The "S" Storm

Will Your Sub-Chapter "S" Corp Weather the Perfect Storm of 2009?

By
Dan Romain

If you believe; "No one saw the financial crisis coming," then you probably won't believe what's coming next.

Imagine for a moment, it's the last week of December. The air is brisk, in stark contrast to the Holiday retail-sales reports. Your gifts have been un-wrapped and your 1-1 renewals are all but wrapped-up. That quick trip to the mall this morning just solved the whole sweater-vest tragedy and now you have some cash for lunch.

Predictably, most of your Producers have headed to the slopes or the beaches with their families where you plan to be just after this morning's yearend Board meeting with your CFO (Controller, bookkeeper, whatever). It's distribution time at the ol' "S" Corp (see appendix). It's a time where the annual migration of cash flocks from the agency's nest-egg to your stockholders ' W-2's in advance of the K-1's to follow. The mood is festive and your partners are anxious to hear the news.

"OK Bob, let's get this started," you nod to your accountant who is poised behind neatly organized stacks of reports and spreadsheets. "What do we have?"

Your CFO's hesitation catches your eye. He clears his throat, adjusts his glasses and leans into the conversation nervously. He leads-off with an 11/30 P&L update and a projected 12/31 close. The numbers sound good in contrast to his dour tone. Your partners seem pleased, but his pensive mannerism begs your attention.

"What's eating you Bob? The numbers look pretty good, but you don't seem to be very upbeat. Did Jenny run your credit card up again this Christmas?" you pry, hoping to loosen his mood.

"Well" he begins "we have a bit of a problem…"

"We?" one of your partners injects. "*Oui*" "*Oui*" another partner feigns in a French accent poking fun at the notion that they could possibly have a problem.

"I'm afraid so" your CFO sighs. "We" as in each one of you…"

The looks from the Board stiffen as they often do when driver-expressives outnumber analytic-introverted accounting types.

Bob goes-on to recap a conversation he had with the P&C manager yesterday wherein the profit-sharing projections from the Marketing Reps don't look so good and it's not the usual IBNR *razzmatazz*. The infusion of first-quarter contingency cash has helped the firm's cash-flow, the required distributions to stockholders. Bob has had to revise his Statement of Cash-flow projections and it's going to be tight.

"How much of a shortfall?" you ask. "Can we borrow it from our working line?"

Bob nods a reassuring "yes" and goes on. "The problem isn't so much this year." He replies. "We didn't touch our line of credit at all this year. The Producers did a great job with receivables, we held-on to our accounts and the new business helped offset the overall premium reductions, so we didn't need to tap the line. The problem is that the Bank sent a notice that they are going to pull our line without personal guarantees from each one of you and I know how that discussion goes. So, we should probably draw-down as much as possible this week before the rules change, pay the distributions…but we gotta pay the Bank back and that's where the contingent income shortfall hammers us. It also costs us $6,000 a month to carry the debt".

Bob becomes the target of disapproving stares and accusing tones. Each member takes a turn expressing surprise and anger with Bob's lack of planning. As the CEO, you're not pleased to hear about this in a group setting either, blindsided by facts. Still, you've been thru this before and you regain the room's composure.

"OK, OK…let's not panic here," you advise. "Bob couldn't see this coming. It's not his fault. How much can we get Bob if we refuse to sign those personal guarantees?" you ask.

Bob looks down at his shoes.

"That much?" you sigh slumping into your chair. "Did you talk to Sandy over there?" "She's got to have some flexibility I would think".

"I thought so too," Bob says with a dead-end shrug.

Honing the edge of the dilemma now facing the Board, Bob goes on.

"We can't flip-flop from "S" to "C" so everyone must sign the GIA's for equal consideration and enforceability. They won't take out the joint-and-severable language either. This being a community property state, Frank over here will have to get his wife to sign-off and we've been down that whole family-trust road before. That's why the Bank only gave us a $500,000 line last year. Say the word and I can pull from the operating account enough to cover your taxes until the profit-sharing money comes-in and we will probably squeak by, but that means we have no reserves for June and July which are low cash months and I just don't see any way we can cash-flow payroll those months without at least as much line as we have now."

