Capitas Financial Client Profiles

Key Person Coverage

Potential Client:
An employer or business that will be financially harmed if a key employee, key owner or key stakeholder is taken out of daily operations due to a disability or death.

OVERVIEW

Small business owners know how important their employees are to their success. Sometimes the contributions of a select few are especially significant. These are the people who are critical to the business and whose death or disability could threaten the business' survival. Key person coverage commonly consists of life and/or disability insurance that the business owns on its key employees to protect the business. The benefit paid from a life insurance or disability insurance policy is generally tax-free and can help the business recruit and train a replacement, pay off debts, or transition the business in an orderly manner if desired. In a tragic situation, key person coverage can provide the company with financial options to make the appropriate adjustments.

OPPORTUNITY TO THE CLIENT

Often when a business owner client thinks about the impact of the death or disability of an employee, the needs of the employee's family immediately come to mind. When it comes to key employees, there is also a potential financial loss to the company. These costs can be significant and include items such as replacing lost profits and finding a replacement employee. The good news is that the strategy to protect against this risk is relatively straight forward. The company can purchase a life and/or disability insurance policy on the key employee(s). The company is the owner and beneficiary of the policy and is responsible for paying premiums. While the key employee is the insured, they have no rights to the policy and must consent to the business purchasing coverage on their life. If the key employee dies while the life insurance policy is in-force, the business receives the death benefit, which is generally income tax-free. Disability insurance policies are also available to cover these same costs in the case a key employee becomes disabled. Insurance benefits from key person coverage can:

- Provide funds to pay off or reduce business debts
- Replace lost profits due to a key employee's death or disability
- Offset costs of recruiting, hiring, and training a replacement employee

HOW DOES IT WORK?

An important first step when it comes to key person coverage is deciding who should be covered. These are employees that have unique skills or that have relationships that would be costly and/or difficult to replace. This list could include technical experts, sales leaders, or other industry specialists. Don't forget to consider how the death of an employee owner would impact the viability of the business; owner employees are often also key employees.

Once your client has identified all key employees, you can begin the discussion as to how much coverage and what duration can best meet their needs. Consider the amount of profit that is attributed to a key employee and the amount of time that would be needed for the business to recover that amount. Next calculate what expenses would be incurred to find a replacement employee.

Common costs include recruiting, signing bonuses, and training once they are in place. By combining these two amounts, you can help quantify the potential financial risk that the loss of a key employee would have on your client's business.

CLIENT PROFILE

Using insurance to cover expenses from the death or disability of key employees has many advantages but may not be the best strategy for every client. When reviewing your client list, use the following criteria as a guideline when determining which clients could benefit from this approach.

Key person coverage can be most effective for clients who:

- Own a small business
- Have owner employees who are critical to the company's success
- Have non-owner employees who are critical to the company's success

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CONVERSATION STARTERS

Asking the following questions can help jump-start a conversation with your business owner clients on how insurance can play a role in protecting against the financial impact due to the loss of a key employee:

"Which of your employees would be the hardest to replace?

Identifying which employees, including owners, whose death or disability would have significant impact to the health of the business is a critical first step. These are often employees who have established sales relationships or technical skills that are not readily available in the job market. Once identified, you can expand the conversation and help quantify the financial impact to the business should a key employee become disabled or die.

"When did you last have your key person coverage reviewed?"

Just like with any other planning process, it is important that your client's key person coverage keep up with the growth of their business. The addition or loss of a key employee or changes in their contributions to the business both warrant a review of their key person coverage. As a best practice, consider incorporating regular insurance reviews into your existing client meetings.

"Is your buy-sell agreement aligned with your key person coverage?"

A buy-sell agreement is funded to protect the ownership of a company in the case of the death or disability of an owner. The agreement is not intended to cover lost profits and replacement costs associated with the death or disability of significant contributors. These risks are generally addressed through a key person coverage strategy.

"How much money would you have invested in this business if you weren't in it?"

This is a thought provoking question to open a conversation about the value of employee owners. Many business owners may not consider themselves in the list of "key employees" but their contributions are likely critical to the ongoing success of the company. This is an important opportunity to discuss the differences in what a buy-sell agreement does compared to key person coverage.