When Attorneys Need Overhead Expense Insurance Coverage

Overhead Expense insurance is a disability policy that pays the **fixed overhead** of the insured's business during periods of disability. The first question that needs to be answered is **do you need it?**

Law is a fee for service business. So, whether you are self employed or work in a small firm, if you are not there to see clients, once your accounts receivables run out**, all revenue to the firm stops**.

In a large firm other partners or associates may be able to replace the lost revenue of a disabled partner by seeing his/her clients and performing the fee generating services. This doesn't work for self-employed attorneys or small firms. So, the question you need to ask yourself is … **How is office overhead paid once accounts receivables stop or are reduced to an insignificant amount**?

There are 4 solutions to this problem … the disabled attorney pays expenses out of savings, in a multi-attorney firm the working partners pay the salary and expenses of a disabled partner, a replacement attorney or associate is hired to do the work, or Overhead Expense Insurance pays the expenses.

USING YOUR SAVINGS

Using your personal savings is the **most expensive way** to pay business expenses. In order to save $1, you have to gross $4 of business revenue. Assuming your overhead is 50% of collections, you pay $2 of your $4 for overhead. The remaining $2 is income taxable, which leaves you with $1, after taxes, to put in savings. **The last place you want take money from to pay business expenses is your personal savings**!

SMALL MULTI-ATTORNEY FIRM

In a multi-attorney firm, the working attorneys would have to generate enough revenue to pay the disabled attorney's share of overhead PLUS any salary paid to the disabled attorney, after accounts receivables run out. In large firms with lots of associates and/or with more than one attorney in each area of specialization, this is not a problem. The workload is given to an associate or other partners take it over. However, in a small firm this may not be possible.

Example: In a firm with four attorneys **producing equally**, if one attorney becomes disabled, the three working attorneys would each have to **increase their production by 33%,** to replace 100% of the disabled attorney's revenues. In most firms, this is not possible, as all the attorneys are already seeing as many clients as they can. Furthermore, if the disabled attorney has a specific specialty in law that the working partners can't duplicate, those clients will be lost.

COMPENSATION FORMULAS AND SALARY CONTINUATION AGREEMENTS

If an attorney is totally disabled, the firm compensation formula and salary continuation agreement determine if the working attorneys are responsible for covering the disabled attorney's share of expenses and how much salary/income, if any, continues to be paid to the disabled attorney. There are many different types of compensation formulas and salary continuation agreements. We will highlight a couple of the most common below and describe the impact on the firm during the disability of a partner.

Compensation Formulas

- If profits are split evenly or there is a base salary and excess profits are split evenly, **everyone takes a reduction in income if the firm's gross revenues go down.** So, if the working attorneys don't want to take a cut in pay because a partner has become disabled, they have to produce enough extra revenue to cover the disabled attorney's share of overhead and his/her salary, as long as it is continued.
- If income is **production based** (each attorney is paid based on what he/she **bills**), then the working attorneys only have to cover the disabled attorney's share of overhead during a disability. When billings stop, the attorney's income stops.
- If income is **production based** (each attorney is paid based on what he/she **collects**), then the working attorneys only have to cover the disabled attorney's share of overhead, after accounts receivables have fallen to a level that is insufficient to pay the disabled attorney's share of expenses.
- If income is a **combination** of base salary with a bonus based on production, the working partners have to pay the disabled partner's base salary and share of expenses once accounts receivables run out.

Salary Continuation Agreements

Salary continuation agreements can either be an **extension** of the compensation agreement or they can **alter** the compensation agreement, during periods of disability.

If the salary continuation agreement **extends** the compensation agreement, then the risk to the working attorneys is as described above.

If the salary continuation agreement **alters** the compensation agreement, it generally **increases the risk to the working partners**.

Example: Most salary continuation agreements we see continue the salary payments or the "average monthly income prior to disability," of the disabled partner, for 180 days to 365 days. *So, the working partners are not only responsible for paying the disabled attorney's share of overhead but they may also have to continue paying monthly income as well*.

When discussing these cash flow issues with attorneys in small firms, we frequently hear, "we manage when someone is on vacation. Why would it be any different if one of us was disabled?" Covering each other's vacation time works because **all the attorneys take vacation time**. So, it evens out over the course of the year. Furthermore, most vacations only last a week or two at a time. It is a very different situation if one attorney is gone for 90 days or longer.

Hiring a Replacement Attorney

Finding a replacement attorney who does competent work, gets along with the other partners and is willing to step down if the disabled partner recovers, may prove to be an impossible task. Even if you are successful, it still doesn't solve the problem. If the firm has a salary continuation agreement that allows for the continued payment of the disabled partner's salary, the replacement attorney must produce enough revenue to cover his/her salary, the disabled partner's share of the overhead and the disabled partner's salary. Since this is incredibly unlikely, the working partners would have to pay the shortfall out of their production, reducing their incomes.

Overhead Expense Insurance (OE)

OE is a very inexpensive solution to the problem of how to pay fixed overhead. In the case of a self-employed attorney, it allows you to keep staff working and to pay your medical insurance premiums, rent, loan payments, and other fixed expenses. **If you recover and return to work full or part-time**, the best policies pay the difference between what you collect and your fixed overhead, while you are rebuilding your cash flow.

If you work in a firm, OE provides the firm with cash to pay the fixed expenses of the disabled partner. If the firm salary continuation agreement calls for continued salary payments to a disabled attorney beyond the period that accounts receivables are collected, the working partners have to cover this expense out of their production.

OE premiums are **income tax deductible**, even if you are a sole proprietor, partnership or Sub-S Corporation. The premiums are also very inexpensive, because of the short benefit period (typically 12, 18 or 24 months).

OE is an **expense reimbursement** product. The insured must incur the expense in order for the policy to pay the benefit. So, if you sell your practice or are a partner and are bought out and no longer incurring covered expenses, **the benefits stop**. This is why most OE policies are issued with short benefit periods, 12 to 24 months. The disabled attorney will have to sell his/her practice (if self employed) or will be bought out (if in a partnership) within this time frame. This is a very good thing to remember if you are drafting the buy-sell documents for professional and business owner clients.

For personalized premium quotes for Disability Income, Overhead Expense, or DI Retirement Security and a complete summary of the program offering (including the actual policy definitions, details of the MGI qualification requirements and underwriting rules), return to the home page and click on the **Request a Quote** button or call Disability Specialists, Inc. (DSI) at (888) 279-8348 (7:00 am – 4:00 pm Mountain Time). Just identify yourself as an association member when you call and you will be given information on the programs in which you are interested.