"OK Bob, why don't we max-out the line now, pigeon-hole the half-million and use it this summer when we need it?" one of your partners asks.

"I can do that, but that means by April 15th each one of you will need to come-up with $75,000 to pay the Federal and State tax! It also means we'll eat-up $50,000 in interest expense. All of that is probably doable, but that creates a perfect storm for next yearend doesn't it? What if commissions drop 5%? What if we have another down year in contingencies? I've re-run the Trust Account three times this morning and there are no commissions still in there. It's all premiums."

The rancor resumes giving passers-by every impression that a Knick's game has broken-out behind the fogged board-room glass.

In the end, the Board agrees to distribute enough to the younger stockholders to cash-flow their stock payments so that roughly 60% of that distribution comes-back in the form of paid-in capital. It directs Bob to distribute enough to all stockholders to help cover their individual tax obligations on the corporate earnings and suspend Board member book true-ups and any management bonus pending March 21st, when contingency checks must be issued.

Later, when the P&C Manager learns that the Board wants him to approach Carriers for bridge-loans; he takes those marching orders and marches into your office and respectfully laughs. He's not even going to ask the carriers until there's a melt-down, because the rumor-mill would destroy his upbeat pitch with those carriers and it would probably get back to the employees. "It's better to start laying-off a few nonessential types now," he offered. "Besides, if this is happening to us it's happening to other agencies, so let them start things-off…better for us if we follow rather than lead".

"Why don't we move that Calamity Casualty book?" you ask. "That's got to help our contingencies with Partner's Indemnity, doesn't it?"

"It would but…" your P&C manager agrees "…our pick-up rate will be…"

"Our what?" you interrupt.

"Our pick-up rate…our retention on those accounts…typically we lose 10% to 12% on a book-roll, because the folks don't want to move or can't because of activity or the guy down the street takes it on BOR. Besides, when you push renewals onto another carrier the revenue lags 60 days so we'd actually see less revenue and less cash unless you have some way of getting the carrier to annualize commissions?"

"Come 'on." you concede. "I managed to free-up some cash for lunch this morning.
I'm buying…" you offer, knowing full-well there will be very little "lunch" involved in this particular lunch.

Now, some of you Superman "S" types are saying, "This could *never* happen to us!"

Really?

If you're an "S" Corp, you don't have a choking balance sheet with liquid assets at the ready (unless you're a near-fully funded ESOP). Personally, you may (probably do) have a healthy net-worth which you may be willing to sacrifice on the Joint-and - Severable altar for the good of the Corp. OK, great. Just one catch. Banks will say "no" unless every Board member signs. (Case law nullifying indemnity agreements because consideration of your partner's assets was on your mind when you signed and he later declined to sign.) Who gets to tell Frank he's been tossed off the Board? Better still, who gets to tell the younger stockholders why?

Even if Frank can get his wife to sign…these guys just had a banner year and in a matter of days they've leveraged their lives' work to borrow to pay bonuses to cover taxes! Moreover, I'm not entirely sure there's much commercial paper out there right now. I guess you can forget the bank and personally loan to the Agency or issue dilutive shares for cash, but isn't that a scene out of Monty Python with the no-arms no-legs guy defending the bridge?

Trust me! It's going to happen to a beloved competitor near you in 2009!

A few years ago, the Big-Four accounting firms (when there were four) had to break up the close ties between their consultancy work and the auditing functions. As a result, even "Bob from Accountemps" will model a Statement of Cash-Flows. That's the statement 95 out of 100 agency leaders never get on a regular basis and a majority never have. If Bob's report shows a narrowing cash cushion, then the fourth paragraph on the CPA's cover letter to your financial statement will read, "…and we have expressed to management our doubts that adequate cash-flows will sustain operations".

The Bank ought to love reading that!

Still not convinced?

