

Human Capital Risks in SMEs & Trustee Considerations

Along with the growth of Family Trusts to hold family assets such as the home there has been a trend over recent years for the owners of private enterprises to transfer the ownership of their shares to a Family Trust as well.

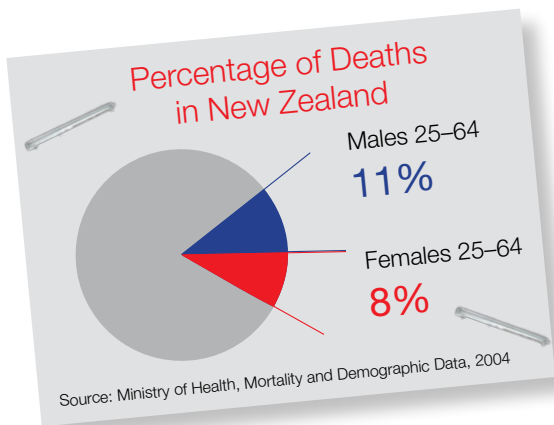
While a director has defined obligations under the Companies Act 1993 to protect creditors and shareholders, they do not have obligations to their future beneficiaries to protect the value of the business asset while the shares are held in their own name.

However, the transfer of the shares to a Trust enforces the Trustees to uphold a duty of care to ensure the protection of beneficiary interests and to protect Trust property against loss or the risk of loss.

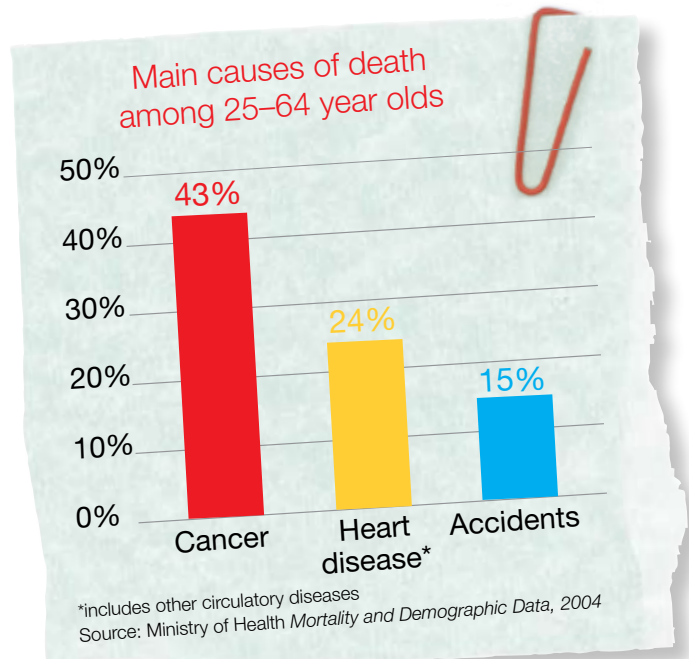
Small to medium businesses are typically dependent on the proprietors for profitability and solvency. The business proprietor and their family are also typically dependent on the business and the income it generates to maintain their personal lifestyle and to support their standard of living in retirement.

In 2003 ACC estimated that more than 1,800 businesses folded because of injury to an owner or a key staff member. 43% had been in business for more than 10 years and 41% of people whose businesses had closed due to injury were not currently working. The value that can be realised from the sale of the business assets under a fire sale is typically only one third of what the business owners believe the business is worth.

The statistical risks of premature death and disablement are substantially greater than the risk of other common threats to businesses such as fire and flood.



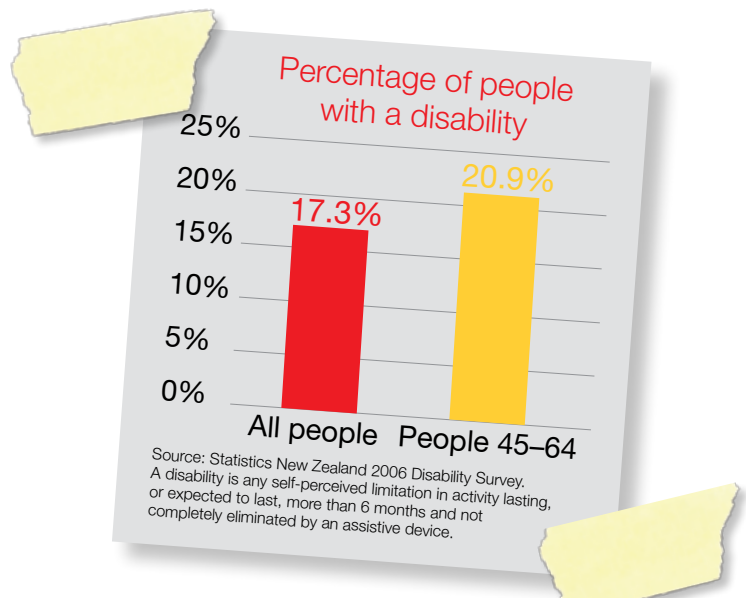
The combination of probability and effect make Human Capital Risk a substantial risk. Where the assets of a Trust include the shares of a small to medium business the Trustees should address the issue to minimise the risk of losses. Trustees should also ensure that they understand risks that are inherent in insurance products.



