruce Whitfield [00:10:51] And the difference then between the concept of term and whole of life in a new entity. I mean, start-ups are interesting things because most of them will fail, as we know, but some will succeed. Some will stay under the care and ownership of the of the founders forever. And some will be sold four or five years in. What is the difference then between term and whole of life?

Daniel Stoch [00:11:14] So term assurances is typically insurance that expires at a specific date. And so across the market, you'll you'll find different types of term cover,

sometimes for terms as little as five years and oftentimes extending to a longer period of time, sometimes until the partners reach age 65, whereas whole of life cover typically covers a client for whole of life, for for things like life cover, disability benefits, all typically tend to be term benefits up until the age of 65. So that's the usual structure that you'll see between between the two types of cover. And generally, that's dictated by the need for the assurance. So if a business takes out a loan, for example, that has a certain 10 year term, the business may opt to to go for a 10 year term insurance policy after which the policy would expire and the business would no longer be covered. Now if the business believes that they may need to take out a loan in future. They may opt to go for a whole of life policy, given that the future term is a little bit uncertain. So typically, term cover makes the most sense when you are very certain that that's the term that you'll need the cover for. But as we all know, it is it is very difficult to know what the future may hold for for a business.

Bruce Whitfield [00:12:32] Harry, talk to me about the risks of not taking out this kind of insurance, because often in many start-ups we were school friends, we were university friends, we fought in the trenches together. Whatever it might be that brought us together is not necessarily what keeps us together in the world of business. Things go wrong, debts, whether the key person dies, whether or not we then need to buy them out or sell a stake in the business in the event of another family member wanting to become involved. What are the risks to the business of not taking out this assurance?

Harry Joffe [00:13:06] I agree, Bruce. It's a very tricky issue because as I say, you normally need three different kinds of assurance. You need to cover a key man policy which would be owned by the company to protect itself if an individual dies, you would need a contingent liability policy to cover debt, which really covers the director who stood surety and then you need your buy and sell policy to cover each individual shareholder. And normally, as you say, the company said we can't afford all three, which is the most important, and then you're got to actually sit down and try and rank it. I would say if a company has debt, particularly in this environment now, you know, everybody's so jittery if the suretyship dies, the bank are going to call in the loan straight away. And that could be the end of the company. So, debt to me is a is a vital concomitant of a company's survival. If you are going to have debt, you must insure that debt, you must cover that debt, or the company won't survive if someone dies. And then it becomes a debate after that, what you cover. Buy and sells: the main shareholder dies, and now the remaining shareholders are stuck with their son, who knows nothing about the business and is demanding dividend payments to fund his lifestyle. That, again, would put the business under severe strain and it might not survive. But I mean, we've all seen these court cases play out in the Sunday Press where the shareholders are in court locked in litigation over shared values and over family members that have want. So, again, those kind of things, if you don't do it properly and you don't structure, will put the future survival of their business at risk. And as I say, you need not only policies. And I think the point to stress: policy is only

one part of it, but you need the contracts. You know, you need to buy and sell contract. What happens if that major shareholder dies, that he has to sell your shares? You need to contingent liability contract, that the company will take a policy and will use those proceeds to cover debt if that life assured dies.

Bruce Whitfield [00:14:54] Again, Daniel Stoch, I mean, one looks at business assurance and go 'all right, it's a bit like going to your favourite supermarket and saying cans of beans. There is one at R15.99, there's one at R18.99 and there's one a R27.99. They're all just beans. And for this sort of insurance, for business assurance, you can't be treating it like cans of baked beans, I suspect.

Daniel Stoch [00:15:20] Business assurance is a very commoditised product and that often the cheapest premium wins the business and typically policies are quite similar across the market. And but I think this introduced an opportunity for Discovery Life to somehow work our shared value insurance model into business assurance. And the interesting thing here is the model actually creates a sort of environment where all of the stakeholders are instantly better off for it. So, you have a scenario where business assurance with with Discovery Life provides a payback benefit to the the life assured every five years based on how well they manage the health and wellness. So that's sort of the first incentive that that encourages healthy behaviour for the actual life insured, which is very important from an insurer perspective, that means a healthier life. Who's less likely to claim which generates a surplus on our side. And that surplus is obviously used to to provide the payback to the life assured, but it's also used to help maintain discounts that the policy owner pays on the premiums for the policy. So, it results in cheaper premiums for the policy owner, a payback for the life assured and better claims experience for the insurer. So, the sort of holistic protection and an environment where where everyone is better off.