Well, I've always said it's a cash-flow business. Most are. That, by the way, defines the financial crisis small business is now in. Let's assume your operations fund the agency with some cash-flow to spare and that contingent income is just "gravy" which you pour onto such things as funding internal perpetuation, client resources, gold-standard benefits for staff and a mere pittance for the Board. So, in order for the perfect storm to hit here's what you'd have to see on the financial Doppler radar:

- Towers Perrin reports the P&C industry lost $42 billion or 8% of total surplus in Q3 2008 and is projected to lose even more in the current quarter. $80 billion or 15% of total surplus over 180-days is equivalent to $445 million every 24 hours. I tried to find that metric in the AM BEST guide, you know…the one where $310,000 of

surplus disappears from the industry's collective balance sheet every minute, but I couldn't find it. Whatever. If BEST isn't panicking why should we? It's not like an A++12 can go to a B++ overnight… (You may want to read that last sentence again.)

- In a recently sponsored *Insurance Journal* study involving more than 1000 independent agencies across all categories, the number one fear they have is the loss or reduction of contingent income. (It's always something with these guys!)

- Bermuda and European capital goes "Poof". Reinsurance Treaties go north on 1/1. Casualty rates stop a two-plus year free fall and rate firmness appears on the horizon giving hope that revenues will stop declining. But, base rates are multiplied by exposures, not hope. Payroll, sales, values…you name it are all down significantly. So capital will target short-tail business, 365-day risks such as coastal property, standard property, national accounts property, HPR exposures, quake, (probably not flood) crime, auto, intermediate trucking, wet marine, etc. as insurers place the same bet of 2007 when the storms didn't occur. The upward pressure on long-tail casualty rates is mitigated by these short-tail bets in other lines. The combination may offset overall rate surge. If it works, 2010 will go softer again. If it doesn't, church gets a little crowded on Sundays.

- With residential construction all but dead, the OCIP/CCIP capital attempts to replace market share in the more resilient commercial construction marketplace that has shown signs of continued life, at least thru Q2 2009. Rate competition, in this more profitable sector, will suppress hardening inclinations.

- Economic downturns bring higher frequency of Work Comp claims. Dwelling and multi-family habitational loss ratios rise. So do personal and commercial auto; in both frequency and severity. That "may" be relevant come profit-sharing calculation time. It's not uncommon to see Earned Premium exceed Written in times like this. That can't be good come contingency season.

- Construction sector (15% of Independent Agency revenue by some estimates, a lot more by others) is on the down-low. Sureties are pulling their support on deteriorating contractor balance sheets, re-evaluating assets (equipment is 30% less in past 18 months) and increasing indemnification requirements while the invisible hand of the marketplace drives-down project margins to a nub. Public Work looks better but with budget deficits at the state and county level it's tough to think the 2008 record-setting bankruptcy filings for contractors won't be broken in 2009. (By Memorial Day, a trade journal predicts)

- Bad-debt write-offs hammer the agency when clients go under; walk away or simply can't pay. There are no more rolling-OCIPs which is nice in a "receivable" sort of way, but how so for "paid when paid" Prime and subcontractors who aren't actually getting paid from cities and states where the delay is now up to 110-days on accepted progress payments! (I can send you the articles.)

- The world's largest and most pervasive insurance carrier goes under, but-for an unsustainable deal struck with the US government (Don't you think Jefferson would have just loved that!) On the side-lines "Hank" himself says the terms are too steep and in less than 27 days the Treasury agrees and re-writes the deal…and another check. "Fire Sale" is used to describe profitable AIG subordinate companies that *YOU* now own! Liberty is downgraded. Hartford's stock plummets after comments on the Senate floor paving the way for Alliance (F. Fund's alter-ego) to foretell of ever-more carrier consolidation. Just the same' ol same' ol… I guess.

- Community Banks have all but divorced from their relationship lending practices, so a 90-day signature note or a "phone call" can't solve problems like before.

- Interest income from trust and sweep-operating accounts is trending towards zero. Money market assets and other agency equities have been cut 37% since the Super Bowl. And good luck refinancing the building you and your partners lease-back to the agency (bank wants an appraisal this time).

- It just seems like…well…this summer you were still getting one call a week from eager Agency Buyers. Then "poof" they stop calling? Isn't that odd?

- Carrier's premium financing has taken a bit of a turn in the past few months. They're actually refusing to reinstate late pays without confirming financials which, let's face it; you really don't want them to see. Mr. Patience, your largest Producer was just looking for you to approve an advance to a victimized client he had to re-write for just that very thing.