Over the coming editions of this newsletter we will address the specific issues to Trusts and Trustees:

- Business Ownership risks following the death or disablement of a proprietor
- Key Person risk and its potential impact on Trust Assets
- Business Liabilities and risk of default

In this edition we highlight some aspects of insurance that may create unintended risks for Trustees.



as life happens



Replacement of Existing Policies

The majority of insurance policies sold today are yearly renewable term contracts (YRT).

These policies have no cash values on cancellation and typically increase in premium each year as the life assured grows older. With mortality rates improving across both genders, the underlying market rate for life insurance has been decreasing almost annually.

As insurers do not generally apply rate reductions to existing policies, a policy taken out four years ago can be 10% to 20% more expensive than an equivalent sum assured today. Clients and Trustees can be easily convinced of the merits of replacing policies without being made aware of the potential risks.

Suicide Exclusions

All term life policies (other than accidental death only policies) include a standard suicide exclusion for the first 13 months from the date of commencement. Once the policy has been in force for 13 months the policy covers death by suicide (unless a specific exclusion has been signed by the policy owners accepting a permanent suicide clause).

When an existing policy is replaced with a new one, the standard suicide exclusion will reapply until the policy reaches the 13 month anniversary. Typically neither the Trustees nor the life assured are aware of this fact. If the insurance is in place to repay debts and the life assured took their own life within the excluded period, the Trustees may find they do not have the funds to repay the debts.

A competent insurance consultant can negotiate with an insurer to waive this exclusion where a new policy is replacing an existing one for the same sum assured.

Trustees should not allow existing policies to be replaced purely on the grounds of cost reduction without understanding the accrued benefits they may be losing. They should also seek the Adviser to negotiate for

the retention of benefits that may be material to a future claim.

Stand Down Periods – Trauma Insurance

Trauma insurance policies include an exclusion for claims arising from specified conditions which include Heart Attack, Stroke, and Cancer in the first three months of the policy from the date of commencement. Once this three month period has been reached then all conditions stated in the policy are covered.

Over recent years the range of benefits covered within a trauma contract have increased. Many of the added benefits are insignificant to the effectiveness of the policy but are justified to encourage a client to replace an existing trauma policy with another one.

When an existing Trauma policy is replaced the three month exclusion will reapply to the new contract. Where the client was protected against these risks on the previous contract they are now exposed under the new contract for that three month period.

Trustees should seek clarification as to the significance of the new benefits within the replacement contract and be satisfied that these outweigh the risks of the loss of continuous cover. They should also seek that the new insurer waive the three month exclusion period.

General Health Exclusions

It is common to see the general health of a client change as they grow older. Insurance policies issued some years ago were underwritten without exclusions as there were no material health issues to affect the risk profile of the client. Replacement policies may attract exclusions for specific conditions that were previously covered under the old contract.

Trustees must make enquiry as to the effect of any exclusions being applied

to replacement contracts. Sometimes a relatively small reduction in premium will not warrant the increased risk the Trustees may expose the Trust assets to.

Non-Disclosure

Under current New Zealand insurance law an insurer is entitled to avoid a claim and cancel a policy from its inception if they deem there is material non-disclosure. The test for materiality is based on what a prudent insurer would deem material to the underwriting of the contract. If the information undisclosed would have altered the way a prudent insurer would have assessed the risk then it is deemed material. The popular and misguided opinion is that information is only material if it relates to the actual condition which has given rise to a claim.

The insurer is not obliged to apply more lenient actions to non-disclosure which was inadvertent or not. Under New Zealand law if the policy is older than five years the insurer must prove that the non-disclosure was intentional and material - a much harder test than for any policy less than three years old.

As many of you will know, insurance application forms are lengthy and complicated.

Our ability to recall a long history of health and health treatments is often poor. It is easy for a client to forget health conditions that had previously been disclosed when completing new applications and typically they do not have access to copies of past application forms.

Non-disclosure therefore becomes an increasing risk each time a policy is replaced. Trustees must ensure that full disclosure of health conditions has been obtained before signing ownership of replacement policies to minimise the risk of avoidance of a claim due to non-disclosure. This is especially important where the policy being replaced is five years or older.

Source: Triplejump Limited. ACC New Zealand

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