



A Business Does Not Need to Die At the Death of a Key Employee

Businesses are born when the market has a need and someone has a great idea for meeting the need. A product or service is developed and offered to the public. Over time, the skill, knowledge, leadership, and experience of the business's key people make it possible for it to grow and produce a profit.

But what would happen to the business if death or disability prevents a key person from returning to work? Would the business continue to run smoothly or would projects be stalled, customers lost, and productivity reduced? Studies indicate that four out of every five businesses that suffer the loss of a key person will go out of business within three years. Today with many businesses already suffering a loss as a result of closure due to COVID-19 many may need to close their doors immediately at the death of a key employee! Consequently, financial advisors should be asking all their business owner clients, especially today, what would happen to their business if their key employee was not able to return to work. The following discussion is background information on key person life insurance coverage.



How Do You Identify a Key Person?

A key person can be anyone – an owner or nonowner. What distinguishes someone as a key person is that his or her loss would severely impact a business until a replacement is found. Key people can be found in a variety of positions and with an assortment of titles.

What Does Key Person Insurance Cover?

The primary purpose of insurance on a key person is to help the business get through potentially difficult times should a key person die. Depending on who the key person is, the business may need funds to hire and train replacements, pay expenses while the business stabilizes, and maintain the confidence of employees, customers and creditors.

Key person life insurance can also help a business access credit. When a banker is dealing with a business that has a key person whose loss would disrupt the business, the banker will often make key person life insurance – with benefits equal to the credit line assigned to the bank – part of the approval process.

Finally, in a closely held business where the loss of an owner can have a devastating impact on the operation of the business, especially if other employees would be enticed to leave the business, key person coverage on the owner can help fund the cost of a stay bonus plan to retain valuable employees.

Why Life Insurance and How is Key Person Policy Structured?

While cash or loans can be used to pay the costs of replacing a key person, life insurance may be a more cost-effective alternative especially as a business recovers from closure due to the Coronavirus. Using cash takes money out of the day-to-day operation of the business. Loans come with the disadvantage that the business will have to repay the loan with interest – that is if the business is able to get a loan. Life insurance, on the other hand, is easy to administer and funds are immediately available, even if death occurs shortly after the policy is issued. Term insurance is often the product of choice when key person coverage is the only need the business seeks to cover.*

When using life insurance to provide key person coverage, the business is typically the owner and beneficiary of the policy in a face amount sufficient to cover the loss the business is expected to incur at the death of the key person. Insurance carriers typically base the appropriate amount of life insurance coverage on a multiple of five to ten times the key person’s compensation. The premiums are paid by the business, but they are not deductible as a business expense. Finally, it’s important to note that prior to policy issue, the business must provide the key person specific written notice of its intent to acquire coverage and receive his or her written consent in order to comply with the Employer Owner Life Insurance rules established under IRC §101(j).



How DBS Can Help

Business owners don’t think twice about the need to insure buildings, inventory, and equipment used in the business, but many overlook protecting the business against the loss of its most valuable assets – its key people. During this time of COVID-19 it is especially important to consider the impact a key person has on the success of the business.

* When key person coverage is combined with buy-sell or a business owned executive benefit plan usually the business purchases a permanent policy.