



Key Person Coverage: As An Aid To Buy-Sell Coverage

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For this trimester we are focusing on various business strategies. One of the easiest strategies to explain and implement with business owners is Key Person coverage. The primary purpose of insuring a key person is to help the business get through potentially difficult times should a key person die. A key person can be the business owner or a valued employee. 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 confidences of employees, customers, and creditors. Key person life insurance can also help a business access credit.

Key person coverage may also be used as a “placeholder” while trying to determine or establish a buy-sell arrangement or used as a way to acquire additional buy-sell coverage for a fast-growing business. The following two cases provide an example of how Key Person coverage was used to support a business owner’s buy-sell objectives.

Situation #1

The proposed insured is the majority-owner of multiple business entities at different locations, all involved in the same form of medical practice and all structured as LLCs taxed as a partnership. Each business arrangement is with a different individual. Each entity has a separate operating agreement which provides some directions for the buyout of a deceased owner/member’s interest. The majority-owner wants to establish a more formal buy-sell agreement with one of the minority-owners, an individual the majority owner believes has the capability to assume his role in all the businesses.

Problem: No formal buy-sell agreement existed between the majority owner and the minority owner outside of the provisions in the operating agreement for the one LLC they owned together. While the provisions in an operating agreement will normally satisfy a carrier’s requirement that a buy-sell agreement is in place, for this situation the operating agreement only addressed the buyout of one business entity. So, the majority owner clearly needed to have a discussion with his tax and legal counsel concerning the appropriate structure and drafting of a formal buy-sell agreement covering all the majority owner’s interests in the multiple entities. But what, if anything, can be done in the interim to cover the risk of an untimely death?

Solution: The DBS advanced marketing associate informed the financial advisor and business owner that their question was a common one. Often a business owner will want to do something to cover the risk prior to a buy-sell agreement being in place. The DBS associate stated that often it’s possible to purchase key person coverage as a “placeholder” while the specifics of a buy-sell agreement are being determined. In this situation it was determined that the business which the majority and minority owners owned together would purchase and be the owner and beneficiary of a policy of an amount equal to 10 times the majority owner’s income (the typical key person guideline followed by underwriters at most carriers). Once the buy-sell agreement was established then, depending on the terms of the new agreement, it might be possible to use the existing policy to formally fund the buy-sell. If the existing policy cannot be used, then the insurance could be repurposed as personal insurance coverage or maintained as key person coverage.

Result: The majority owner agreed to purchase key person coverage. While the amount of coverage was not sufficient to purchase the majority owner’s entire interest in all the entities it provided adequate downpayment for the minority owner to acquire an interest in the other entities if an untimely death occurred prior to the establishment of the formal buy-sell agreement.

Situation #2

The proposed insureds are owners of a newly established business entity. Previously, all the owners had their own business in the same industry. All earned six figure incomes. Due to the owners’ prior experience and a proprietary product, the new business is growing at an astonishingly fast rate.

Problem: When acquiring life insurance to fund the purchase of a buy-sell agreement, typically the amount of life insurance permitted by carriers is based on the fair market value of the business with a little growth. In this situation, the owners were concerned that this amount would not be adequate. They wanted to purchase coverage exceeding the current value of the business. In addition, the owners did not have a buy-sell agreement in place.

Solution: The financial advisor was directed to a DBS associate with significant experience working with carriers on difficult business financial underwriting situations. The DBS associate explained that carriers will typically want to wait three years before agreeing to underwrite coverage on a new business start-up because many new businesses fail. However, a cover letter explaining that the new entity is a continuation of the owner’s prior business should be adequate to overcome this hurdle.

The next hurdle is the lack of buy-sell agreement. The DBS associate indicated the carrier will require some form of buy-sell before issuing a policy. However, the provisions may be contained in an operating agreement. The DBS associate offered to review the agreement.

Finally, the concern regarding adequate coverage. To cover the exponential growth experienced by this business the associate indicated key person coverage can be acquired on top of the buy-sell coverage. As the business continues to grow some of the key person coverage can be used to fund a buyout. The key person coverage can be a cushion. Furthermore, in this situation where there may not be a buy-sell agreement, key person coverage can be acquired without having to provide proof of a buy-sell agreement.

Result: The business owners liked the idea of acquiring key person coverage as an initial placeholder before they establish a buy-sell arrangement and as a cushion to buy-sell coverage once the agreement is implemented.

Business life insurance cases tend to require more documentation than a typical life insurance case. Your dedicated DBS Case Design Analyst can help you determine the type of documentation a carrier will likely request.

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