ARLENgroup
EMPLOYEE BENEFITS

Disability Insurance for Partners of Law Firms

A Thought Piece for Strategic Decision Makers Inside Law Firms

ArlenGroup White Paper Series

Strategies for Income Protection for Partners

This white paper addresses the income continuation under-insurance exposures faced by law firm partners. It summarizes the key challenges to law firms and outlines some of the strategies firms can use to deliver adequate and cost-effective income protection to partners.

Overview

A softening economy, hardening insurance market, and significant growth in partner income over the last 5 years have created significant income continuation under-insurance exposures for law firm partners. It is increasingly difficult to adequately and cost-effectively protect partners' incomes against the risk of long-term disability (LTD). There is no simple turnkey solution, even when the price of coverage is not a driving concern.

Building insurance solutions for law firm partners requires a keen understanding of tax regulations, insurance markets, partnership agreements, firm administrative capabilities, and partner expectations. This white paper summarizes the key challenges to law firms and outlines some of the strategies firms can use to deliver adequate and cost-effective income protection to partners.

Challenges

While the list and prioritization of issues varies from firm to firm, the challenges in managing long-term disability insurance tend to fall into the following areas:

Disability insurance solutions can't keep pace with growth in partner income.
Most firms suspect they have an under-insurance situation but have not quantified its magnitude. It is not uncommon for 1/3 of a firm's partners to have less than 33% of their income insured against long-term disability. A typical scenario is shown in **Exhibit 1.**

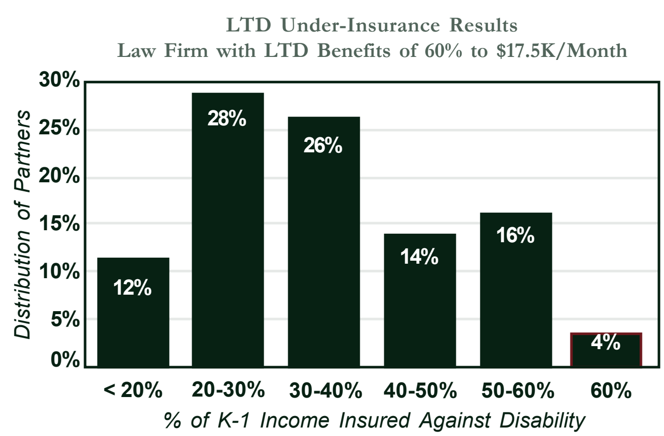

Exhibit 1

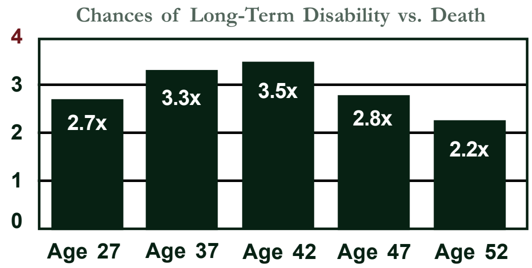

Exhibit 2

Appropriate coverage is difficult to evaluate and obtain.

Fewer insurers are underwriting high limit LTD. Obtaining even $180,000 ($15,000/month) in annual group LTD insurance has become a challenge.

Individual disability policies can be part of the answer; however, individual disability policies are expensive to purchase and difficult to communicate and administer.

Policy Gaps.

Partnership agreements often don't dovetail with insurance contracts, creating inefficient and potentially costly gaps. For example, some firms' partnership agreements include disability buy-out provisions, but pay little or no attention to corresponding and appropriate insurance solutions.

Partners expect things to be "taken care of."

Partners usually don't read insurance or benefit-related communications, but expect that things be "taken care of," creating a gap between the reality of insurance coverage and the expectations of the firm's owners.

Benefit administrators can be intimidated by partners, and poor internal communication from a disabled partner frequently leads to delayed initial claim reporting, which can result in a firm's funding compensation that might otherwise be payable by the LTD underwriter.

Most disability policies don't address the loss of retirement plan funding.

When a partner is totally disabled, retirement funding abilities are severely compromised. Most disability policies cease benefit payments at age 65, creating a significant potential income shortfall.

Losing a "rain maker" to a disability.

Many firms have done a good job protecting themselves from the financial impact of the death of a rain making partner, but few have adequately protected against the same exposure posed by disability, when in fact, disability is the greater risk. As shown in **Exhibit 2**, people age 37 to 52 are two to three times more likely to become disabled for more than three months than they are to die *(Source: National Association of Insurance Commissioners; CSO Mortality Table, Society of Actuaries, 1980).*

Solutions

The answer to LTD under-insurance exposure is not always a single solution, but often a carefully mapped combination of strategies that meet the best interests of the partners and the firm. The right solution for a particular firm will be based on their unique fact pattern. The skill and knowledge of the professionals who survey the insurance marketplace on the firm's behalf will strongly influence the strategy and outcome.

