Is Practice Pay-Out Insurance Necessary?

Many dermatology groups indiscriminately follow the advice of insurance agents and buy life and/or disability buy-out insurance on each group member to provide proceeds for the pay-out of group members. While somewhat emotionally comforting to know that the departure of a group member will result in little or no cash outlay by the group because of the insurance, this approach is both expensive and illogical.

The Insurance Fallacy

Take an oversimplified example of two dermatologist-shareholders of a professional corporation in which the only asset is $400,000 of accounts receivable -- the product of the two doctors' own work. If they cause the corporation to buy $200,000 of life insurance on each of them so there will be funds to buy either member out upon death, it looks on the surface as though for a nominal premium, each member will be treated properly.

However this is not as logical as it may seem. As a result of each doctor having "paid" for his own insurance premiums --by having forsaken the income used by the professional corporation to pay both premiums -- his beneficiary would receive $200,000 upon his death. This shortchanges the deceased member since he had both "paid" for the $200,000 of insurance and also worked hard enough to realize $200,000 on the accounts receivable. The life insurance would, in effect, have obscured the true economic worth of his practice.

The doctors would be better served simply personally buying their own insurance policies with no connection to their professional corporation or to their pay-out arrangements. In such case, upon a doctor's death, his beneficiary would receive *both* the $200,000 life insurance proceeds *and* the $200,000 accounts receivable pay-out.

The same objection applies to disability buy-out insurance. While the industry has created a special "buy-out disability policy," it tends to be even more expensive than life insurance and thus is not often used.

Set the Pay-out First

Insurance is often proposed to fund a pay-out for a departing doctor using the argument that the ongoing practice may need the funds in order to afford the pay-out obligation. If, however, the pay-out is more or less the same regardless of why a departing doctor leaves the group (as we suggest), then life insurance is useful in only one of the many ways a doctor might leave a group and thus be entitled to a pay-out. A $200,000 life or disability buy-out insurance policy will not do much good in paying out a doctor who retires or chooses to withdraw and move out of town.

Arrangements for paying out a group member must, of course, be affordable and appropriate within the ongoing group's likely finances regardless of any insurance protection. The group members should look to the group and its actual financial attributes and values in deciding on a fair pay-out arrangement. If that is done, then the insurance should not be a necessary factor in structuring the group's pay-out arrangements.

"Key Person Insurance"

Despite this overriding and sensible guiding principle, some doctors still prefer obtaining insurance, particularly on the life of a key member, and often depending on their own risk adversity. If a key member's drawing power is so great, and if the other doctors are unsure they can actually retain the group's volume in case of that key member's death, then insurance may be justified. The group usually purchases the insurance, and the premiums are charged to the other doctors, since the purpose of such insurance is to provide them with a special element of protection.

This is known as "key person insurance." Such key person life and/or disability buy-out insurance may also be useful to a group fearing an inability to cope financially with a sudden, catastrophic loss of any member. Instead of being able to plan for replacement of the departed member, so cash flow can be kept smooth, a sudden death may render the ongoing doctors unable to meet patient care demands; and this may continue for months until the necessary replacement doctor can be recruited and hired. As above, key person insurance to cover this risk should be payable to the corporation and not be part of any pay-out arrangement. Its role is to protect the group from the impact of the sudden loss of any key (productive) group member, and not to fund a pay-out.

Summary

Life and/or disability buy-out insurance has an important place in protecting a group from the unexpected need to pay-out a member of the group. However, a group's pay-out needs to be fair and appropriate in all events regardless of the circumstances of a doctor's pay-out. The pay-out should be established first without regard to insurance. Only then should the group decide whether insurance would be desirable for protection's sake.