- Customer RP's (Return Premium Audits) results in a steady flow of commission take-down adjustments for commissions already booked and spent. Everybody is talking about converting to "fees" all the sudden. (That's odd too isn't it?)

- You got the strangest e-mail from your E&O carrier the other day about carrier insolvency coverage.

- "…so you see Mr. Big" your CPA continues "with the new income tax rates and the new cap-gains rates and the new corporate tax rates and the new FICA load and the new Health Benefit assessment and the new Alternative Minimum and the loss of SSI thresholds and the increases in, well…you get the point…multiplied by your 7 other

owners it looks like you're going to need this much, right here set aside by yearend to fund the…." (Loud thump)

And, if that wasn't enough…

- After betting a sizable amount on the Patriots to "win it all," Tom Brady goes out for the season!

Well, there's "possible" and then there's "probable". So allow me to upholster your imagination with the rich supple comfort we all find in numbers as you order another round of "lunch".

First, I'm talking to you…big or small, I'm talking to a fairly similar group in four important ways. Unless you're over $25mm in revenue:

1. The average age of the largest stockholder is in his/her mid-50s.
2. You operate, on average, at around 6.5% pre-tax without contingencies and the float. And that my friends "aren't all bad!"
3. For every dollar that hits the till, on average 10-cents comes from contingencies which comprises 65% of your "profit".
4. The majority of you are "S" corps.

Let's spend a moment on item #4.

Starting with the smallest of agencies and continuing the trend, the larger a firm becomes, the majority of retail Brokers elect the "S" taxation method. In fact, the bigger they are the more likely they are to be "S" corps (65% for firms between $10mm and $25mm) until they become so large ($25mm +) when they are almost 50% less likely to be "S" corps (drops to 32%). Why are those same +$25mm firms quite likely (40%) to involve ESOP's and other mechanisms to cash-flow perpetuation? The reason (whether those ESOP's are fully funded or not) is cashflow! Cash-flow is blood-flow. Nothing else matters.

- Firms between $5mm and $10mm average $7.2mm. They receive $612,000 (8.5%) on average from contingencies and are most likely "S" Corps.

- That same firm earns another $470k (6.5%) from day-to-day operations.

Let's apply those numbers to something useful. (Reality.)

What if operational margins fell from 6.5% to 3% and contingents fell from roughly 8.5% to 5%. That's not a stretch for 2009: Retention; fee competition; lower exposure units; re-marketing every account (you get the idea). Growth kickers baked into contingent formulae aren't triggered. It's plausible, perhaps even conservative and if true, the resulting tax on the $575k of pre-tax would be $207k. The gross-up of distributions to cover those taxes would

result in little to no cash left (maybe one more "lunch"). Still, the firm weathered the storm. But here's an even more conservative scenario that may surprise you. Not all cash flows equally.

If operating margins remained the same at 6.5% (nice job!), because the owners adjusted their expenses and fought-off the revenue loss with vigorous practices (or as some believe, rates harden significantly) but contingent income fell from 8.5% to 4% due to the inability to hit growth targets, rising loss ratios, IBNR's go up smidgen, the perennial UIM loss, and the wonks at the carriers who re-designed the formulas for 2009, then the resulting tax on that $756k of pre-tax would be $275k. However, there would only be $290k of ready cash from contingents.

That's half of what's needed to cover the shareholder's tax burden if the Corp intended to gross-up the distributions to cover the tax. The agency needs $466k of operational cash or Bob is going home with lumps on his head.

What a coincidence! That's exactly the amount of pre-tax the firm has which means it has the cash right? …WRONG!

Pre-tax on the Income Statement (P&L) doesn't mean you have that much cash available. You don't. In some cases there may be more, but chances are really good that you have less. Any A/R's out there? Do you agency-bill anything in November or December? Did you get paper (finance agreements) on a client and have yet to receive your commissions from the finance company? Holiday bonuses? Retired stockholder payments at yearend? A matching 401(k) contribution due soon? E&O premium? Annualized Club dues? Do you insure contractors? Is Employee Benefits revenue still dribbling in month-to-month after a 60 day lag? Are you like virtually everyone else with demands on your cash for 364-days prior to those 12/31 distributions (which we all know happen in January!)? You don't have that kind of cash lying around at the end of the year and operating profit didn't go down!