Following are a number of process-oriented steps that can lead to more effective and thorough solutions:

Leverage other insurance purchases to obtain the most favorable costs and terms for LTD.

Experience has shown that insurers are more interested and competitive when group life insurance is integrated with the purchase of disability insurance. An added benefit is that an integrated insurance purchase may help persuade the carrier to allow the filing of an LTD claim to satisfy the "waiver of premium" notification under the group life plan (a waiver of premium provision states that the policy is to continue in force without the need to pay the premium under certain conditions, such as disability). Automatic notification relieves the employer of a significant potential administration-related liability.

Maximize group LTD coverage before looking to individual LTD products as supplements.

Group LTD has three significant advantages over individual LTD:

1. Group LTD is generally about half the cost per $1000 of coverage when compared to individual LTD coverage (see **Exhibit 3**).
2. Group LTD is easier to implement because the coverage is generally "guaranteed issue" (no medical evidence) and there are no applications for each insured to complete.
3. Group LTD is purchased as a percentage of covered compensation, making it easier to administer on a monthly basis and to communicate to a large number of insureds.

   Individual LTD does have certain advantages (see **Exhibit 4**), but it should play a complementary as opposed to a core role in developing an LTD insurance strategy.

Individual LTD has a role when utilized appropriately.

Individual LTD can play an important part in a firm's overall income replacement strategy. The primary advantages of individual LTD are that it can't be cancelled; premiums are fixed at the

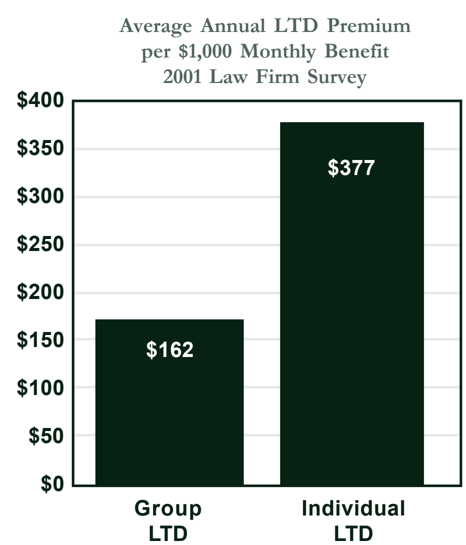

Exhibit 3

Exhibit 4

Key Differences Between Group and Individual Disability Insurance

	Group LTD	*Individual LTD*
Benefit Amount	Percentage of pre-disability income (usually 50-60%), up to a stated monthly dollar maximum. Coverage amount changes as income changes.	Monthly flat dollar benefit that doesn't automatically increase or decrease with changes in income.
Covered Compensation	As defined in the policy. Usually some measure of earned income. Often tied to K-1 income for partnerships.	Only applicable at the time of contract issuance in order for the policyholder to qualify for the coverage amount. Insurers generally won't issue an individual policy if it would cause the person's total disability protection from all sources to exceed 70%.
Definition of Disability	Can vary by job classification. Alternatives include: · Own occupation for 24-60 months · Own occupation to age 65 · Own occupation in the specialty of law.	Usually "own occupation to age 65."
Duration of Benefits	Generally to age 65	Generally to age 65
Premium Rates	Subject to change on annual, bi-annual or tri-annual basis as negotiated with the insurer.	Premium rates are generally locked in at the policyholder's age at the time of issue.
Benefit Consistency	The insurer has the right to increase or decrease premium rates and plan provisions at stipulated intervals (usually policy anniversary). In practice, insurers rarely mandate a reduction in the amount of coverage available.	Benefits cannot be reduced.
Mental Nervous Benefits	Usually restricted to 24 months	Payable to age 65.
Offsets	Benefits are reduced by income form other sources.	Benefits are generally not reduced by income from other sources.
Experience Rating	Claim experience can impact premium rates, depending on the size of the overall group.	The claim experience of one policyholder does not impact the premium rates paid by others.
Cost	Premiums average 50% of Individual LTD premiums.	Premiums vary by age. On average premiums are double the costs of coverage for group LTD.
Portability	Generally not portable at termination of "employment." Some carriers permit conversion of a small portion of the insured benefit.	Portable at termination.
Enrollment	Usually requires no enrollment form.	Requires enrollment forms be completed by each prospective insured at time of issuance. Subsequent amendments also require policyholder signatures.
Medical Underwriting	Usually requires no proof of insurability, although pre-existing condition limitations usually apply.	Some amount of guaranteed issue may be available, with higher dollar amounts requiring medical and earned income insurability.
Retirement Funding	No special benefit to fund loss of retiree contributions.	Some carriers offer special riders that will fund an annuity or other investment vehicle to make up for lost contributions to a retirement account.
Long Term Care	No benefit.	Some policies have riders that increase payable benefits in the event the disabled meets criteria for loss of activities of daily living. Some policies permit the policyholder to convert the LTD benefit to LTCI at a specified age.