Bruce Whitfield [00:16:44] What are the myths that exist about this cover? Are there common errors, mistakes that people make in terms of what they believe it covers, don't believe it covers, think it does and doesn't cover? What are the biggest myths that you need to quash before we wrap up here, Daniel?

Daniel Stoch [00:17:02] So we touched on the first, which was for buy and sell, sometimes only life cover is included. But there's actually an interesting second point there, which is what happens when you include disability cover on a business insurance policy. Now, lump sum disability cover typically pays out if a client is unable to perform their occupation or if they're permanently disabled. Now, if you take a normal disability benefit, there is a scenario where you could become or be deemed to be permanently disabled, but you could still actually be able to perform your occupation and you may not want to to be bought out in that scenario. But as per the buy and sell agreement, because there is a payment on the life assurance policy, you land up with a scenario where the payout is is paid and the owners actually forced out of the business, and so there are alternative benefits in the market which require both

objective medical criteria to be met and the inability to perform a client's occupation. And if that happens, then the policy pays out a lump sum and the buy and sell contract is triggered. So that's one subtlety when it comes to buy and sell business assurance. Another interesting one is on key person cover, because typically when we think about business assurance, we think about life cover, we think about disability cover. But there's also a very real risk that a key individual becomes sick and on key person policies you are actually able to add severe illness cover as well. And so it's a great way to make sure that the key individual within a business is comprehensively protected against sort of a full array of risks, remembering that severe illness benefits pay out at multitudes of levels. So even if the life assured isn't too severely ill, there would still be some sort of payment that pays out to make sure that the business can continue running as smoothly as possible.

Bruce Whitfield [00:19:03] And Harry Joffe, I mean, final word to you on this. I mean, really, business assurance is making sure that as you go through the life stages of your business that you truly never walk alone.

Harry Joffe [00:19:17] Thanks Bruce, kind of you to throw in that simile, but I think the key issue here as well, I mean, you're asking Dan to talk about some common problems. And I can tell you, Bruce, the most common question I get asked: Partner A insures partner B. Partner A and partner B have a fallout, they go their separate ways, but now partner A still has this life policy floating around on partner B. Partner B says to partner A: can I have my policy back? Partner A says: get lost. I'm going to wait for you to die, I'm going to cash in. Now. I mean, it sounds morbid and it sounds incredible, but it happens all the time. And then I say to the partners because they always phone me. There's a problem in our common law. And our common law says you have to have an insurable interest in that person's life, but only when you take out the policy. Here, of course, partner A did have an interest in partner B's life when they took the policy out, they don't have it anymore. But that doesn't matter in terms of our common law, partner A can carry on with the policy, wait for it partner B to die and then just cash in. I had one particular case; a client phoned me and he said to me, his partner B still owns his policy on his life. And his partner B said to him, I'm not going to wait for you to die a natural death. I need my money now. I'm going to push things along and try and get you killed off a bit quicker. And when he told me that, I said to him don't worry. And he said to me, no, I had a break in at my house last week. And the people that broke in, came, took all my guns, all my defensive weapons. And they said, we're coming back for you next time to finish the job. This isn't just a joke. And I think it's a real problem, Bruce that you've got to understand, that if you're insuring each other in your contract, I mean, I'm a legal person, I'm obsessed with contracts. We've got a whole paragraph in our contracts. What happens, when the business breaks up, to these policies floating around that we oblige the owners to seek the policies back or we give the life assured the right to demand session back of the policies of their lives? And it's just so important to think about when things go wrong because it happens in a buy and sell, it happens in a key man. Company

insures an individual, individual leaves. Now, the company says we'll carry on with the policy, wait for you to die and we'll cash in. It's exactly the same problem. You need to have contracts, you need to have these clauses that oblige the policies to follow the life assured, because without those clauses, not only do you have endless trouble, but you have an incentive for a, let us say a person is not so scrupulous to try and speed along a death to cash in. And it's a very big problem.

Bruce Whitfield [00:25:57] Mushrooms, with your steak, sir? No. Exactly. Thank you very much, Harry Joffe, for that very real South African conundrum. Harry Joffe, the Head of Legal Services at Discovery. Daniel Stoch, thank you to you as well, Senior Risk Specialist at Discovery.