PURCHASING KEY PERSON INSURANCE IS A ***BEST PRACTICE***

If something happened to one of your key people, how much would your business suffer?

Beyond the sorrow when a key member of a company dies unexpectedly lay consequences even seasoned executives often don't anticipate. And they can affect every last employee. In the event of death, a key executive's history of developing relationships of trust with customers, vendors, lenders, credit agencies and employees on behalf of the leadership team can dissolve in an instant. The impact that is felt for the ensuing months or even years is never immaterial, and usually, it is quite significant.

Prudent companies plan for this possibility by purchasing either term or whole/variable and long-term disability insurance on those leaders whose loss could impact industry standing and vital financial interests.

Who should I consider for key person coverage?

Eligible employees are those for whom the company has an "insurable interest", meaning their death or disability would result in financial harm to the firm. Look to these questions to identify your key persons:

- Are they among the highest paid? The people who command the largest total compensation packages are generally considered the most valuable assets.
- Are they critical to the company's source of capital? Consider who has developed the trust relationships with lenders and/or investors.
- Do they have a unique talent or a knowledge base or skill set that makes them uniquely valuable to your business?
- Do they call the shots? Are they entrusted with top-level decision-making authority?
- Are they the top operatives responsible for getting the job done within the organization?

Should I buy term life or whole life to protect my company?

Term Life Insurance

Because of the lower cost, more companies purchase term than whole life insurance on their key people. An appropriate level of term life insurance meets the goal of bridging the gap that opens when a key manager passes.

While the "rule of thumb" is to buy an amount equal to 5-10 times annual compensation, we recommend you don't adopt a cookie cutter approach. Rather, you should evaluate such factors as each key person's contributions to company profits, the likely time period needed to reestablish out-of-house and in-house relationships on a new footing, as well as the time and expense involved in recruiting and getting a replacement up to speed.

Whole or variable life Insurance

The benefits of whole or variable life insurance extend beyond meeting the goals of covering this time gap. As with individual whole life policies, a key person whole life policy becomes an asset with cash value. The company can take policy loans and withdrawals from the policy's potential cash value to cover unexpected corporate expenses. It can also be an executive perk, used to provide supplemental retirement plan income or simply be transferred to the executive upon retirement.

The higher price of whole life insurance may be more than made up for when the benefits of quick liquidity and the supplemented value of the total compensation package are considered.

Should I Purchase Disability Insurance as Well?

Statistically, for an employed person of any age, it is far more likely that they will become disabled than that they will die. Deaths from the big three (cancer, heart attack and stroke) continue to decrease, while disability from these illnesses rises.

Disability insurance of up to $50,000 a month can be purchased to cover many of the same expenses that would have accrued if the key person had died. Depending on the specifics of the disability, there may be a similar net effect on the business. Proceeds can also be used to supplement the key employee's personal disability insurance benefits, which replace between 40 and 70% of income.

What About Tax and Other Considerations?

A few key things to be aware of: the premiums for key person insurance are not tax-deductible for the company and with C corporations, policy ownership may trigger the alternative minimum tax. Also, if the policy is later used to provide supplemental retirement income to the key person, s/he will be taxed on that income.

Ten Benefits of Insuring Your "Key Persons"

In summary, a thoughtful plan to provide life and disability insurance can enable you to:

1. Maintain adequate revenues to continue to make scheduled payments such as payroll, A/P and other debt, without liquidating assets.

2. Ensure cash flow to keep the business operating smoothly

3. Fund recruitment, onboarding and the learning curve of the key person's replacement

4. Assure creditors that the company is stable

5. Assure customers that the company will honor commitments on current and future orders

6. Protect remaining owners' equity in the business

7. Meet lender requirements

8. Protect your credit rating

9. Provide a transferrable asset for the key person to use upon retirement *

10. Supplement company retirement plan payments to that key executive

*Proposed Plan With Policy Transferred to Executive

Graphic insert

The purchase of life insurance has costs and risk associated with it, including the cost of the insurance. Purchasing variable life insurance also involves investing in underlying investment accounts that correspond to a client's investment objectives and level of risk tolerance. The types of risks associated with investing in these accounts include potential market, portfolio, inflation and international risk. The primary purpose of variable life insurance is to provide lifetime protection against economic loss due to the benefit of the insured person. Variable life insurance products are long-term contracts and are sold by prospectus.