policyholder's entry age; contract provisions tend to be more liberal; and it is portable. The combination of these factors makes it easier for a law firm to hit income protection targets. Coverage for the majority of the firm's population can be accommodated by a standard group insurance policy, readily available from a large number of insurers, while the higher dollar amount benefits for highly compensated partners can be obtained through individual policies.

Explore Long Term Care Insurance to increase overall income protection.

Long Term Care Insurance (LTCI) can be used to supplement group and individual disability insurance as a means of increasing a partner's overall income replacement. While it is more difficult to qualify for LTCI benefits (the insured must provide evidence of "loss of activities of daily living" versus "loss of income"), LTCI is significantly lower in cost than disability insurance and will fill the same need in the event of a catastrophic disability. As an added benefit, a partner can continue an LTCI policy after retirement from the firm, providing a valuable portable benefit as compared to a disability policy, which has little or no value in retirement. Recently, certain individual disability providers have developed products that a partner can convert from LTD to LTCI after age 60.

Concede insurance provisions in exchange for more favorable costs and terms.

A classic example of an insurance provision that is not likely to be of value to the firm is a definition of disability that specifies "own specialty in the practice of law." This is the most favorable definition for the insured partner because it gives the insurer the least leeway to deny or cut back a benefit. For this reason, however, it is also an expensive provision. It may be appropriate to recommend that firms with little or no litigation practice avoid or concede this provision as it is of little practical value to the partner relative to a more general "own occupation" definition of disability.

Be aggressive with early claim reporting.

A back injury is a classic example of a situation where a partner tries to work through a disability, only to find that after a year of 50% billings their health condition isn't improving. They and the firm then decide to file a disability claim, attempting to recover back wages paid by the firm at 100% of target pay.

This creates two real dilemmas for the firm. First, most insurance contracts require a claim be filed within 90 days of claim onset. While a carrier may waive this notification provision if prodded, the carrier is often disadvantaged (and understandably so) in attempting to make a reasonable assessment of the partner's physical condition one year earlier. Second, even if the carrier is willing to approve the disability retroactively, the partner will have trouble proving the loss of income because the past year's pay stubs don't show any reduction in pay while they were "disabled."

Firms that continue a partner's income beyond the elimination period of a disability insurance contract should do so with a written understanding that the payment is a loan which must be repaid to the firm, and such payment is not contingent upon approval for disability benefits.

Review the firm's partnership agreement for any disability-related provisions.

It's not uncommon for firms, particularly well-established ones, to have partnership agreements that include specific disability-related provisions. These provisions could be tied to capital re-purchase, accounts receivables, or special considerations surrounding key person disability insurance for rainmakers. Money and time can be saved if these provisions are reviewed as part of an overall assessment of disability-related needs.

Retirement funding can continue through a disability.

Some insurers can provide supplemental disability benefits to continue contributions to qualified retirement plans. The organizational structure of the law firm and its retirement plans will dictate whether the firm's partners are eligible for this type of coverage.

Two uses for key person coverage

Key person disability coverage can be expensive and, as such, is usually restricted to no more than a dozen key partners. Key person proceeds are generally tax-free to the firm and can be used to help the firm meet expenses as it works to replace lost revenues and/or to address potentially expensive buy/sell provisions.

Develop a partner communication campaign.

A short and simple personalized communication campaign will go a long way towards educating partners about how much LTD coverage they have –and how much they don't have. This is an important step toward avoiding conflict at the onset of a claim.

Communication pieces can educate partners in more detail about their firm-provided disability benefits and can direct them to third party advisors qualified to assist them with additional insurance should they require it.

Summary

At first glance, disability insurance appears to be a simple insurance purchase with few variables. In practice, it is a complex purchase that should be part of an overall income continuation strategy. LTD plans in particular have many "moving parts" and present significant financial risk to the partner and the firm if not properly designed, purchased, communicated and administered.

A relatively low claim frequency leads many firms to turn a blind eye to a thorough review of disability options, hoping both that a large claim never occurs and that in-force contracts will be adequate. Diligent planning and effective insurance procurement are critical to effective disability management for partners.

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