"Hey, Bob…is that your head in a vice? Come' on…lighten-up a little would ya? Let me take you to lunch!"

Besides, maybe your agency's last quarter was a high-cash period? There's *probably* enough cash.

Don't you just love words like "probably"? I never understood why the weasel wordsmiths who draft things like "Duty to Defend" or "Right to Settle" language don't just cut to the easier-to read version like: "We might" or "maybe we will". It would sure make that whole *Reservations of Rights* thingy easier to explain to a client! So come-on Bob! Relax! Everything will *probably* work out!

If operations stay just as profitable in 2009 as they are this year, but your contingencies drop because some octogenarian you insure piles into a church group, after the Carrier dropped the stop-loss provision, "maybe" you will have the cash…you might! And this is exactly where I

should end this, but for one itty-bitty point that seems *soooo unlikely!* (I can't believe I'm even bringing this up):

> *All of this cash-flow hand-wringing assumes that the current tax rates will stay the same! Who knows…maybe federal and state income taxes will go down!?*

OK…so before you head to the garage and hang yourself (or an effigy of me!) here's some advice from a guy who remains very-much an optimist. Really! I get that "Polly Anna" thing *all the time!*

Let's put this in terms we all understand: Managing the Risk. If you think there's a shred of possibility the whole "perfect storm" thingy could occur, you have two options in the short term (remembering that you can't cost-reduce yourself to long-term prosperity!):

1. Manage the Risk:

   a. Make a few holes in your agency's belt. Tackle operations, drive cash-flow and be honest about un-vetted producers, comatose partners, perks and pet projects that seemed affordable last year.
   b. Require a cash-flow forecast by month on a twelve month rolling basis from your accountant and don't let him/her go 30-days without updating it for you. Demand this report!
   c. Set producer draws at something around 85% of projected 2009 book and to prevent a cash-run at yearend, true-up around the half-way mark in a month that you are good on cash. Hold-back for accounts past-due 90-days at the time of true-up until collected. (You don't want the producer's money; you just want them to be on top of their receivables. In most cases, the CSR's know more [endorsement, audit, whatever] so meet with them as a team and be supportive. Reward your best teams too!)
   d. True-ups and bonuses can be paid in debt forgiveness (Careful…see "Debt Forgiveness in the appendix).
   e. True-ups and bonuses can be cashless grants or exchanges of stock where the recipient covers the imputed tax. If you need cash now, you can worry about dilution later!
   f. Stock offerings to worthy parties who can fund their own off-balance sheet debt service or make payments into treasury on regular intervals.
   g. There are some Carriers who won't laugh at you. It may not hurt to ask discretely.
   h. Draw your employees closer and engender their loyalty and appreciation. They read the papers and need to be reminded that they work for a proactive agency. That will go a long way and maybe silence the "we need more help" crowd for a while.
   i. Renegotiate contingency agreements to the best of your ability and model "guaranteed" lower percentages in exchange for guaranteed money at some

base level of production. (Again, for those of you who can. Contingencies are, after all, still called "unilateral" for a reason.)

j. Get collections in order if they're not!

k. Take a look at inching the minimum account size up ever so slightly without sending your Producers to Home Depot to buy pitch forks!

l. Typically Premium Finance contracts do not come with UCC filings and don't require nearly as much as the customer's bank does. Get serious about this aspect of your firm if you still offer this. And, don't be afraid to get 1% or more!

m. Don't be so certain some of your note-holders won't be willing to renegotiate to a few more years with a slight up-tick in interest. Maybe you offer them first position if you haven't given that away already? (Only contact the ones who will keep their mouths shut! Get a nondisclosure just to be safe!)

n. Approach capital sources: Carriers, Assurex, Intersure, and other trade connections. Their capacities may be limited or gone, but they may help you continue the search. Hales offers a capital provider sourcing service that could be just the ticket and is building-out a major funding source for just such a reason!

o. Loan cash to the corporation at market rates with stock as collateral in a first position. If several owners pitched-in, the amounts might not be burdensome. Defer a cash payment re-written as deferred comp or an open-loan with nominal interest and a balloon payment when you sell the place (next week!)

p. Banks aren't supposed to link all of your business…so do it for them! Consolidate for leverage!

q. I could go on, but I won't…unless you call of course.

