

## HIDDEN BUSINESS ASSETS GET M&A DEALS DONE

By Rhona Sacks, JD, MBA, CLU

When deciding to sell a company and retire, a business owner's primary goal is to extract maximum value from the company he or she has worked hard to build. Unfortunately, too many exiting entrepreneurs (and their M&A advisors) fail to recognize the enormous value hidden within one of their most overlooked and underutilized business assets.

*“No gain is so certain as that which proceeds from the economical use of what you already have.”*

~Latin Proverb~

### Increasing Competition

Due to the aging of the baby boomers, we are at the precipice of the largest business transition in history, with millions of entrepreneurs seeking to monetize business equity for maximum value. Deloitte & Touche recently reported that, “71% of small and mid-sized enterprise owners plan to exit their businesses within the next ten years.”<sup>1</sup> Because only 30% of family businesses survive to the second generation and just 15% survive to the third<sup>2</sup>, most companies are sold, and if a sale isn't possible—closed. With so many companies up for sale at the same time, the increasing competition to sell demands innovative asset leveraging strategies to capture optimum value as well as create more cash with which to expedite a sale.

### Hidden Business Assets

Throughout the business cycle, companies purchase numerous business life insurance policies for risk management, employee benefit and investment purposes. Examples include policies funding buy/sell agreements, key-person policies, split-dollar policies, policies securing business loans, policies funding retirement and employee benefit plans and estate liquidity and equalization policies. Traditionally considered inflexible assets with little liquidity, they have long been viewed as necessary yet unrecoverable expenses.

When a company is up for sale, some of these life contracts may become obsolete because the reasons for their purchase are no longer relevant. And after a company is sold, additional business life policies may outlive their usefulness.

Historically, exiting entrepreneurs faced limited disposition options when their changing needs rendered their business life policies unnecessary: allowing the policy to lapse, thereby forfeiting the value of all premiums paid or surrendering the policy to the original insurance carrier for its cash surrender value, an amount which doesn't reflect its true value.

There is another option. You can use an innovative asset optimization technique—a life settlement—to convert the hidden value in qualified business life insurance contracts to significant immediate cash, providing a much higher return on investment.

## **What is a life settlement?**

A life settlement is the sale of a life insurance policy to an institutional investor for a cash payment that is greater than the policy's cash surrender value. The platform for the life settlement industry was created in 1911 by virtue of *Grigsby v. Russell*<sup>3</sup>. In this seminal case, the US Supreme Court declared insurance policies to be personal property and freely assignable, thereby granting a policyholder the right to transfer ownership to others.

With a life settlement, when no longer needed term or cash value business life policies are sold for the highest quality institutional offer, the policy owner receives a lump-sum cash payment which can be used for any purpose, including facilitating the sale of a company for the desired price and on favorable terms.

## **An Entrepreneurial Tale**

Three business partners, ages 66, 68 and 70, were the principals of a successful company. To fund a cross-purchase buy/sell agreement, each partner owned two \$3,000,000 term policies (no cash surrender value) on the lives of the other partners. Seeking to sell their firm, these entrepreneurs received no offers that they felt were adequate for achieving their retirement and legacy goals. Unfortunately, their M&A advisors were unaware of the enormous value hidden within these business term policies, believing that they were worthless due to having -0- cash redemption value.

Instead of lapsing the policies and receiving no return on the premiums they had paid for many years, these three wise men sold their policies to institutional investors in the secondary life insurance market and received cash windfalls of approximately \$600,000 each.

By coordinating the sale of their company with the sale of their obsolete buy/sell policies, the owners were able to sell their company quickly at a reduced all-cash price because the life settlement proceeds provided the money they needed to fill the gap between their original selling price and the offers from buyers.

## **Life Settlement Basics**

Although life settlement viability is determined on a case-by-case basis, with all transactions subject to relevant legal requirements and underwriting authorization, the general purchasing parameters are: the insured is 65 or older, the policy's death benefit is \$250,000 or more, and the policy has been in force at least two years.

Unlike applying for life insurance, no medical exams or extensive interviews are required. The underwriting process involves only paperwork, such as a life insurance policy and an in-force ledger as well as medical records, which are necessary to verify the specifics of the policy owner's insurance and the insured's health. Furthermore, there are no appraisal, application or processing fees.

Large portfolios of life policies are purchased by institutional investors seeking predictable non-market correlated returns based on the future value of policy proceeds. In 2009, corporate money managers purchased \$11.8 billion in life settlements<sup>4</sup> -- more than double the amount of 2007 -- because they are increasingly interested in purchasing pools of life policies to diversify their portfolios into alternative investments.

### **End of a Monopsony**

Imagine a world where you were only permitted to sell your house back to the builder, your automobile back to the dealer and your stocks back to the issuing corporation. This is what a world without secondary markets would look like, and this is the world that life insurance policyholders have traditionally encountered.

Before the emergence of the secondary life insurance market in the late 1990s, the originating insurer was the only potential purchaser for expendable business life insurance contracts, thereby restricting policy disposition options to receiving an artificially low cash redemption value. Because the insurance companies set the re-purchase price, policy holders traditionally received little economic value from their superfluous life contracts, on average just 4% of the policy's face value<sup>5</sup>.

Fortunately, the life settlement industry has replaced this monopsony (an anti-competitive market situation in which a seller is only permitted to sell to one buyer) with a free market alternative wherein companies competitively bid to acquire the rights and obligations in dispensable business life policies. This vibrant marketplace enables policy owners to retrieve the fair market value from these otherwise illiquid business assets. With the average life settlement payout being 16% of the face value<sup>6</sup>, a life settlement can be an effective tool for liberating substantial liquidity hidden within a dormant business asset.

### **Caveats**

Although selling unnecessary business life policies in the secondary life insurance market can be profitable, navigating the labyrinthine life settlement marketplace can be challenging. The nascent life settlement industry, in general, lacks ample due diligence and transparency as well as knowledge of and services responsive to the unique needs of retiring entrepreneurs in the process of selling their companies.

Analyzing the expendability of business life policies, coordinating the sale of obsolete policies with the sale of a company, safeguarding privacy and securing the highest quality institutional offer demand specialized advisory skills in exit planning, business life insurance and life settlements. Working with an independent advisor who has expertise in these disciplines is the key to a successful, efficient transaction.

## Get the Deal Done

Every day, retiring business owners who reject purchasing offers for their firms unknowingly discard valuable capital assets by cash surrendering and lapsing their no longer needed business life policies. Selling these hidden business assets can be the answer to easily getting the deal done.

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Rhona Sacks is the founder and president of Legal Life Settlements, an M&A advisory company specializing in helping retiring business owners extract maximum value from their hidden business assets. Legal Life Settlements is the only firm in the life settlement industry exclusively dedicated to serving the unique needs of exiting entrepreneurs. For more information or to receive a copy of the article, “10 Tips for Optimizing Your Life,” please call (650) 477-2726 or visit [www.legallifesettlements.com](http://www.legallifesettlements.com).

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### Endnotes

1. *“Is Your Business Worth What You Think It Is?”* Deloitte & Touche LLP – Canada, 2006
2. Small Business Administration, 2003
3. 222 U.S. 149 (1911)
4. Life Insurance Settlement Association, 2009
5. *“Turn Unneeded Policies Into Cash: A Life Settlement Can Be A Better Alternative Than Surrendering A Policy,”* Journal of Accountancy, September 2005, James D. Warring
6. Advanced Settlements, 2009

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