2. Option Two: Transfer the Risk

-Call Broker's Path to help you interview an M&A firm to sell your Agency

Get advice.

Here's why.

Driving superior results next year will actually make your personal tax liability complements of the "S" Corp worse by increasing the corporation's pre-tax. It's all about cash-flow and the test in 2009 has been changed to "pass-fail".

Anyone can cut payroll and free-up cash in the short term. It takes a serious plan to increase your spread while growing the top line. We know how to do that and we can help.

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***Appendix:**

Loan Forgiveness:

Question: When is a loan not a loan?
Hint: (Think brother-n-law)
Answer: When borrower doesn't treat it like a loan!

The IRS will look to see if you set this up right from the beginning, no cocktail napkins please! If the agency is collecting interest or properly imputing it and you have been receiving payments (say annual stock payments for the past 5 years on a 7-year note) and the agency forgives some, part, or all of the balance you may be fine. (Warning! *"may"* is a weasel word! See your CPA!) I've seen it done up close and I've seen the IRS/CPA's nod their approval.

The advantage of (one time!) full or partial loan balance forgiveness is that you pay the Producer/Stockholder without using your precious cash. If it's a big number, you'll probably need to distribute some ordinary income (W-2 bonus) to help them cover the imputed tax.

Debt forgiveness affects your balance sheet, but really, who cares?! Most agency balance sheets are as stimulating as an Amish quilting-bee. It's not like you're going to be able to borrow on the strength of your balance sheet anyway! It's not an ideal situation, but it's an idea if you're in "a situation".

"S-Corp in English"

Don't you just hate it when articles start-off explaining things as nail-biting as the correlative characteristics of "S" corps before they get to the point? Well I do. Still, I thought it wouldn't hurt to offer-up the whole "S" Corp thing. I'll be mercifully brief, if not almost accurate.

A popular misconception is that "S" Corps are formed differently than "regular" corporations otherwise known as "C". They're not. Corporations are legal entities that can enter into contracts, convey property, be liable for sales outings that get out of hand and have the legal status of a citizen. They just can't fog a mirror. "C" and "S" are legally the same.

An "S" Corp is a tax election deemed copasetic by the IRS. It's merely an election on how the corporation will be taxed, or more correctly, not taxed.

"C" corps pay around 40% Fed tax on their profits which is why they run-off profit at yearend in the form of dividends and yearend bonuses. If they don't they are also subject to an accumulated earnings penalty if they squirrel-away more than $250,000 ($150,000 for personal service corps). In spinning-off the cash the recipient then pays something around 36% but we all know it's really closer to half.

"S" corps don't pay tax. They pass it onto the owners even if the owners didn't actually get the money. In an "S" Corp there is only one tax. It's paid by the owners.

For many agencies an "S" Corp was/is a no-brainier! Take a look at this before distributions:

	"C"	**"S"**
Pre-Tax	$1,000,000	$1,000,000
Tax @ 40%	$400,000	"Zippo"
Money available to distribute	$600,000	$1,000,000!!!!
Individual Tax Rates @ 36%	$216,000 (You pay too)	$360,000
Money left to spend	$384,000	$640,000

There are a few technicalities to be an "S" Corp. Most stockholders have to fog a mirror (be people), but not all of them (domestic trusts for example). There can't be more than 75 owners but, if you have more than 75 owners you're probably one of the big guys, an ESOP or just plain mad.

"S" corps must issue a K-1 form to each owner before April 15th or the owners will beat your bookkeeper about the head and shoulders. That bookkeeper may hardly notice since "S" Corps must also close the books on 12/31, so he/she may not have slept in weeks.

A buyer prefers buying "S" Corps if it's an asset/liability purchase because they can depreciate those assets and that makes you more desirable. Owners also get some "free money" when they sell too. Last I checked the first $300,000 wasn't taxed, but I don't check. Your CPA does!